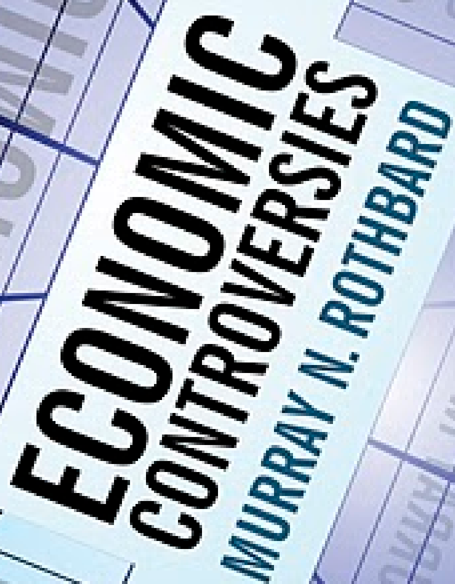
# ECONOMIC CONTROVERSIES

MURRAY N. ROTHBARD



ECONOMIC

*Controversies*

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# Economic Controversies

Murray N. Rothbard

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# Introduction

It was nearly forty years ago that Murray Rothbard changed my life. I was then a PhD candidate in economics at the New School for Social Research in downtown Manhattan, while also teaching Principles courses at a local university. And I was rapidly losing interest in the whole subject.

Bored by the prattling of the left-wing crowd who dominated the New School, I could find nothing very satisfying in mainstream economics either. The New School's left-wingers certainly cared about achieving a free society. But their radical agenda mainly consisted of the "instrumentalist" ideas of the econ department's emeritus professor Adolph Lowe, which boiled down to coercing people into following the dictates of elitists like him.

My only real objection to conventional economics was that it also bored me. If a theory like "perfect competition" was remote from reality, it seemed like a judgment on the imperfections of capitalism. After all, to the degree that capitalism was not perfectly competitive, it fell prey to the evils of "imperfect competition," which might require intervention from antitrust. As a typically zonked-out product of conventional schooling, I vaguely believed, that to the degree that any textbook theory failed to explain reality, so much the worse for reality. (Not long ago I spoke with an econ grad student who, when pressed, believed this quite explicitly.)

Always a compulsive book-browser, I had more than once leafed through a two-volume work titled *Man, Economy, and State* in the New School library, whose author, Murray Rothbard, I had barely heard of. After the third or fourth look, I finally began reading the book—and experienced one eureka moment after another. Two

especially memorable moments reflected the leftist tradition in which I was then mired.

First, I learned that, if leftists thought "capital" deserved no share of the economic bounty, they were in a sense more right than they knew. Rothbard explained that, in a free market, there were no financial returns to owners of capital goods as such. Since capital goods consisted of such items as factories, machinery, offices, and desks, these goods were entirely the product of labor and land (or resources). So the monetary value of newly created capital goods is entirely attributable to the purchase of land and labor, with nothing remaining for capital goods owners.

How, then, did capital goods owners make any money at all? The money they received came in two forms: interest payments for advancing resources in the present and profits for their entrepreneurial foresight—unless, of course, they were unsuccessful entrepreneurs and suffered losses.

Second was Rothbard's devastating refutation of the theory of imperfect or "monopolistic" competition—dear to leftists' hearts, since it highlighted the irrationality of capitalism. A cornerstone of this theory is that a monopolistic competitor like "Marioni Brothers' Barbershop" (monopolistic because there is only one set of Marioni Brothers; competitive, since there are many barbershops), always operate with excess capacity.

Economist Paul Samuelson had in fact targeted barber shops in his best-selling *Principles* text, observing that "The barbershop has excess capacity, with empty chairs much of the time," as he inveighed against the "wasteful social losses" resulting.[1]

Even before I read Rothbard, it occurred to me that, in this case at least, Professor Samuelson may have been missing something. Given his flexible work schedule, he may have had a habit of going for his haircut on a weekday, which would explain why he kept noticing empty chairs. Had he gone instead on Saturdays, he might have noticed that all the barber chairs were full, and that business was actually backed up. It then might have occurred to him that our

[1]Paul A. Samuelson, *Economics*, 9th ed. (New York: McGraw-Hill, 1973), p. 518.

hypothetical Marioni Brothers were not so dumb as to waste their money on excess capacity.

The problem they actually faced as businessmen was the classic tradeoff between peaks and troughs in demand. Had they not had empty chairs during the week, they wouldn't have been able to take advantage of the glut in demand on weekends.

Such were my tentative doubts. What Rothbard exposed was the preposterousness of the whole formulation. For why assume that all such monopolistic competitors *necessarily* invest in excess capacity? "To plan a plant for producing x units," he quotes economist Roy Harrod observing, "while knowing that it will only be possible to maintain an output of x – y units, is surely to suffer from schizophrenia."[2] It made no more sense to believe that all such businessmen would waste funds on excess as it was to believe that they would all consistently underinvest and plan on inadequate capacity.

Then came what for me—robotically drawing all those cost and demand curves with the aid of differential calculus—was the *coup de grace*. Rothbard demonstrated that the whole naïve error hinged on the technicalities of geometry. The theory was simply a prisoner of the way the demand curve was made tangent to the cost curve! He then adroitly showed two different ways of drawing the graph, without violating any of the assumptions. The miraculous result: The monopolistic competitor was now operating at the low point of his average cost curve, or at full capacity.[3]

I found such moments profoundly empowering, making me realize that, whenever I thought about economics outside formal straitjackets, I naturally fell back on modes of reasoning used by Rothbard and his mentor, Ludwig von Mises. That's why the very term, "Austrian economics," is a kind of redundancy. Whenever people think sensibly about economics, they think like Austrians—one key reason why even the mainstream can have a few things to teach us, especially when they're writing mere journalism.

[2]Murray Rothbard, *Man, Economy, and State* (Los Angeles: Nash, 1970), p. 642; combined with *Power and Market* to become the scholar's edition (Auburn, Ala.: Ludwig von Mises Institute, 2009), p. 732.

[3]Rothbard, *Man, Economy, and State*, pp. 642–45; scholar's edition, pp. 732–36.

After finishing *Man, Economy, and State*, I discovered the Laissez-Faire bookshop, then a well-stocked store on Mercer Street, which regrettably shut down years ago. Browsing at that bookshop virtually every Saturday, I gradually bought up all the Rothbard I could find, plus all the Mises, F.A. Hayek, and Israel Kirzner.

I formed a reading group in Austrian economics, attended late-afternoon seminars chaired by Kirzner at New York University—and even barged into one of Rothbard's classes at Brooklyn Polytechnic Institute, where he taught for many years.

I say "barged in" because somehow I forgot to ask him if I could sit in and audit. That might explain why he gave me a perplexed look when I raised my hand to ask a question, a reaction that discouraged me from chatting with him afterward. (The session must have been somewhere in the middle of the semester, since it was devoted entirely to the mundane task of reviewing the material to prepare students for the mid-term exam.)

When I became a senior economist at the New York Stock Exchange, the director I reported to once told me, "Gene, you're the only guy I ever met who reads economics for fun." I was honestly surprised, and might have remarked that if everyone read Rothbard and the Austrians, they might have just as much fun.

My only real, albeit brief, conversation with Rothbard occurred over the phone in October 1993, by which point he was teaching at the University of Nevada in Las Vegas, and I had just begun as a journalist at *Barron's*. University of Chicago economist Gary Becker had just won the economics Nobel, partly in recognition of his insight that a family was like a firm. (But how much more intriguing to theorize that a firm is like a family?)

Asking Rothbard what he thought of Becker's win, I expected him to tell me that he thought applying economics to non-economic issues was foolish. Instead he began by saying that it was gratifying to see a free market-oriented economist like Becker gain such recognition.

Then I asked, "But what do you think of the theory that a family is like a firm?"

Rothbard answered, "I think it's *nuts*!" And I was thus treated, first-hand, to that nasal voice going squeaky.

I had already become familiar with that nasal voice in the scores of audio-tapes I'd heard of Rothbard's lectures, along with the salty insights tossed off with dazzling ease, punctuated by the signature giggle. To me, the joy in that giggle bespeaks an indefatigable spirit.

In Rothard's lectures on economic history, I caught him in a rare moment of hypocrisy. While he blasted the use of price indexes in his writings, he never hesitated to use a price index to prove a point about historical trends. He was of course quite right to criticize the pseudo-science of price indexes. But he might have acknowledged more explicitly that they sometimes come in handy as a rough approximation of price trends.

To get a sense of the fun it must have been to be Murray Rothbard or to merely know him, try listening to one of his best lectures, "The Meaning of Ludwig von Mises."[4]

We all know there could be no Murray Rothbard the great writer and thinker without his great teacher, Ludwig von Mises. Those who read and love Rothbard would be cheating themselves if they did not also read Mises's many books. In my case, reading Mises's *magnum opus*, *Human Action*, for the first time, I found his discussion of wages finally cemented my understanding of why wages inevitably rise in a free market with rising productivity—an insight that helped seal my conversion to libertarianism.

It's remarkable that Mises's books read as well as they do, both in translation and in the English he began to write in at age 60. Rothbard had the advantage of being an extraordinary writer in the language he grew up in, as well as a devoted student of Mises. It was therefore left to him to render Mises's great theories in clear, accessible prose, while often bringing those theories to a new level.

So I think of Rothbard as having been Plato to Mises's Socrates—an analogy I might push further if Rothbard were not so critical of Plato. Try his discussion of Aristotle's refutation of Plato's communism in *Economic Thought Before Adam Smith*, the first of his two books on the history of economic thought. Among all of Rothbard's writings—the second volume is called *Classical Economics*—these two books are the ones I prefer to dip into again when I'm looking for something diverting to reread.

[4]This lecture is available for download at the Mises Institute website.

The whole informed guided tour of the way people thought about economics is vastly entertaining. My favorite part is probably the devastating dissection of the supposed "father" of economics, Adam Smith. It's tragic that Rothbard didn't live to complete the third and final volume, which would have dealt with economic thought in the modern era.

Which brings us to the tome you hold in your hand. It contains all of Rothbard's best essays. If there is any single book worthy of being called a companion volume to *Man, Economy, and State*, this is it.

You should start, as the book does, with the magisterial essay "The Mantle of Science," in which Rothbard lays the groundwork on how to think about economics. After finishing this essay, you might reflect that all the writer has really done is make explicit a mode of thinking that comes naturally to us all. And just as I felt after I finished *Man, Economy, and State*, you might find it similarly empowering.

Mainstream economics suffers from two main handicaps: (a) the desire to sound like a branch of physics, which feeds the elitist fantasies of those who aspire to be professional economists, and (b) the desire to sit at the tables of power à la John Maynard Keynes and Alan Greenspan, which spawns such top-down monstrosities as "macroeconomics."

Given these handicaps, it's remarkable, as mentioned, that mainstream economists can still be insightful at times, especially in their journalism. I submit it's because even they are still capable of using the mode of thinking Rothbard sets forth in "The Mantle of Science."

You might then jump, for comic relief, to "The Hermeneutical Invasion of Philosophy and Economics." In that essay, Rothbard makes fun of the heavy thinkers who keep telling us, in effect, that words have no meaning. Of course, if they are right that words have no meaning, we can only respond that this key message of theirs is incomprehensible.

For me the greatest eureka moment of all is when I first read Rothbard's essay "The Austrian Theory of Money." That was when I fully grasped Mises's most beautiful insight, called the "regression theorem," in which Mises was able to show that all money must have

originated in some commodity (gold, seashells), that if you regress backward in time, you'll find this had to have been the case. What people think of as government-created money (dollars, euros) is nothing of the kind, but came from those same commodities. For me, the beauty of the regression theorem lies in its power to infer historical fact from simple logic about human action.

I did not read Rothbard's 1972 essay "Heilbroner's *Economic Means and Social Ends*" until years after it was first published. It's a devastating critique of a book edited by New School economics Professor Robert Heilbroner, about the ideas of the abovementioned Adolph Lowe.

Here, too, Plato comes up. "Professor Lowe's political economics," observes Rothbard, "is of a piece with an unfortunate penchant of intellectuals since the days of Plato: to impose their own arbitrary and static 'order' upon the rest of society, to freeze and annul change by their coercive fiat…." Had I read this essay when it first came out, it probably would have gotten me to read more of Rothbard, even if I hadn't been lucky enough to find his economic treatise in the stacks.

There are many "first books" on libertarianism in general and Austrian economics in particular. Which one is most suitable depends on the individual. For me, the way in was *Man, Economy, and State*, which had a great deal to do with me and my circumstances at the time. If my counterpart today finds that book and this one in the stacks, I would say that *Economic Controversies* is probably the better way in. *Man, Economy, and State* can come a bit later.

Gene Epstein<br>
Economics Editor<br>
*Barron's*<br>
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## Section One

# Method

# 1
# The Mantle of Science

In our proper condemnation of scientism in the study of man, we should not make the mistake of dismissing *science* as well. For if we do so, we credit scientism too highly and accept at face value its claim to be the one and only scientific method. If scientism is, as we believe it to be, an improper method, then it cannot be truly scientific. Science, after all, means *scientia*, correct knowledge; it is older and wiser than the positivist-pragmatist attempt to monopolize the term.

Scientism is the profoundly unscientific attempt to transfer uncritically the methodology of the physical sciences to the study of human action. Both fields of inquiry must, it is true, be studied by the use of reason—the mind's identification of reality. But then it becomes crucially important, in reason, not to neglect the critical attribute of human action: that, alone in nature, human beings possess a rational consciousness. Stones, molecules, planets cannot *choose* their courses; their behavior is strictly and mechanically determined for them. Only human beings possess free will and consciousness: for they are conscious, and they can, and indeed must, choose their course of action.[1] To ignore this primordial fact about the nature of man—to ignore his volition, his free will—is to misconstrue the facts of reality and therefore to be profoundly and radically unscientific.

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Originally appeared as a chapter in *Scientism and Values*, Helmut Schoeck and James W. Wiggins, eds. (Princeton, N.J.: D. Van Nostrand, 1960).

[1]Human action, therefore, does not occur apart from cause; human beings *must* choose at any given moment, although the contents of the choice are *self*-determined.

Man's necessity to choose means that, at any given time, he is acting to bring about some end in the immediate or distant future, that is, that he has purposes. The steps that he takes to achieve his ends are his *means*. Man is born with no innate knowledge of what ends to choose or how to use which means to attain them. Having no inborn knowledge of how to survive and prosper, he must learn what ends and means to adopt, and he is liable to make errors along the way. But only his reasoning mind can show him his goals and how to attain them.

We have already begun to build the first blocks of the many-storied edifice of the true sciences of man—and they are all grounded on the fact of man's volition.[2] On the formal fact that man uses means to attain ends we ground the science of *praxeology*, or economics; *psychology* is the study of how and why man chooses the contents of his ends; *technology* tells what concrete means will lead to various ends; and *ethics* employs all the data of the various sciences to guide man toward the ends he should seek to attain, and therefore, by imputation, toward his proper means. None of these disciplines can make any sense whatever on scientistic premises. If men are like stones, if they are not purposive beings and do not strive for ends, then there is no economics, no psychology, no ethics, no technology, no science of man whatever.

## The Problem of Free Will

Before proceeding further, we must pause to consider the validity of free will, for it is curious that the determinist dogma has so often been accepted as the uniquely scientific position. And while many philosophers have demonstrated the existence of free will, the concept has all too rarely been applied to the "social sciences."

In the first place, each human being knows universally from introspection that he chooses. The positivists and behaviorists may scoff at introspection all they wish, but it remains true that the introspective knowledge of a conscious man that he is conscious and acts

[2]The sciences which deal with the functioning of man's automatic organs—physiology, anatomy, and so on—may be included in the physical sciences, for they are not based on man's will—although even here, psychosomatic medicine traces definite causal relations stemming from man's choices.

is a fact of reality. What, indeed, do the determinists have to offer to set against introspective fact? Only a poor and misleading analogy from the physical sciences. It is true that all mindless matter is determined and purposeless. But it is highly inappropriate, and moreover question-begging, simply and uncritically to apply the model of physics to man.

Why, indeed, should we accept determinism in nature? The reason we say that things are determined is that every existing thing must have a *specific* existence. Having a *specific* existence, it must have certain definite, definable, delimitable attributes, that is, every thing must have a specific *nature*. Every being, then, can act or behave only in accordance with its nature, and any two beings can interact only in accord with their respective natures. Therefore, the actions of every being are caused by, determined by, its nature.[3]

But while most things have no consciousness and therefore pursue no goals, it is an essential attribute of *man's* nature that he has consciousness, and therefore that his actions are self-determined by the choices his mind makes.

At very best, the application of determinism to man is just an agenda for the future. After several centuries of arrogant proclamations, no determinist has come up with anything like a theory determining all of men's actions. Surely the burden of proof must rest on the one advancing a theory, particularly when the theory contradicts man's primary impressions. Surely we can, at the very least, tell the determinists to keep quiet until they can offer their determinations—including, of course, their advance determinations of each of our reactions to their determining theory. But there is far more that can be said. For determinism, as applied to man, is a self-contradictory

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[3]See Andrew G. Van Melsen, *The Philosophy of Nature* (Pittsburgh, Penn.: Duquesne University Press, 1953), pp. 208ff., 235ff.

While free will must be upheld for man, determination must be equally upheld for physical nature. For a critique of the recent fallacious notion, based on the Heisenberg Uncertainty Principle, that atomic or sub-atomic particles have "free will," see Ludwig von Mises, *Theory and History* (New Haven, Conn.: Yale University Press, 1957), pp. 87–92; and Albert H. Hobbs, *Social Problems and Scientism* (Harrisburg, Penn.: Stackpole, 1953), pp. 220–32.

thesis, since the man who employs it relies implicitly on the existence of free will.

If we are determined in the ideas we accept, then X, the determinist, is determined to believe in determinism, while Y, the believer in free will, is also determined to believe in his own doctrine. Since man's mind is, according to determinism, not free to think and come to conclusions about reality, it is absurd for X to try to convince Y or anyone else of the truth of determinism. In short, the determinist must rely, for the spread of his ideas, on the nondetermined, free-will choices of others, on their free will to adopt or reject ideas.[4] In the same way, the various brands of determinists—behaviorists, positivists, Marxists, and so on—implicitly claim special exemption for themselves from their own determined systems.[5] But if a man cannot affirm a proposition without employing its negation, he is not only caught in an inextricable self-contradiction; *he is conceding to the negation the status of an axiom.*[6]

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[4]Francis L. Harmon, *Principles of Psychology* (Milwaukee: Bruce Publishing, 1938), p. 487, and pp. 493–99.

> Even the controversial writings of the mechanists themselves appear to be intended for readers endowed with powers of choice. In other words, the determinist who would win others to his way of thinking must write as if he himself, and his readers at least, had freedom of choice, while all the rest of mankind are mechanistically determined in thought and in conduct.

Also see Joseph D. Hassett, S.J., Robert A. Mitchell, S.J., and J. Donald Monan, S.J., *The Philosophy of Human Knowing* (Westminster, Maryland: Newman Press, 1953), pp. 72–73.

[5]See Mises, *Theory and History*, pp. 258–60; and Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1949), pp. 74ff.

[6]Phillips therefore calls this attribute of an axiom a "boomerang principle . . . for even though we cast it away from us, it returns to us again," and illustrates by showing that an attempt to deny the Aristotelian law of noncontradiction must end by assuming it. R.P. Phillips, *Modern Thomistic Philosophy* (Westminister, Maryland: Newman Bookshop, 1934–35), vol. 2, pp. 36–37. Also see John J. Toohey, S.J., *Notes on Epistemology* (Washington, D.C.: Georgetown University Press, 1952), *passim*, and Murray N. Rothbard, "In Defense of 'Extreme Apriorism,'" *Southern Economic Journal* (January 1957): 318; reprinted in this volume as chapter 6.

A corollary self-contradiction: the determinists profess to be able, some day, to determine what man's choices and actions will be. But, on their own grounds, their own knowledge of this determining theory is itself determined. How then can they aspire to know *all*, if the extent of their *own* knowledge is itself determined, and therefore arbitrarily delimited? In fact, if our ideas are determined, then we have no way of freely revising our judgments and of learning truth—whether the truth of determinism or of anything else.[7]

Thus, the determinist, to advocate his doctrine, must place himself and his theory outside the allegedly universally determined realm, that is, he must employ free will. This reliance of determinism on its negation is an instance of a wider truth: that it is self-contradictory to use reason in any attempt to deny the validity of reason as a means of attaining knowledge. Such self-contradiction is implicit in such currently fashionable sentiments as "reason shows us that reason is weak," or "the more we know, the more we know how little we know."[8]

Some may object that man is not really free because he must obey natural laws. To say that man is not free because he is not able to do anything he may possibly desire, however, confuses freedom and power.[9] It is clearly absurd to employ as a definition of "freedom"

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[7]In the course of a critique of determinism, Phillips wrote: "What purpose . . . could advice serve if we were unable to revise a judgment we had formed, and so act in a different way to which we at first intended?" Phillips, *Modern Thomistic Philosophy*, vol. 1, p. 282.

For stress on free will as freedom to think, to employ reason, see Robert L. Humphrey, "Human Nature in American Thought," *Political Science Quarterly* (June 1954): 269; *Readings in Ethics,* J.F. Leibell, ed. (Chicago: Loyola University Press, 1926), pp. 90, 103, 109; Robert Edward Brennan, O.P., *Thomistic Psychology* (New York: Macmillan, 1941), pp. 221–22; Van Melsen, *The Philosophy of Nature*, pp. 235–36; and Mises, *Theory and History*, pp. 177–79.

[8]"A man involves himself in a contradiction when he uses the reasoning of the intellect to prove that that reasoning cannot be relied upon" (Toohey, *Notes on Epistemology*, p. 29). Also see Phillips, *Modern Thomistic Philosophy*, vol. 2, p. 16; and Frank Thilly, *A History of Philosophy* (New York: Henry Holt, 1914), p. 586.

[9]See F.A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944), p. 26.

the power of an entity to perform an impossible action, to violate its nature.[10]

Determinists often imply that a man's ideas are necessarily determined by the ideas of others, of "society." Yet A and B can hear the same idea propounded; A can adopt it as valid while B will not. Each man, therefore, has the free choice of adopting or not adopting an idea or value. It is true that many men may uncritically adopt the ideas of others; yet this process cannot regress infinitely. At some point in time, the idea originated, that is, the idea was *not* taken from others, but was arrived at by some mind independently and creatively. This is logically necessary for any given idea. "Society," therefore, cannot dictate ideas. If someone grows up in a world where people generally believe that "all redheads are demons," he is free, as he grows up, to rethink the problem and arrive at a different conclusion. If this were not true, ideas, once adopted, could never have been changed.

We conclude, therefore, that true science decrees determinism for physical nature and free will for man, and for the same reason: that every thing must act in accordance with its specific nature. And since men are free to adopt ideas and to act upon them, it is never events or stimuli external to the mind that *cause* its ideas; rather the mind freely adopts ideas about external events. A savage, an infant, and a civilized man will each react in entirely different ways to the sight of the same stimulus—be it a fountain pen, an alarm clock, or a machine gun, for each mind has different ideas about the object's meaning and qualities.[11] Let us therefore never again say that the Great Depression of the 1930s *caused* men to adopt socialism or interventionism (or that poverty *causes* people to adopt Communism). The depression existed, and men were moved to think about this striking event; but that they adopted socialism or its equivalent as the way out was not determined by the event; they might just as well have chosen *laissez-faire* or Buddhism or any

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[10]John G. Vance, "Freedom," quoted in Leibell, *Readings in Ethics*, pp. 98–100. Also see Van Melsen, *The Philosophy of Nature*, p. 236, and Michael Maher, "Psychology," quoted in Leibell, *Readings in Ethics*.

[11]Thus, cf., C.I. Lewis, *Mind and the World Order* (New York: Dover Publications, 1956), pp. 49–51.

other attempted solution. The deciding factor was the *idea* that people chose to adopt.

What *led* the people to adopt particular ideas? Here the historian may enumerate and weigh various factors, but he must always stop short at the ultimate freedom of the will. Thus, in any given matter, a person may freely decide either to think about a problem independently or to accept uncritically the ideas offered by others. Certainly, the bulk of the people, especially in abstract matters, choose to follow the ideas offered by the intellectuals. At the time of the Great Depression, there was a host of intellectuals offering the nostrum of statism or socialism as a cure for the depression, while very few suggested *laissez-faire* or absolute monarchy.

The realization that ideas, freely adopted, determine social institutions, and not *vice versa*, illuminates many critical areas of the study of man. Rousseau and his host of modern followers, who hold that man is good, but corrupted by his institutions, must finally wither under the query: And who but *men* created these institutions? The tendency of many modern intellectuals to worship the primitive (also the childlike—especially the child "progressively" educated—the "natural" life of the noble savage of the South Seas, and so on) has perhaps the same roots. We are also told repeatedly that differences between largely isolated tribes and ethnic groups are "culturally determined": tribe X being intelligent or peaceful because of its X-culture; tribe Y, dull or warlike because of Y-culture. If we fully realize that the men of each tribe created its own culture (unless we are to assume its creation by some mystic *deus ex machina*), we see that this popular "explanation" is no better than explaining the sleep-inducing properties of opium by its "dormitive power." Indeed, it is worse, because it adds the error of social determinism.

It will undoubtedly be charged that this discussion of free will and determinism is "one-sided" and that it leaves out the alleged fact that all of life is multicausal and interdependent. We must not forget, however, that the very goal of science is simpler explanations of wider phenomena. In this case, we are confronted with the fact that there can logically be only one *ultimate sovereign* over a man's actions: either his own free will or some cause outside that will. There is no other alternative, there is no middle ground, and therefore the fashionable eclecticism of modern scholarship must in this case yield to the hard realities of the Law of the Excluded Middle.

If free will has been vindicated, how can we prove the existence of consciousness itself? The answer is simple: to prove means to make evident something not yet evident. Yet some propositions may be already evident to the self, that is, self-evident. A self-evident axiom, as we have indicated, will be a proposition which cannot be contradicted without employing the axiom itself in the attempt. And the existence of consciousness is not only evident to all of us through direct introspection, but is also a fundamental axiom, for the very act of doubting consciousness must itself be performed by a consciousness.[12] Thus, the behaviorist who spurns consciousness for "objective" laboratory data must rely on the consciousness of his laboratory associates to report the data to him.

The key to scientism is its denial of the existence of individual consciousness and will.[13] This takes two main forms: applying mechanical analogies from the physical sciences to individual men, and applying organismic analogies to such fictional collective wholes as "society." The latter course attributes consciousness and will, not to individuals, but to some collective organic whole of which the individual is merely a determined cell. Both methods are aspects of the rejection of individual consciousness.

## The False Mechanical Analogies of Scientism

The scientistic method in the study of man is almost wholly one of building on analogies from the physical sciences. Some of the common mechanistic analogies follow.

*Man as Servomechanism*: Just as Bertrand Russell, one of the leaders of scientism, reverses reality by attributing determinism to men, and free will to physical particles, so it has recently become the fashion to say that modern machines "think," while man is merely a complex form of machine, or "servomechanism."[14] What is overlooked

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[12]See Hassett, Mitchell, and Monan, *The Philosophy of Human Knowing*, pp. 33–35. Also see Phillips, *Modern Thomistic Philosophy*, vol. 1, pp. 50–51; Toohey, *Notes on Epistemology*, pp. 5, 36, 101, and 107–08; and Thilly, *A History of Philosophy*, p. 363.

[13]Professor Strausz-Hupé also makes this point in his paper, "Social Science Versus the Obsession of Scientism," in Schoeck and Wiggins, eds., *Scientism and Values*.

[14]Mises, *Theory and History*, p. 92.

here is that machines, no matter how complex, are simply devices made by man to serve man's purposes and goals; their actions are preset by their creators, and the machines can never act in any other way or suddenly adopt new goals and act upon them. They cannot do so, finally, because the machines are not alive and are therefore certainly not conscious. If men are machines, on the other hand, then the determinists, in addition to meeting the above critique, must answer the question: Who created *men* and for what purpose?—a rather embarrassing question for materialists to answer.[15]

*Social Engineering*: This term implies that men are no different from stones or other physical objects, and therefore that they should be blueprinted and reshaped in the same way as objects by "social" engineers. When Rex Tugwell wrote in his famous poem during the flush days of the New Deal:

> I have gathered my tools and my charts,
> My plans are finished and practical.
> I shall roll up my sleeves—make America over,

one wonders whether his admiring readers thought themselves to be among the directing engineers or among the raw material that would be "made over."[16]

*Model-Building*: Economics, and recently political science, have been beset by a plague of "model-building."[17] People do not construct

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[15]Ibid., pp. 94–95:

> A machine is a device made by man. It is the realization of a design and it runs precisely according to the plan of its authors. What produces the product of its operation is not something within it but the purpose the constructor wanted to realize by means of its construction. It is the constructor and operator who create and produce, not the machine. To ascribe to a machine any activity is anthropomorphism and animism. The machine . . . does not move; it is put into motion by men.

[16]See ibid., pp. 249–50.

[17]On this and many other points in this paper I am greatly indebted to Professor Ludwig von Mises and to his development of the science of praxeology. See Ludwig von Mises, "Comment about the Mathematical Treatment of Economic Problems," *Studium Generale* 4, no. 2 (1953); Mises,

theories any more; they "build" models of the society or economy. Yet no one seems to notice the peculiar inaptness of the concept. An engineering model is an exact replica, in miniature, that is, in exact quantitative proportion, of the relationships existing in the given structure in the real world; but the "models" of economic and political theory are simply a few equations and concepts which, at the very best, could only approximate a few of the numerous relations in the economy or society.

*Measurement*: The Econometric Society's original motto was "Science is measurement," this ideal having been transferred intact from the natural sciences. The frantic and vain attempts to measure intensive psychic magnitudes in psychology and in economics would disappear if it were realized that the very concept of measurement implies the necessity for an objective *extensive* unit to serve as a measure. But the magnitudes in consciousness are necessarily *intensive* and therefore not capable of measurement.[18]

*The Mathematical Method*: Not only measurement but the use of mathematics in general in the social sciences and philosophy today, is an illegitimate transfer from physics. In the first place, a mathematical equation implies the existence of quantities that can be equated, which in turn implies a unit of measurement for these quantities. Second, mathematical relations are *functional*; that is, variables are interdependent, and identifying the causal variable depends on which is held as given and which is changed. This methodology is appropriate in physics, where entities do not themselves provide the causes for their actions, but instead are determined by discoverable quantitative laws of their nature and the nature of the interacting

*Human Action*, *passim*; and Mises, *Theory and History*, pp. 240–63. The foundations of praxeology as a method were laid by the English classical economist, Nassau Senior. Unfortunately, the positivistic John Stuart Mill's side of their methodological debate became much better known than Senior's. See Marian Rowley, *Nassau Senior and Classical Economics* (New York: Augustus M. Kelley, 1949), chap. 1, esp. pp. 64–65.

[18]For a critique of recent attempts to fashion a new theory of measurement for intensive magnitudes, see Murray N. Rothbard, "Toward a Reconstruction of Utility and Welfare Economics," in *On Freedom and Free Enterprise: Essays in Honor of Ludwig von Mises*, Mary Sennholz, ed. (Princeton, N.J.: D. Van Nostrand, 1956), pp. 241–43; reprinted in this volume as chapter 17.

entities. But in human action, the free-will choice of the human consciousness is the cause, and this cause generates certain effects. The mathematical concept of an interdetermining "function" is therefore inappropriate.

Indeed, the very concept of "variable" used so frequently in econometrics is illegitimate, for physics is able to arrive at laws only by discovering *constants*. The concept of "variable" only makes sense if there are some things that are *not* variable, but constant. Yet in human action, free will precludes any quantitative constants (including constant units of measurement). All attempts to discover such constants (such as the strict quantity theory of money or the Keynesian "consumption function") were inherently doomed to failure.

Finally such staples of mathematical economics as the calculus are completely inappropriate for human action because they assume infinitely small continuity; while such concepts may legitimately describe the completely determined path of a physical particle, they are seriously misleading in describing the willed action of a human being. Such willed action can occur only in discrete, non-infinitely-small steps, steps large enough to be perceivable by a human consciousness. Hence the continuity assumptions of calculus are inappropriate for the study of man.

Other metaphors bodily and misleadingly transplanted from physics include: "equilibrium," "elasticity," "statics and dynamics," "velocity of circulation," and "friction." "Equilibrium" in physics is a state in which an entity remains; but in economics or politics there is never really such an equilibrium state existing; there is but a *tendency* in that direction. Moreover, the term "equilibrium" has emotional connotations, and so it was only a brief step to the further mischief of holding up equilibrium as not only possible, but as the ideal by which to gauge all existing institutions. But since man, by his very nature, must keep acting, he cannot be in equilibrium while he lives, and therefore the ideal, being impossible, is also inappropriate.

The concept of "friction" is used in a similar way. Some economists, for example, have assumed that men have "perfect knowledge," that the factors of production have "perfect mobility," and so on, and then have airily dismissed all difficulties in applying these absurdities to the real world as simple problems of "friction," just as the physical sciences bring in friction to add to their "perfect"

framework. These assumptions in fact make *omniscience* the standard or ideal, and this cannot exist by the nature of man.

## The False Organismic Analogies of Scientism

The organismic analogies attribute consciousness, or other organic qualities, to "social wholes" which are really only labels for the interrelations of individuals.[19] Just as in the mechanistic metaphors, individual men are subsumed and determined, here they become mindless cells in some sort of social organism. While few people today would assert flatly that "society is an organism," most social theorists hold doctrines that imply this. Note, for example, such phrases as: "Society determines the values of its individual members"; or "The individual's actions are determined by the role he plays in the group to which he belongs," and so on. Such concepts as "the public good," "the common good," "social welfare," and so on, are also endemic. All these concepts rest on the implicit premise that there exists, somewhere, a living organic entity known as "society," "the group," "the public," "the community," and that that entity has values and pursues ends.

Not only are these terms held up as living entities; they are supposed to exist *more* fundamentally than mere individuals, and certainly "their" goals take precedence over individual ones. It is ironic that the self-proclaimed apostles of "science" should pursue the sheer mysticism of assuming the living reality of these concepts.[20] Such concepts as "public good," "general welfare," and so on, should, therefore, be discarded as grossly unscientific, and the next time someone preaches the priority of "public good" over the individual good, we must ask: Who is the "public" in this case? We must remember that in the slogan justifying the public debt that rose to

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[19]On the fallacy of conceptual realism (or Platonic ultra-realism) involved here, and on the necessity for methodological individualism, see F.A. Hayek, *The Counter-Revolution of Science* (Glencoe, Ill.: The Free Press, 1952), *passim*, and Mises, *Human Action*, pp. 41ff. and 45.

[20]We may therefore say with Frank Chodorov that "society are people." Frank Chodorov, *Society Are People* (Philadelphia: Intercollegiate Society of Individualists, n.d.). For a critique of the mystique of "society," see Mises, *Theory and History*, pp. 250ff.

fame in the 1930s: "We owe it only to ourselves," it makes a big difference for every man whether he is a member of the "we" or of the "ourselves."[21]

A similar fallacy is committed, alike by friends and by foes of the market economy, when the market is called "impersonal." Thus, people often complain that the market is too "impersonal" because it does not grant to them a greater share of worldly goods. It is overlooked that the "market" is not some sort of living entity making good or bad decisions, but is simply a label for individual persons and their voluntary interactions. If A thinks that the "impersonal market" is not paying him enough, he is *really* saying that individuals B, C, and D are not willing to pay him as much as he would like to receive. The "market" is individuals acting. Similarly, if B thinks that the "market" is not paying A enough, B is perfectly free to step in and supply the difference. He is not blocked in this effort by some monster named "market."

One example of the widespread use of the organismic fallacy is in discussions of international trade. Thus, during the gold-standard era, how often did the cry go up that "England" or "France" or some other country was in mortal danger because "it" was "losing gold? What was actually happening was that English*men* or French*men* were voluntarily shipping gold overseas and thus threatening the banks in those countries with the necessity of meeting obligations (to pay in gold) which they could not possibly fulfill. But the use of the organismic metaphor converted a grave problem of banking into a vague national crisis for which every citizen was somehow responsible.[22]

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[21]See the delightful essay by Frank Chodorov, "We Lose It to Ourselves," *analysis* (June 1950): 3.

[22]A similar error of metaphor prevails in foreign policy matters. Thus:

> When one uses the simple monosyllabic "France" one thinks of France as a unit, an entity. When . . . we say "France sent her troops to conquer Tunis"—we impute not only unity but personality to the country. The very words conceal the facts and make international relations a glamorous drama in which personalized nations are the actors, and all too easily we forget the flesh-and-blood men and women who are the true actors . . . if we had no such word as "France" . . . then we should more accurately

So far we have been discussing those organismic concepts which assume the existence of a fictive consciousness in some collective whole. There are also numerous examples of other misleading biological analogies in the study of man. We hear much, for example, of "young" and "old" nations, as if an American aged twenty is somehow "younger" than a Frenchman of the same age. We read of "mature economies," as if an economy must grow rapidly and then become "mature." The current fashion of an "economics of growth" presumes that every economy is somehow destined, like a living organism, to "grow" in some predetermined manner at a definite rate. (In the enthusiasm it is overlooked that too many economies "grow" backward.) That all of these analogies are attempts to negate individual will and consciousness has been pointed out by Mrs. Penrose. Referring to biological analogies as applied to business firms, she writes:

> where explicit biological analogies crop up in economics they are drawn exclusively from that aspect of biology which deals with the nonmotivated behavior of organisms. . . . So it is with the life-cycle analogy. We have no reason whatever for thinking that the growth pattern of a biological organism is willed by the organism itself. On the other hand, we have every reason for thinking that the growth of a firm is *willed* by those who make the decisions of the firm . . . and the proof of this lies in the fact that no one can describe the development of any given firm . . . except in terms of decisions taken by individual men.[23]

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> describe the Tunis expedition in some such way as this: "A few of . . . thirty-eight million persons sent thirty thousand others to conquer Tunis." This way of putting the fact immediately suggests a question, or rather a series of questions. Who are the "few"? Why did they send the thirty thousand to Tunis? And why did these obey? Empire-building is done not by "nations," but by men. The problem before us is to discover the men, the active, interested minorities in each nation, who are directly interested in imperialism and then to analyze the reasons why the majorities pay the expenses and fight the wars. (Parker Thomas Moon, *Imperialism and World Politics* [New York: Macmillan, 1930], p. 58)

[23]Edith Tilton Penrose, "Biological Analogies in the Theory of the Firm," *American Economic Review* (December 1952): 808.

## Axioms and Deduction

The fundamental axiom, then, for the study of man is the existence of individual consciousness, and we have seen the numerous ways in which scientism tries to reject or avoid this axiom. Not being omniscient, a man must learn; he must ever adopt ideas and act upon them, choosing ends and the means to attain these ends. Upon this simple fundamental axiom a vast deductive edifice can be constructed. Professor Mises has already done this for economics, which he has subsumed under the science of praxeology: this centers on the universal formal fact that all men use means for chosen ends, without investigating the processes of the concrete choices or the justification for them. Mises has shown that the entire structure of economic thought can be deduced from this axiom (with the help of a very few subsidiary axioms).[24]

Since the fundamental and other axioms are qualitative by nature, it follows that the propositions deduced by the laws of logic from these axioms are also qualitative. The laws of human action are therefore qualitative, and, in fact, it should be clear that free will precludes quantitative laws. Thus, we may set forth the absolute economic law that an increase in the supply of a good, given the demand, will lower its price; but if we attempted to prescribe with similar generality *how much* the price would fall, given a definite increase in supply, we would shatter against the free-will rock of varying valuations by different individuals.

It goes without saying that the axiomatic-deductive method has been in disrepute in recent decades, in all disciplines but mathematics and formal logic—and even here the axioms are often supposed to be a mere convention rather than necessary truth. Few discussions of the history of philosophy or scientific method fail to make the ritual attacks on old-fashioned argumentation from self-evident principles. And yet the disciples of scientism themselves implicitly assume as self-evident not what cannot be contradicted, but simply that the methodology of physics is the only truly scientific methodology. This methodology, briefly, is to look at facts, then frame ever more general

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[24]In his *Human Action*. For a defense of this method, see chapter 6, this volume; and Rothbard, "Praxeology: Reply to Mr. Schuller," *American Economic Review* (December 1951): 943–46; reprinted in this volume as chapter 7.

hypotheses to account for the facts, and then to test these hypotheses by experimentally verifying other deductions made from them. But this method is appropriate only in the physical sciences, where we begin by knowing external sense data and then proceed to our task of trying to find, as closely as we can, the causal laws of behavior of the entities we perceive. We have no way of knowing these laws directly; but fortunately we may verify them by performing controlled laboratory experiments to test propositions deduced from them. In these experiments we can vary one factor, while keeping all other relevant factors constant. Yet the process of accumulating knowledge in physics is always rather tenuous; and, as has happened, as we become more and more abstract, there is greater possibility that some other explanation will be devised which fits more of the observed facts and which may then replace the older theory.

In the study of human action, on the other hand, the proper procedure is the reverse. Here we *begin* with the primary axioms; we know that men are the causal agents, that the ideas they adopt by free will govern their actions. We therefore begin by fully knowing the abstract axioms, and we may then build upon them by logical deduction, introducing a few subsidiary axioms to limit the range of the study to the concrete applications we care about. Furthermore, in human affairs, the existence of free will prevents us from conducting any controlled experiments; for people's ideas and valuations are continually subject to change, and therefore nothing can be held constant. The proper theoretical methodology in human affairs, then, is the axiomatic-deductive method. The laws deduced by this method are *more*, not less, firmly grounded than the laws of physics; for since the ultimate causes are known directly as true, their consequents are also true.

One of the reasons for the scientistic hatred of the axiomatic-deductive method is historical. Thus, Dr. E.C. Harwood, inveterate battler for the pragmatic method in economics and the social sciences, criticizes Mises as follows:

> Like the Greeks, Dr. Mises disparages change. "Praxeology is not concerned with the changing content of acting, but with its pure form and categorical structure." No one who appreciates the long struggle of man toward more adequate knowing would criticize Aristotle for his adoption of a similar viewpoint 2,000 years ago, but, after all, that *was* 2,000 years ago; surely economists

> can do better than seek light on their subject from a beacon that was extinguished by the Galilean revolution in the 17th century.[25]

Apart from the usual pragmatist antagonism to the apodictic laws of logic, this quotation embodies a typical historiographical myth. The germ of truth in the historical picture of the noble Galileo *versus* the antiscientific Church consists largely in two important errors of Aristotle: (a) he thought of physical entities as acting teleologically, and thus in a sense as being causal agents; and (b) he necessarily had no knowledge of the experimental method, which had not yet been developed, and therefore thought that the axiomatic-deductive-qualitative method was the only one appropriate to the *physical* as well as the human sciences. When the seventeenth century enthroned quantitative laws and laboratory methods, the partially justified repudiation of Aristotle in physics was followed by the unfortunate expulsion of Aristotle and his methodology from the human sciences as well.[26] This is true apart from historical findings that the Scholastics of the Middle Ages were the forerunners, rather than the obscurantist enemies, of experimental physical science.[27]

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[25]E.C. Harwood, *Reconstruction of Economics* (Great Barrington, Mass.: American Institute for Economic Research, 1955), p. 39. On this and other examples of scientism, see Leland B. Yeager, "Measurement as Scientific Method in Economics," *American Journal of Economics and Sociology* (July 1957): 337. Also see Yeager, "Reply to Col. Harwood," ibid. (October 1957): 104–06. As Yeager wisely concludes, "Anthropomorphism, rightly scorned in the natural sciences as prescientific metaphysics, is justified in economics because economics is about human action."

[26]Van Melsen, *The Philosophy of Nature*, pp. 54–58.

[27]As Schumpeter declared: "The scholastic science of the Middle Ages contained all the germs of the laical science of the Renaissance." The experimental method was used notably by Friar Roger Bacon and Peter of Maricourt in the thirteenth century; the heliocentric system of astronomy originated inside the Church (Cusanus was a cardinal and Copernicus a canonist); and the Benedictine monks led the way in developing medieval engineering. See Joseph A. Schumpeter, A *History of Economic Analysis* (New York: Oxford University Press, 1954), pp. 81ff.; and Lynn White, Jr., "Dynamo and Virgin Reconsidered," *The American Scholar* (Spring, 1958): 183–212.

One example of concrete law deduced from our fundamental axiom is as follows: Since all action is determined by the choice of the actor, any particular act demonstrates a person's preference for this action. From this it follows that if A and B voluntarily agree to make an exchange (whether the exchange be material or spiritual), both parties are doing so because they expect to benefit.[28]

## Science and Values: Arbitrary Ethics

Having discussed the properly scientific, as contrasted to the scientistic, approach to the study of man, we may conclude by briefly considering the age-old question of the relationship between science and values. Ever since Max Weber, the dominant position in the social sciences, at least *de jure*, has been *Wertfreiheit*: that science itself must not make value judgments, but confine itself to judgments of fact, since ultimate ends can be only sheer personal preference not subject to rational argument. The classical philosophical view that a rational (that is, in the broad sense of the term, a "scientific") ethic is possible has been largely discarded. As a result, the critics of *Wertfreiheit*, having dismissed the possibility of rational ethics as a separate discipline, have taken to smuggling in arbitrary, ad hoc ethical judgments through the back door of each particular science of man. The current fashion is to preserve a façade of *Wertfreiheit*, while casually adopting value judgments, not as the scientist's own decision, but as the consensus of the values of others. Instead of choosing his own ends and valuing accordingly, the scientist supposedly maintains his neutrality by adopting the values of the bulk of society. In short, to set forth one's own values is now considered biased and "nonobjective," while to adopt uncritically the slogans of other people is the height of "objectivity." Scientific objectivity no longer means a man's pursuit of truth wherever it may lead, but abiding by a Gallup poll of other, less informed subjectivities.[29]

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[28]For a refutation of the charge that this is a circular argument, see Rothbard, "Toward a Reconstruction of Utility and Welfare Economics."

[29]"When they [the practical scientists] remember their vows of objectivity, they get other people to make their judgments for them." Anthony Standen, *Science Is a Sacred Cow* (New York: E.P. Dutton, 1958), p. 165.

The attitude that value judgments are self-evidently correct because "the people" hold them permeates social science. The social scientist often claims that he is merely a technician, advising his clients—the public—how to attain their ends, whatever they may be. And he believes that thereby he can take a value position without really committing himself to any values of his own. An example from a recent public finance textbook (an area where the economic scientist must constantly confront ethical problems):

> The present-day justification for the ability principle (among economists) is simply the fact that . . . it is in accord with consensus of attitudes toward equity in the distribution of real income and of tax burden. Equity questions always involve value judgments, and tax structures can be evaluated, from an equity standpoint, only in terms of their relative conformity with the consensus of thought in the particular society with respect to equity.[30]

But the scientist cannot thereby escape making value judgments of his own. A man who knowingly advises a criminal gang on the best means of safe-cracking is thereby implicitly endorsing the end: safe-cracking. He is an accessory before the fact. An economist who advises the public on the most efficient method of obtaining economic equality is endorsing the end of economic equality. The economist who advises the Federal Reserve System how most expeditiously to manage the economy is thereby endorsing the existence of the system and its aim of stabilization. A political scientist who advises a government bureau on how to reorganize its staff for greater efficiency (or less inefficiency) is thereby endorsing the existence and the success of that bureau. To be convinced of this, consider what the proper course would be for an economist who *opposes* the existence of the Federal Reserve System, or the political scientist who would like to see the liquidation of the bureau. Wouldn't he be betraying his principles if he helped what he is against to become more efficient? Wouldn't his proper course either be to refuse to advise it, or perhaps to promote its *in*efficiency—on the grounds of the classical remark by a great American industrialist (speaking of government corruption): "Thank God that we don't get as much government as we pay for"?

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[30]John F. Due, *Government Finance* (Homewood, Ill.: Richard D. Irwin, 1954), p. 122.

It should be realized that values do not become true or legitimate because many people hold them; and their popularity does not make them self-evident. Economics abounds in instances of arbitrary values smuggled into works the authors of which would never think of engaging in ethical analysis or propounding an ethical system. The virtue of equality, as we have indicated, is simply taken for granted without justification; and it is established, not by sense perception of reality or by showing that its negation is self-contradictory—the true criteria of self-evidence—but by assuming that anyone who disagrees is a knave and a rogue. Taxation is a realm where arbitrary values flourish, and we may illustrate by analyzing the most hallowed and surely the most commonsensical of all tax ethics: some of Adam Smith's famous canons of "justice" in taxation.[31] These canons have since been treated as self-evident gospel in practically every work on public finance. Take, for example, the canon that the costs of collection of any tax be kept to a minimum. Obvious enough to include in the most *wertfrei* treatise? Not at all—for we must not overlook the point of view of the *tax collectors*. They will favor high administrative costs of taxation, simply because high costs mean greater opportunities for bureaucratic employment. On what possible grounds can we call the bureaucrat "wrong" or "unjust"? Certainly no ethical system has been offered. Furthermore, if the tax itself is considered bad on other grounds, then the opponent of the tax may well favor high administrative costs on the ground that there will then be less chance for the tax to do damage by being fully collected.

Consider another seemingly obvious Smith canon, namely, that a tax be levied so that payment is convenient. But again, this is by no means self-evident. Opponents of a tax, for example, may want the tax to be made purposely inconvenient so as to induce the people to rebel against the levy. Or another: that a tax be certain and not arbitrary, so that the taxpayers know what they will have to pay. But here again, further analysis raises many problems. For some may argue that uncertainty positively benefits the taxpayers, for it makes requirements more flexible, thus allowing more room for possible bribery of the tax collector. Another popular maxim is that a tax be

[31] Adam Smith, *The Wealth of Nations* (New York: Modern Library, 1937), pp. 777–79.

framed to make it difficult to evade. But again, if a tax is considered unjust, evasion might be highly beneficial, economically and morally.

The purpose of these strictures has not been to defend high costs of tax collection, inconvenient taxes, bribery, or evasion, but to show that even the tritest bits of ethical judgments in economics are completely illegitimate. And they are illegitimate whether one believes in *Wertfreiheit* or in the possibility of a rational ethic: for such ad hoc ethical judgments violate the canons of either school. They are neither *wertfrei* nor are they supported by any systematic analysis.

## Conclusion: Individualism vs. Collectivism in the Study of Man

Surveying the attributes of the proper science of man as against scientism, one finds a shining, clear theory separating one from the other. The true science of man bases itself upon the existence of individual human beings, upon individual life and consciousness. The scientistic brethren (dominant in modern times) range themselves always against the meaningful existence of individuals: the biologists deny the existence of life, the psychologists deny consciousness, the economists deny economics, and the political theorists deny political philosophy. What they affirm is the existence and primacy of social wholes: "society," the "collective," the "group," the "nation." The individual, they assert, must be value-free himself, but must take his values from "society." The true science of man concentrates on the individual as of central, epistemological and ethical importance; the adherents of scientism, in contrast, lose no opportunity to denigrate the individual and submerge him in the importance of the collective. With such radically contrasting epistemologies, it is hardly sheer coincidence that the political views of the two opposing camps tend to be individualist and collectivist, respectively.

# 2

# What is the Proper Way to Study Man?

If the proper study of mankind is man, the question immediately arises: what is the proper way to study man? In recent generations, the enormous prestige gained by physics in advancing our knowledge of the material world has led to the uncritical transfer of the methods appropriate in the natural sciences to the study of actions of men. These three books illuminate different aspects of the important truth that differences between the nature of human action and the behavior of unmotivated physical objects require different methodologies of scientific study.

The science of economics has always had a separate methodology of its own; but, as in almost all successful sciences, it did not begin to examine and analyze its methodology until it had developed the bulk of its laws and principles. However, if a well-analyzed methodology is not established in time, a science is in danger of falling into gross error by wandering down plausible but invalid paths. In an age when many widely divergent and even contradictory paths of inquiry are open to economists, it is more important than ever that economic science develop a more critical awareness of its proper methodology. Ludwig von Mises's *Grundprobleme der Nationalökonomie*, published in 1933, was a monumental achievement in

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Originally appear in the September 15, 1961 issue of *The National Book Foundation.* A review of Ludwig von Mises's, *Epistemological Problems of Economics* (Princeton, N.J.: D. Van Nostrand, 1960); *Essays in European Economic Thought*, Louise Sommer, ed. (Princeton, N.J.: D. Van Nostrand, 1960); and Richard von Mises, *Probability, Statistics, and Truth*, 2nd revised English edition, prepared by Hilda Geiringer (New York: Macmillan, 1957).

the study of economic methodology. While previous work by Senior, Cairnes, and Menger had vindicated the validity of economic theory, Mises's volume was the first to rid the methodology of economics of all traces of positivism and relativism. For the first time, Mises explained fully why the laws of human action (economics and, more widely, "praxeology") cannot be "tested" by reference to statistical or historical "data." In the behavior of physical objects, science begins by empirical observation of constant relations, and then frames tentative hypotheses of explanatory laws, these hypotheses being always subject to testing and revision by referring their deduced consequents to controlled experiments, where all but the relevant, isolated factors are held constant. This is the "scientific method" of physics. But in the study of human action, as Mises shows, the reverse is true; here, we begin by knowing the causal laws: by *knowing* the fact of human consciousness, of free will, of motivated, purposeful action of human beings in using given means for the attainment of desired ends. On the other hand, the facts of human history are not, as in physics, controllable and subject to testing; they are the complex and changing resultants of the interplay of human motives and actions, impinging on the natural environment and on each other. The laws of economic science, therefore, can only be constructed by starting with apodictically known axioms and deducing from them a body of necessarily true laws.

The best-known modern work on economic methodology in the English-speaking world has been Lionel Robbins's *An Essay on the Nature and Significance of Economic Science*, published at about the same time as *Grundprobleme*. But Mises's book is a far more profound and basic work in the same general tradition, and its present translation as *Epistemological Problems of Economics* therefore fills a vital gap by bringing us the outstanding work on the methodology of economics.

*Essays in European Economic Thought* brings to the American reader translations of seven important European economic essays of the past century. Perhaps the outstanding article in the collection is the brilliant critique of mathematical economics by Paul Painlevé, an eminent French mathematician who wrote the essay as the introduction to the French translation of W. Stanley Jevons's *Theory of Political Economy* in 1909. Jevons's work was one of the first, and one of the least harmful, of the increasingly frequent incursions into economics

of the mathematical method; and yet, in his critique of Jevons, Painlevé already saw the dangers and fallacies. The Austrian, praxeological tradition has always recognized that mathematics, and quantitative methods generally, are appropriate to the physical sciences where behavior is continuous and unmotivated; but that verbal logic, in contrast, is the appropriate method where one is studying the necessarily discrete, motivated, qualitative actions of men. In a field where mathematical economists are too often inclined to dismiss critics as ignorant of mathematics, the arguments of this distinguished mathematician carry particular weight.

Richard von Mises's great classic, *Probability, Statistics, and Truth*, effected a revolution in the nature of probability theory during the 1920s and 1930s. "Classical" probability theory considered numerical probability to be derived from "equal ignorance" about the potential events being considered: thus, the probability of obtaining a "three-spot" upon the throw of a die was considered to be "one-sixth" because there are six possibilities and we do not know if one possibility is stronger than another. Mises (the brother of Ludwig von Mises), demonstrating the contradictions of this approach, insisted that the probability is *not* one-sixth if the die happens to be "loaded," and that the only way to find out if a die is loaded is by tossing it a large number of times. Thus was born the "frequency theory" of numerical probability, based on knowledge and not on ignorance. The frequency theory implies that to say the probability of a die showing "three" is "one-sixth" means that, if a die is thrown a great many times, the number of occasions on which "three" is obtained will approach one out of every six throws. But this means, that numerical and mathematical probability theory cannot really apply to each single case, but only to the proportion of randomly-selected homogeneous events as tossing a coin or throwing a die. This fact is much more true of the unique, non-random events of ordinary human (and entrepreneurial) action. It becomes evident from Richard von Mises's fundamental work that mathematical probability theory can never be applicable to economics, or to any other study of human action.

At the present time, when mathematical probability theory is very heavily used in economics and sociology, the translation of the third German edition of Mises's work is particularly welcome. For Mises here refutes various modern criticisms of his theory and

demolishes the attempts of such philosophers as Carnap and Reichenbach to establish a mathematical theory for individual *cases*, as contrasted to large homogeneous *classes*, of human actions.

# 3

# Praxeology as the Method of the Social Sciences

## The Praxeological Method

During the past generation, a veritable revolution has taken place in the discipline of economics. I am referring not so much to the well-known Keynesian revolution, but to the quieter yet more profound revolution in the methodology of the discipline. This change has not occurred simply in the formal writings of the handful of conscious methodologists; it has spread, largely unnoticed, until it now permeates research and study in all parts of the field. Some effects of this methodological revolution are all too apparent. Let the nonspecialist in economics pick up a journal article or monograph today and contrast it with one of a generation ago, and the first thing that will strike him is the incomprehensibility of the modern product. The older work was written in ordinary language and, with moderate effort, was comprehensible to the layman; the current work is virtually all mathematics, algebraic or geometric. As one distinguished economist lamented, "Economics nowadays often seems like a third-rate sub-branch of mathematics," and one, he added, that the mathematician himself does not esteem very highly.

Of course, economics shares this accelerated mathematization with virtually every other field of knowledge, including history and literature. But, laboring under the common notion that it is a science with a special focus on *quantities*, economics has proceeded farther

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Originally appeared in *Phenomenology and the Social Sciences*, Maurice Natanson, ed. (Evanston, Ind.: Northwestern University Press, 1973), vol. 2, pp. 31–61.

and faster than any of its sister disciplines down the mathematical and statistical road.

The emphasis on mathematics is a symptom of a deeper change in the discipline: the rapid adoption of what we may broadly call "positivism" as the guide for research and the criterion for the successful construction of economic theory. The growing influence of positivism has its source in the attempt of all social sciences to mimic the (allegedly) supremely successful science, physics. For social scientists, as for almost all intellectuals, physics has unfortunately all but replaced philosophy as the "queen of the sciences." In the hands of the positivists, philosophy has almost come to be an elaborate running commentary on and explication of physics, too often serving as the handmaiden of that prestigious science. What positivists see as the methodology of physics has been elevated, at their hands, to be *the* scientific method, and any deviant approach has been barred from the status of science because it does not meet the rigorous positivist test.

At the risk of oversimplification, the positivist model of the scientific method may be summarized as follows:

Step 1. The scientist observes empirical regularities, or "laws," between variables.

Step 2. Hypothetical explanatory generalizations are constructed, from which the empirically observed laws can be deduced and thus "explained."

Step 3. Since competing hypotheses can be framed, each explaining the body of empirical laws, such "coherence" or consistent explanation is not enough; to validate the hypotheses, other deductions must be made from them, which must be "testable" by empirical observation.

Step 4. From the construction and testing of hypotheses, a wider and wider body of generalizations is developed; these can be discarded if empirical tests invalidate them, or be replaced by new explanations covering a still wider range of phenomena.

Since the number of variables is virtually infinite, the testing in Step 3, as well as much of the observation in Step 1, can only be done in "controlled experiments," in which all variables but the ones under study are held constant. Replicating the experimental conditions should then replicate the results.

Note that in this methodology we proceed from that which is known with certainty—the empirical regularities—up through ever wider and more tentative hypotheses. It is this fact that leads the layman to believe erroneously that Newton "overthrew" his predecessors and was in his turn "overthrown" by Einstein. In fact, what happens is not so much substitution as the addition of more general explanations for a wider range of phenomena; the generalizations of a Newton or an Einstein are far more tentative than the fact that two molecules of hydrogen combine with one molecule of oxygen to produce water.

Now, I am not expert enough in the philosophy of science to challenge this positivist model of the methodology of physics, although my reading in the philosophy of nature leads me to suspect that it is highly inadequate.[1] My contention is rather that the wholesale and uncritical application of this model to economics in recent decades has led the entire discipline badly astray.

There is, however, unbeknownst to most present-day economists, a competing methodological tradition. This tradition, the method of most of the older classical economists, has been called "praxeology" by Ludwig von Mises, its most eminent modern theorist and practitioner. Praxeology holds that in the social sciences where human beings and human choices are involved, Step 3 is impossible, since even in the most ambitious totalitarian society, it is impossible to hold *all* the variables constant. There *cannot* be controlled experiments when we confront the real world of human activity.

Let us take a recent example of a generally unwelcome economic phenomenon: the accelerated price inflation in the United States in the last few years. There are all manner of competing theoretical explanations for this, ranging from increases in the money supply to a sudden increase in greed on the part of the public or various segments thereof. There is no positivist empirical way of deciding between these various theories; there is no way of confirming or disproving them by keeping all but one supposedly explanatory variable constant, and then changing that variable to see what happens to prices. In addition, there is the well-known social science analogue

[1]On this, see Andrew G. Van Melsen, *The Philosophy of Nature* (Pittsburgh, Penn.: Duquesne University Press, 1953).

of the Heisenberg uncertainty principle: positivist science contains predictions, but how can predictions be tested when the very act of prediction itself changes the forces at work? Thus, economist A predicts a severe recession in six months; acting on this, the government takes measures to combat the supposedly imminent recession, the public and the stock market react, and so on. The recession then never takes place. Does that mean that the economist was basing his prediction on erroneous theories, or that the theories were correct but inappropriate to the actual data, *or* that he was "really" right but that prompt action forestalled the dreaded event? There is no way to decide.

One further example: Keynesian economists hold that depressions can be cured by massive doses of deficit spending by the government. The United States government engaged in large-scale deficit-spending to combat the depression in the late 1930s, but to no avail. The anti-Keynesians charge that this failure proves the incorrectness of Keynesian theory; the Keynesians reply that the doses were simply not massive enough, and that far greater deficits would have turned the tide. Again, there is no positivist-empirical way to decide between these competing claims.

Praxeologists share the contention of the impossibility of empirical testing with other critics of positivism, such as the institutionalists, who for this reason abandon economic theory altogether and confine themselves to purely empirical or institutional economic reportage. But the praxeologist does not despair; he turns instead to another methodology that *can* yield a correct body of economic theory. This methodology begins with the conviction that while the economist, unlike the physicist, cannot test his hypotheses in controlled experiments, he is, in another sense, in a *better* position than the physicist. For while the physicist is certain of his empirical laws but tentative and uncertain of his explanatory generalizations, the economist is in the opposite position. He begins, not with detailed, quantitative, empirical regularities, but with broad explanatory generalizations. These fundamental premises he knows with certainty; they have the status of apodictic axioms, on which he can build deductively with confidence. Beginning with the certain knowledge of the basic explanatory axiom A, he deduces the implications of A: B, C, and D. From these he deduces further implications, and so on. If he knows that A is true, and if A implies B, C, and D, then he

knows with certainty that B, C, and D are true as well. The positivist, looking through the blinders imposed by his notion of physics, finds it impossible to understand how a science can possibly begin with the explanatory axioms and work downward to the more concrete empirical laws. He therefore dismisses the praxeological approach as "mythical" and "apriorist."

What are these axioms with which the economist can so confidently begin? They are the existence, the nature, and the implications of human action. Individual human beings exist. Moreover, they do not simply "move," as do unmotivated atoms or molecules; they *act*, that is, they have goals and they make choices of means to attain their goals. They order their values or ends in a hierarchy according to whether they attribute greater or lesser importance to them; and they have what they believe is technological knowledge to achieve their goals. All of this action must also take place through time and in a certain space. It is on this basic and evident axiom of human action that the entire structure of praxeological economic theory is built. We do not know, and may never know with certainty, the ultimate equation that will explain all electromagnetic and gravitational phenomena; but we do know that people act to achieve goals. And this knowledge is enough to elaborate the body of economic theory.[2]

There is considerable controversy over the empirical status of the praxeological axiom. Professor Mises, working within a Kantian philosophical framework, maintained that like the "laws of thought," the axiom is *a priori* to human experience and hence apodictically certain. This analysis has given rise to the designation of praxeology as "extreme apriorism." Most praxeologists, however, hold that the axiom is based squarely in empirical reality, which makes it no less certain than it is in Mises's formulation. If the axiom is empirically

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[2]Thus the fact that people act to achieve their goals implies that there is a scarcity of means to attain them; otherwise the goals would already have been attained. Scarcity implies costs, which in a monetary system (developed much later in the logical elaboration) are reflected in prices, and so forth. For a consciously praxeological development of economic theory, see Ludwig von Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1949); and Murray N. Rothbard, *Man, Economy, and State*, 2nd ed. (Kansas City: Sheed Andrews and McMeel, 1970).

true, then the logical consequences built upon it must be empirically true as well. But this is not the sort of empiricism welcomed by the positivists, for it is based on universal reflective or inner experience, as well as on external physical experience. Thus, the knowledge that human beings have goals and act purposively to attain them rests, not simply on observing that human beings exist, but also on the introspective knowledge of what it means to be human possessed by each man, who then assents to this knowledge. While this sort of empiricism rests on broad knowledge of human action, it is also prior to the complex historical events that economists attempt to explain.

Alfred Schütz pointed out and elaborated the complexity of the interaction between the individual and other persons, the "interpretive understanding" or *Verstehen*, upon which this universal, prescientific understanding rests. The common-sense knowledge of the universality of motivated, intentional human action, ignored by positivists as "unscientific," actually provides the indispensable groundwork on which science itself must develop.[3] For Schütz this knowledge is empirical, "provided that we do not restrict this term to sensory perceptions of objects and events in the outer world but include the experimental form, by which common-sense thinking in everyday life understands human actions and their outcome in terms of their underlying motives and goals."[4]

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[3] It is . . . not understandable that the same authors who are convinced that no verification is possible for the intelligence of other human beings have such confidence in the principle of verifiability itself, which can be realized only through cooperation with others by mutual control. (Alfred Schütz, *Collected Papers*, vol. 2: *Studies in Social Theory*, A. Brodersen, ed. [The Hague: Nijhoff, 1964], p. 4)

[4]Alfred Schütz, *Collected Papers*, vol. 1: *The Problem of Social Reality*, Maurice Natanson, ed. (The Hague: Nijhoff, 1962), p. 65; see also pp. 1–66, as well as Peter Winch, "Philosophical Bearings," in *Philosophy of the Social Sciences: A Reader*, Maurice Natanson, ed. (New York: Random House, 1963). On the importance of the commonsense, prescientific presuppositions of science from a slightly different philosophical perspective, see Van Melsen, *Philosophy of Nature*, pp. 6–29.

The nature of the evidence on which the praxeological axiom rests is, moreover, fundamentally similar to that accepted by the self-proclaimed empiricists. To them, the laboratory experiment is evidence because the sensory experience involved in it is available to each observer; the experience becomes "evident" to all. Logical proof is in this sense similar; for the knowledge that B follows from A becomes evident to all who care to follow the demonstration. In the same way, the fact of human action and of purposive choice also becomes evident to each person who bothers to contemplate it; it is just as evident as the direct sense experience of the laboratory.

From this philosophical perspective, then, all disciplines dealing with human beings—from philosophy to history, psychology, and the social sciences—must take as their starting point the fact that humans engage in motivated, purposive action and are thus different from the unmotivated atoms and stones that are the objects of the physical sciences. But where, then, does praxeology or economics differ from the other disciplines that treat human beings? The difference is that, to the praxeologist, economic *theory* (as distinct from applied economics, which will be treated below) deals, not with the content of human valuations, motivations, and choices, but with the formal fact that people engage in such motivated action. Other disciplines focus on the content of these values and actions. Thus, psychology asks how and why people adopt values and make choices; ethics deals with the problem of what values and choices they should adopt; technology explains how they should act in order to arrive at chosen ends; and history tries to explain the content of human motives and choices through recorded time. Of these disciplines, history is perhaps the most purely *verstehende*, for the historian is constantly attempting to describe, understand, and explain the motivations and choices of individual actors. Economic theory, on the other hand, is the least *verstehende*, for while it too begins with the axiom of purposive and intentional human action, the remainder of its elaborated structure consists of the deduced logical—and therefore true—implications of that primordial fact.

An example of the formal structure of economic theory is the well-known economic law, built up from the axiom of the existence of motivated human action, that if the demand for any product increases, given the existing supply, the price of that product will rise. This law holds regardless of the ethical or aesthetic status of the

product, just as the law of gravity applies to objects regardless of their particular identity. The economic theorist is not interested in the content of what is being demanded, or in its ethical meaning—it may be guns or butter or even textbooks on philosophy. It is this universal, formal nature of economic law that has earned it among laymen the reputation of being cold, heartless, and excessively logical.

Having discussed the nature of the axiom on which the praxeological view of economics is grounded, we may now turn to examine the deductive process itself, the way in which the structure of economic laws is developed, the nature of those laws, and, finally, the ways in which the praxeological economist applies these economic laws to the social world.

One of the basic tools for the deduction of the logical implications of the axiom of human action is the use of the *Gedankenexperiment*, or "mental experiment." The *Gedankenexperiment* is the economic theorist's substitute for the natural scientist's controlled laboratory experiment. Since the relevant variables of the social world cannot actually be held constant, the economist holds them constant in his imagination. Using the tool of verbal logic, he mentally investigates the causal influence of one variable on another. The economist finds, for example, that the price of a product is determined by two variables, the demand for it and its supply at any given time. He then mentally holds the supply constant, and finds that an increase in demand—brought about by higher rankings of the product on the value scales of the public—will bring about an increase in price. Similarly, he finds, again using verbal deductive logic, that if these value scales, and therefore public demand, are mentally held constant, and the supply of the product increases, its price will fall. In short, economics arrives at *ceteris paribus* laws: Given the supply, the price will change in the same direction as demand; *given* the demand, price will change in the opposite direction from supply.

One important aspect of these economic laws must be pointed out: they are necessarily *qualitative*. The fact that human beings have goals and preferences, that they make choices to attain their goals, that all action must take place over time, all these are qualitative axioms. And since only the qualitative enters into the logical process from the real world, only the qualitative can emerge. One can only say, for example, that an increase in demand, given the supply, will raise the price; one *cannot* say that a 20 percent increase in demand

will bring about a 25 percent increase in price. The praxeologist must reject all attempts, no matter how fashionable, to erect a theory consisting of alleged quantitative laws. In an age that tries desperately to imitate prestigious physics, with its emphasis on mathematics and its quantitative laws, many social scientists, including many economists, have ignored the praxeological method because of this very insistence on the qualitative bounds of the discipline.

There is a basic reason for the quantitative—qualitative dichotomy between the physical and the social sciences. The objects of physical science do not act; they do not choose, change their minds, and choose again. Their natures may therefore be investigated, and the investigations replicated indefinitely, with quantitative precision. But people do change their minds, and their actions, all the time; their behavior cannot be predicted with exact and therefore scientific precision. Among the many factors helping to determine the demand and the supply of butter, for example, are the valuations placed by each consumer on butter relative to all other products available, the availability of substitutes, the climate in the butter-producing areas, technological methods of producing butter (and margarine), the price of cattle feed, the supply of money in the country, the existence of prosperity or recession in the economy, and the public's expectations of the trend of general prices. Every one of these factors is subject to continuing and unpredictable change. Even if one mammoth equation could be discovered to "explain" all recorded prices of butter for the past 50 years, there is no guarantee, and not even the likelihood, that the equation would have anything to do with *next* month's price.

In fact, if empirical success is the test, it is surely noteworthy that all the determined efforts of quantitative economists, econometricians, and social scientists have not been able to find one single quantitative constant in human affairs. The mathematical laws in the physical sciences contain numerous constants; but the imitative method in the social sciences is proven vain by the fact that not a single constant has ever emerged. Moreover, despite the use of sophisticated econometric models and high-speed computers, the success rate of forecasting economic quantities has been dismal, even for the simplest of aggregates such as Gross National Product, let alone for more difficult quantities; the record of GNP forecasting by economists has been poorer than a simple layman's extrapolation of

recent trends.[5] In fact, the federal government has had notably poor success even in forecasting the one variable under its own absolute control—its *own* expenditure in the near future. Perhaps we will revise our critical opinion of econometric science if and when the econometricians prove themselves able to make flawless predictions of activity on the stock market—and make themselves vast fortunes in the process.

Except for the fact that they are not quantitative, however, the predictions of the praxeologist are precisely the same kind as those of the natural scientist. The latter, after all, is not a prophet or soothsayer; his successful prediction is not what *will* happen in the world, but what *would* happen if such and such should occur. The scientist can predict successfully that if hydrogen and oxygen are combined in proportions of two to one, the result will be water; but he has no way of predicting scientifically how many scientists in how many laboratories will perform this process at any given period in the future. In the same way, the praxeologist can say, with absolute certainty, that if the demand for butter increases, and the supply remains the same, the price of butter will rise; but he does not know whether the public's demand for butter will in fact rise or fall, let alone by how much it will change. Like the physical scientist, the economist is not a prophet, and it is unfortunate that the econometricians and quantitative economists should have so eagerly assumed this social role.[6]

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[5]See Victor Zamowitz, *An Appraisal of Short-Term Economic Forecasts* (New York: National Bureau of Economic Research, 1967). For a record of the problems of forecasting see "Bad Year for Econometrics," *Business Week* (December 20, 1969): 36–40.

[6]The English economist Peter T. Bauer properly distinguishes between scientific prediction and forecasting:

> Prediction, in the sense of the assessment of the results of specified occurrences or conditions, must be distinguished from the forecasting of future events. Even if the prediction that the producers of a particular crop respond to a higher price by producing more is correct, this prediction does not enable us to forecast accurately next year's output (still less the harvest in the more distant future), which in the event will be affected by many factors besides changes in price. (Peter T. Bauer, *Economic Analysis and Policy in Underdeveloped Countries* [Durham, N.C.: Duke University Press, 1957], pp. 10–11; see also pp. 28–32)

The English economist John Jewkes suggests the properly limited role for economic forecasting, as well as for applied economics generally:

> I submit that economists cannot, without stepping outside their discipline, predict in the sense of telling us what will happen in the future. . . .
>
> In the most general sense, there is, indeed, no such thing as the *economic* future. There is only *the* future in which economic factors are bound together, inextricably and quite without hope of separate identification, with the whole universe of forces determining the course of events. . . . Anyone who proposes to look at it [the future] before the event must take as his province the whole of experience and knowledge. He must cease to behave as a specialist, which means that he must cease to behave as an economist. . . .
>
> The economist's claim to predictive authority must be false in that it leads to a palpable absurdity. If the economic future can, indeed, be described, why not also the scientific future, the political future, the social future, the future in each and every sense? Why should we not be able to plumb all the mysteries of future time?[7]

What, then, is the praxeological view of the function of applied economics? The praxeologist contrasts, on the one hand, the body of qualitative, nomothetic laws developed by economic theory, and on the other, a myriad of unique, complex historical facts of both the past and the future. It is ironic that while the praxeologist is generally denounced by the positivist as an "extreme apriorist," he actually has a far more empirical attitude toward the facts of history. For the positivist is always attempting to compress complex historical facts into artificial molds, regarding them as homogeneous and therefore manipulable and predictable by mechanical, statistical, and quantitative operations in the attempt to find leads, lags, correlations, econometric relations, and "laws of history." This Procrustean distortion is undertaken in the belief that the events of human history can be treated in the same mechanistic way as the movements of atoms or molecules—

[7]John Jewkes, "The Economist and Economic Change," in *Economics and Public Policy* (Washington, D.C.: Brookings Institution, 1955), pp. 82–83.

simple, unmotivated, homogeneous elements. The positivist thereby ignores the fact that while atoms and stones have no history, man, by virtue of his acts of conscious choice, creates a history. The praxeologist, in contrast, holds that each historical event is the highly complex result of a large number of causal forces, and, further, that it is unique and cannot be considered homogeneous to any other event. Obviously, there are similarities between events, but there is no perfect homogeneity and therefore no room for historical "laws" similar to the exact laws of physical science.

While accepting that there are no mechanical laws of history, however, the praxeologist holds that he can and must use his knowledge of other nomothetic sciences as part of his *verstehende* attempt to understand and explain the idiographic events of history. Let us suppose that the economic historian, or the student of applied economics, is attempting to explain a rapid rise in the price of wheat in a certain country during a certain period. He may bring many nomothetic sciences to bear: agronomy and entomology may help reveal that an insect mentioned in the historical record was responsible for a drastic fall in wheat production; meteorological records may show that rainfall was insufficient; he may discover that during the periods people's taste for bread increased, perhaps imitating a similar preference by the king; he may discover that the money supply was increasing, and learn from economic theory that an increase in the supply of money tends to raise prices in general, including therefore the price of wheat. And, finally, economic theory states that the price of wheat moves inversely with the supply and directly with the demand. The economic historian combines all of his scientific knowledge with his understanding of motives and choices to attempt to explain the complex historical phenomenon of the price of bread.

A similar procedure is followed in the study of such infinitely more complex historical problems as the causes of the French Revolution, where, again, the historian must blend his knowledge of causal theories in economics, military strategy, psychology, technology, and so on, with his understanding of the motives and choices of individual actors. While historians may well agree on the enumeration of all the relevant causal factors in the problem, they will differ on the weight to be attached to each factor. The evaluation of the relative importance of historical factors is an art, not a science, a matter of personal judgment, experience, and *verstehende* insight

which will differ from one historian to another. In this sense, economic historians, like economists (and indeed other historians), can come to qualitative but not quantitative agreement.

For the praxeologist, forecasting is a task very similar to the work of the historian. The latter attempts to "predict" the events of the past by explaining their antecedent causes; similarly, the forecaster attempts to predict the events of the future on the basis of present and past events already known. He uses all his nomothetic knowledge, economic, political, military, psychological, and technological; but at best his work is an art rather than an exact science. Thus, some forecasters will inevitably be better than others, and the superior forecasters will make the more successful entrepreneurs, speculators, generals, and bettors on elections or football games.

The economic forecaster, as Professor Jewkes pointed out, is only looking at part of a tangled and complex social whole. To return to our original example, when he attempts to forecast the price of butter he must take into consideration the qualitative economic law that price depends directly on demand and inversely on supply; it is then up to him, using knowledge and insight into general economic conditions as well as the specific economic, technological, political, and climatological conditions of the butter market, as well as the values people are likely to place on butter, to try to forecast the movements of the supply and demand of butter, and therefore its price, as accurately as possible. At best, he will have nothing like a perfect score, for he will run aground on the fact of free will altering values and choices, and the consequent impossibility of making exact predictions of the future.[8]

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[8]We may mention here the well-known refutation of the notion of predicting the future by Karl Popper, namely, that in order to predict the future, we would have to predict what knowledge we will possess in the future. But we cannot do so, for if we knew what our future knowledge would be, we would *already* be in possession of that knowledge at the present time. See Karl R. Popper, *The Poverty of Historicism* (New York: Harper and Row, 1964), pp. vi–viii.

## The Praxeological Tradition

The praxeological tradition has a long history in economic thought. We will indicate briefly the outstanding figures in the development of that tradition, especially since these economic methodologists and their views have been recently neglected by economists steeped in the positivist world view.

One of the first self-conscious methodologists in the history of economics was the early-nineteenth-century French economist Jean-Baptiste Say. In the lengthy introduction to his *magnum opus*, *A Treatise on Political Economy*, Say laments that people

> are too apt to suppose that absolute truth is confined to the mathematics and to the results of careful observation and experiment in the physical sciences; imagining that the moral and political sciences contain no invariable facts of indisputable truth, and therefore cannot be considered as genuine sciences, but merely hypothetical systems.

Say could easily have been referring to the positivists of our day, whose methodology prevents them from recognizing that absolute truths can be arrived at in the social sciences, when grounded, as they are in praxeology, on broadly evident axioms. Say insists that the "general facts" underlying what he calls the "moral sciences" are undisputed and grounded on universal observation.

> Hence the advantage enjoyed by every one who, from distinct and accurate observation, can establish the existence of these general facts, demonstrate their connection, and deduce their consequences. They as certainly proceed from the nature of things as the laws of the material world. We do not imagine them; they are results disclosed to us by judicious observation and analysis.. . . That can be admitted by every reflecting mind.

These general facts, according to Say, are "principles," and the science of

> political economy, in the same manner as the exact sciences, is composed of a few fundamental principles, and of a great number of corollaries or conclusions drawn from these principles. It is essential, therefore, for the advancement of this science that these principles should be strictly deduced from observation; the number of conclusions to be drawn from them may afterwards be either

> multiplied or diminished at the discretion of the inquirer, according to the object he proposes.[9]

Here Say has set forth another important point of the praxeological method: that the paths in which the economist works out the implications of the axioms and the elaborated system which results will be decided by his own interests and by the kind of historical facts he is examining. Thus, it is theoretically possible to deduce the theory of money even in an economy of primitive barter, where no money exists; but it is doubtful whether a primitive praxeologist would have bothered to do so.

Interestingly enough, Say at that early date saw the rise of the statistical and mathematical methods, and rebutted them from what can be described as a praxeological point of view. The difference between political economy and statistics is precisely the difference between political economy (or economic theory) and history. The former is based with certainty on universally observed and acknowledged general principles; therefore, "a perfect knowledge of the principles of political economy may be obtained, inasmuch as all the general facts which compose this science may be discovered." Upon these "undeniable general facts," "rigorous deductions" are built, and to that extent political economy "rests upon an immovable foundation." Statistics, on the other hand, only records the ever changing pattern of particular facts, statistics "like history, being a recital of facts, more or less uncertain and necessarily incomplete." Furthermore, Say anticipated the praxeologist's view of historical and statistical data as themselves complex facts needing to be explained. "The study of statistics may gratify curiosity, but it can never be productive of advantage when it does not indicate the origin and consequences of the facts it has collected; and by indicating their origin and consequences, it at once becomes the science of political economy." Elsewhere in the essay, Say scoffs at the gullibility of the public toward statistics: "Sometimes, moreover, a display of figures and calculations imposes upon them; as if numerical calculations alone could prove anything, and as if any rule could be laid down, from

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[9]Jean-Baptiste Say, *A Treatise on Political Economy*, C.C. Biddle, trans. (New York: Augustus M. Kelley, 1964), pp. xxiv, xxv, xlv, xxvi.

which an inference could be drawn without the aid of sound reasoning."[10]

Say goes on to question sharply the value of mathematics in the construction of economic theory, once again referring back to the structure of the basic axioms, or general principles, for his argument. For political economy is concerned with men's values, and these values being "subject to the influence of the faculties, the wants and the desires of mankind, they are not susceptible of any rigorous appreciation, and cannot therefore furnish any data for absolute calculations. In political science, all that is essential is a knowledge of the connection between causes and their consequences." Delving deeper into the then only embryonic use of the mathematical method of economics, Say points out that the laws of economics are strictly qualitative: "We may, for example, know that for any given year the price of wine will infallibly depend upon the quantity to be sold, compared with the extent of the demand." But "if we are desirous of submitting these two data to mathematical calculation," then it becomes impossible to arrive at precise quantitative forecasts of the innumerable, ever changing forces at work: the climate, the quantity of the harvest, the quality of the product, the stock of wine held over from the previous vintage, the amount of capital, the possibilities of export, the supply of substitute beverages, and the changeable tastes and values of the consumers."[11]

Say offers a highly perceptive insight into the nature and probable consequences of the application of mathematics to economics. He argues that the mathematical method, with its seeming exactitude, can only gravely distort the analysis of qualitative human action by stretching and oversimplifying the legitimate insights of economic principles:

> Such persons as have pretended to do it, have not been able to enunciate these questions into analytical language, without divesting them of their natural complication, by means of simplifications, and arbitrary suppressions, of which the consequences, not properly estimated, always essentially change the condition of the problem, and pervert all its results; so that no other inference can be

[10]Ibid., pp. xix–xx, li.

[11]Ibid., pp. xxvi, xxvi*n*.

> deduced from such calculations than from formula arbitrarily assumed.[12]

In contrast to the physical sciences where the explanatory laws or general principles are always in the realm of the hypothetical, in praxeology it is fatal to introduce oversimplification and falsehood into the premises, for then the conclusions deduced from them will be irredeemably faulty as well.[13]

If mathematics and statistics do not provide the proper method for the political economist, what method is appropriate? The same course that he would pursue in his daily life. "He will examine the immediate elements of the proposed problem, and after having ascertained them with certainty . . . will approximately value their mutual influences with the intuitive quickness of an enlightened understanding."[14] In short, the laws of the political economist are certain, but their blending and application to any given historical event is accomplished, not by pseudo-quantitative or mathematical methods, which distort and oversimplify, but only by the use of *Verstehen*, "the intuitive quickness of an enlightened understanding."

The first economists to devote their attention specifically to methodology were three leading economists of mid-nineteenth century Britain: John E. Cairnes, Nassau W. Senior, and John Stuart Mill. Cairnes and Senior, at least, may be considered as proto-praxe-

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[12]Ibid., p. xxvi*n*.

[13]One of the most pernicious aspects of the current dominance of positivist methodology in economics has been precisely this injection of false premises into economic theory. The leading extreme positivist in economics, Milton Friedman, goes so far as to extol the use of admittedly false premises in the theory, since, according to Friedman, the *only* test of a theory is whether it predicts successfully. See Milton Friedman "The Methodology of Positive Economics," in *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), pp. 3–46. Of the numerous critiques and discussions of the Friedman thesis, see in particular Eugene Rotwein, "On The Methodology of Positive Economics," *Quarterly Journal of Economics* 73 (November 1959): 554–75; Paul A. Samuelson, "Discussion," *American Economic Review: Papers and Proceedings* 53 (May 1963): 231–36; Jack Maltz, "Friedman and Machlup on the Significance of Testing Economic Assumptions," *Journal of Political Economy* 73 (February 1965): 37–60.

[14]Say, *Treatise on Political Economy*, p. xxvi*n*.

ologists. Cairnes, after agreeing with Mill that there can be no controlled experiments in the social sciences, adds that they have, however, a crucial advantage over the physical sciences. For, in the latter,

> *mankind have no direct knowledge of ultimate physical principles*. The law of gravitation and the laws of motion are among the best established and most certain of such principles; but what is the evidence on which they rest? We do not find them in our consciousness, by reflecting on what passes in our minds; nor can they be made apparent to our sense the proof of all such laws ultimately resolving itself into this, that, assuming them to exist, they account for the phenomena.

In contrast, however,

> *The economist starts with a knowledge of ultimate causes*. He is already, at the outset of his enterprise, in the position which the physicist only attains after ages of laborious research. If any one doubt this, he has only to consider what the ultimate principles governing economic phenomena are . . . certain mental feelings and certain animal propensities in human beings; [and] the physical conditions under which production takes place. . . . For the discovery of such premises no elaborate process of induction is needed . . . for this reason, that we have, or may have if we choose to turn our attention to the subject, direct knowledge of these causes in our consciousness of what passes in our own minds, and in the information which our senses convey . . . to us of external facts. Every one who embarks in any industrial pursuit is conscious of the motives which actuate him in doing so. He knows that he does so from a desire, for whatever purpose, to possess himself of wealth; he knows that, according to his lights, he will proceed toward his end in the shortest way open to him.[15]

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[15]J.E. Cairnes, *The Character and Logical Method of Political Economy*, 2nd ed. (London: Macmillan, [1857] 1875, repr. 1888), pp. 83, 87–88 (italics in the original). The emphasis of Cairnes and other classical economists on wealth as the goal of economic action has been modified by later praxeological economists to include all manner of psychological satisfactions, of which those stemming from material wealth are only a subset. A discussion similar to that of Cairnes can be found in F.A. Hayek, "The Nature and History of the Problem," in *Collectivist Economic Planning,* F.A. Hayek, ed. (London: Routledge, 1935), pp. 10–11.

Cairnes goes on to point out that the economist uses the mental experiment as a replacement for the laboratory experiment of the physical scientist.

Cairnes demonstrates that deduced economic laws are "tendency," or "if-then," laws, and, moreover, that they are necessarily qualitative, and cannot admit of mathematical or quantitative expression. Thus, he too makes the point that it is impossible to determine precisely how much the price of wheat will rise in response to a drop in supply; for one thing, "it is evident that the disposition of people to sacrifice one kind of gratification to another—to sacrifice vanity to comfort, or decency to hunger—is not susceptible of precise measurement."[16] In the preface to his second edition, two decades later in 1875, Cairnes reiterated his opposition to the growing application of the mathematical method to economics, which, in contrast to its use in the physical sciences, cannot produce new truths; "and unless it can be shown either that mental feelings admit of being expressed in precise quantitative forms, or, on the other hand, that economic phenomena do not depend upon mental feelings, I am unable to see how this conclusion can be avoided."[17]

Cairnes's older contemporary, Nassau Senior, was the most important praxeologist of that era. Before Senior, classical economists such as John Stuart Mill had placed the fundamental premises of economics on the shaky ground of being *hypotheses*; the major hypothesis was that all men act to obtain the maximum of material wealth. Since this is clearly not always true, Mill had to concede that economics was only a hypothetical and approximate science. Senior broadened the fundamental premise to include immaterial wealth or satisfaction, a complete, apodictic, and universally true principle based on insight into the goal-seeking nature of human action.

> In stating that every man desires to obtain additional wealth with as little sacrifice as possible, we must not be supposed to mean that everybody . . . wishes for an indefinite quantity of everything . . . What we mean to state is that no person feels his whole wants to be adequately supplied; that every person has some unsatisfied desires which he believes that additional wealth would gratify. The

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[16]Cairnes, *Character and Logical Method*, p. 127.

[17]Ibid., p. v.

> nature and urgency of each individual's wants are as various as the differences in individual character.[18]

In contrast to the physical sciences, Senior pointed out, economics and the other "mental sciences" draw their premises from the universal facts of human consciousness:

> The physical sciences, being only secondarily conversant with mind, draw their premises almost exclusively from observation or hypothesis. Those which treat only of magnitude or number, . . . the pure sciences, draw them altogether from hypothesis. . . . They disregard almost entirely the phenomenon of consciousness. . . .
>
> On the other hand, the mental sciences and the mental arts thaw their premises principally from consciousness. The subjects with which they are chiefly conversant are the workings of the human mind.[19]

These latter premises are "a very few general propositions, which are the result of observation, or consciousness, and which almost every man, as soon as he hears them, admits, as familiar to his thought, or at least, as included in his previous knowledge."[20]

During the 1870s and 1880s, classical economics was supplanted by the Neoclassical School. In this period the praxeological method was carried on and further developed by the Austrian School, founded by Carl Menger of the University of Vienna and continued by his two most eminent disciples, Eugen von Böhm-Bawerk and Friedrich von Wieser. It was on the basis of their work that Böhm-Bawerk's student Ludwig von Mises later founded praxeology as a self-conscious and articulated methodology.[21] As it was outside the

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[18]Nassau William Senior, *An Outline of the Science of Political Economy* (New York: Augustus M. Kelley, [1836] n.d.), p. 27.

[19]Marian Rowley, *Nassau Senior and Classical Economics* (New York: Augustus M. Kelley, 1949), p. 56.

[20]Ibid., p. 43. See also p. 64, where Rowley points out the similarity between Senior's methodological views and the praxeology of Ludwig von Mises.

[21]The outstanding example is Mises, *Human Action*. See also his *Theory and History* (New Haven, Conn.: Yale University Press, 1957); *The Ultimate Foundation of Economic Science* (Kansas City: Sheed Andrews and McMeel, 1978); and *Epistemological Problems of Economics* (Princeton, N.J.:

increasingly popular intellectual fashion of positivism and mathematics, however, the Austrian School has been greatly neglected in recent years and dismissed as an unsound approximation of the positivist-mathematical theory of the Lausanne School, founded by Léon Walras of Lausanne and continued by the Italian economist and sociologist Vilfredo Pareto.

A few followers or sympathetic observers, however, have carried on investigations into the methodology of the early Austrian School. Leland B. Yeager notes what we now see as the typically praxeological view of the unique advantage of economic theory over the physical sciences: "While the basic elements of theoretical interpretation in the natural sciences, such, he [Menger] says, as forces and atoms, cannot be observed directly, the elements of explanation in economics—human individuals and their strivings—are of a direct empirical nature." Furthermore, "The facts that economists induce from the behavior of themselves and other people serve as axioms from which a useful body of economic theory can be logically deduced, much as in geometry an impressive body of theorems can be deduced from a few axioms." In short, "Menger conceived of economic theory as a body of deductions from basic principles having a strong empirical foundation." Referring to the dominant positivist economists of our own day, Yeager adds perceptively,

> Not sharing . . . Menger's understanding of how empirical content gets into so-called "armchair theory," many economists of our own day apparently regard theoretical and empirical work as two distinct fields. Manipulation of arbitrarily-assumed functional relationships is justified in the minds of such economists by the idea that empirical testing of theories against the real world comes afterward.[22]

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D. Van Nostrand, 1960). See also F.A. Hayek, *The Counter-Revolution of Science* (Glencoe, Ill.: The Free Press, 1955); Lionel Robbins, *An Essay on the Nature and Significance of Economic Science*, 2nd ed. (London: Macmillan, 1949); and Israel M. Kirzner, *The Economic Point of View*, 2nd ed. (Kansas City: Sheed Andrews and McMeel, 1976).

[22]Leland B. Yeager, "The Methodology of Henry George and Carl Menger," *American Journal of Economics and Sociology* 13 (April 1954): 235, 238.

Other writers have discovered links between the Austrian method and various strands of the *philosophia perennis*. Thus, Emil Kauder finds a close relationship between this method and Aristotelian philosophy, which was still influential in Austria at the end of the nineteenth century. Kauder points out that all the Austrians were "social ontologists," and that as such they believed in a structure of reality "both as a logical starting point and as a criterion of validity." He notes Mises's statement that economic laws are "ontological facts," and he characterizes as both ontological and Aristotelian the concern of Menger and his followers to uncover the "essences" of phenomena, rather than to treat superficial and complex economic quantities. Kauder also points out that for Menger and the Austrians, economic theory deals with types and typical relations, which provide knowledge that transcends the immediate, concrete case and is valid for all times and places. Concrete historical cases are thus the Aristotelian "matter" which contains potentialities, while the laws and types are the Aristotelian "forms" which actualize the potential. For the Austrians, and especially for Böhm-Bawerk, furthermore, causality and teleology were identical. In contrast to the functional-mutual determination approach of Walras and of contemporary economists, the Austrians traced the causes of economic phenomena back to the wants and choices of consumers. Wieser especially stressed the grounding of economic theory on the inner experience of the mind.[23]

Furthermore, Ludwig M. Lachmann, in contrasting the Austrian and Lausanne Schools, shows that the Austrians were endeavoring to construct a "*verstehende* social science," the same ideal that Max Weber was later to uphold. Lachmann points out that the older Ricardian economists adopted the "objective" method of the natural sciences insofar as their major focus was upon the quantitative problem of income distribution. In their analysis, factors of production (land, labor, and capital goods) react mechanically to external economic changes. But, in contrast, "Austrian theory is 'subjective' also in the sense that individuals . . . perform acts and lend the imprint of their individuality to the events on the market." As for the contrast between Austria and Lausanne

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[23]Emil Kauder, "Intellectual and Political Roots of the Older Austrian School," *Zeitschrift fur Nationalökonomie* 17, no. 4 (1958): 411–25.

> it is the contrast between those [Lausanne] who confine themselves to determining the appropriate magnitudes of the elements of a system (the conditions of equilibrium) and those [the Austrians] who try to explain events in terms of the mental acts of the individuals who fashion them. Most Austrian thinkers were dimly aware of this contrast, but before Hans Mayer, Mises and Hayek were unable to express it concisely. The validity of the Lausanne model is limited to a stationary world. The background of the Austrian theory, by contrast, is a world of continuous change in which plans have to be conceived and continually revised.[24]

We may conclude this sketch of the history of the praxeological tradition in economics by treating an important but much neglected debate on economic methodology which occurred at the turn of the twentieth century between Pareto and the philosopher Benedetto Croce. Croce, from his own highly developed praxeological position, opened the debate by chiding Pareto for having written that economic theory was a species of mechanics. Vigorously rejecting this view, Croce points out that a fact in mechanics is a mere fact, which requires no positive or negative comment; whereas words of approval or disapproval can appropriately be applied to an *economic* fact. The reason is that the true data of economics are not "physical things and objects, but actions. The physical object is merely the brute matter of an economic act."[25] Economic data, then, are acts of man, and these acts are the results of conscious choice.

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[24]English abstract of Ludwig M. Lachmann, "Die geistesgeschichtliche Bedeutung der österreichischen Schule in der Volkswirtschaftslehre," *Zeitschrift für Nationalökonomie* 26, nos. 1–3 (1966): 152–67, in *Journal of Economic Abstracts* 5 (September 1967): 553–54. See also Lachmann, "Methodological Individualism and the Market Economy," in *Roads to Freedom: Essays in Honor of Friedrich A. von Hayek*, E. Streissler, ed. (New York: Augustus M. Kelley, 1969), pp. 89–103; and Israel M. Kirzner, "Methodological Individualism, Market Equilibrium, and Market Process," *Il Politico* 32, no. 4 (December 1967): 787–99.

[25]Benedetto Croce, "On the Economic Principle: I" (1990), *International Economic Papers* 3 (1953): 173, 195. On Croce's views on economics, see Giorgio Tagliacozzo, "Croce and the Nature of Economic Science," *Quarterly Journal of Economics* 59 (May 1945): 307–29. On the Croce-Pareto debate, see Kirzner, *Economic Point of View*, pp. 155–57.

It is of interest that the Walrasian economist Joseph Schumpeter, in his only untranslated work, *Das Wesen und der Hauptinhalt der theoretischen*

In his lengthy reply, Pareto reiterates the similarity between economics and mechanics, and, like the positivists of today, defends unrealistic mechanistic assumptions as simple abstractions from reality, in the supposed manner of the natural sciences. Professing, in a typical positivist gambit, not to "understand" the concept of value, Pareto writes: "I see . . . that you employ the term *value*. . . . I no longer use it as I do not know what it would convey to other people." The concept of value is vague and complex and not subject to measurement; therefore, "the equations of pure economics establish relations between quantities of things, hence objective relations, and not relations between more or less precise concepts of our minds."[26] Criticizing Croce's evident concentration on the essences of economic action, as exemplified in his insistence that "one ought to study not the things which are the result of actions but the actions themselves," Pareto complains that this method is an ancient scientific fallacy. "The ancients conjured up cosmogonies instead of studying astronomy, wondered about the principles of the elements water and fire . . . instead of studying chemistry. Ancient science wanted to proceed from the origin to the facts. Modern science starts from the facts and proceeds towards the origin at an extremely slow pace." Typically, Pareto sets forth the objectivist, positivist position by arguing from the analogy of the method of the natural sciences, thus completely begging the question of whether the methodologies of the natural and the social sciences should or should not be similar. Thus he concludes that "science proceeds by replacing the relationships between human concepts (which relationships are the first to occur to us) by relationships between things."[27]

Croce replies by criticizing Pareto's restriction of economics to measurable quantities as arbitrary; for what of those economic

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*Nationalökonomie* (Leipzig: Duncker and Humblot, 1908), specifically declared that the economist must only treat changes in "economic quantities" as if they were caused automatically, without reference to the human beings who may have been involved in such changes. In that way, causality and purpose would be replaced in economic theory by functional, mathematical relationships. See Kirzner, *Economic Point of View*, pp. 68–70.

[26]Vilfredo Pareto, "On the Economic Phenomenon" (1900), *International Economic Papers* 3(1953): 187.

[27]Ibid., pp. 190, 196.

situations where the objects of action or exchange are not measurable? Croce suggests that it is Pareto who is really being metaphysical, while Croce is the true empiricist. For "your implied metaphysical postulate is . . . this: that the facts of man's activity are of the same nature as physical facts; that in the one case as in the other we can only observe regularity and deduce consequences therefrom, without ever penetrating into the inner nature of the facts. . . . How would you defend this postulate of yours except by a metaphysical monism?" In contrast, writes Croce, "I hold to experience. This testifies to me of the fundamental distinction between external and internal, between physical and mental, between mechanics and teleology, between passivity and activity." As for value, it is really a simple term wrapped up in human activity: "Value is observed immediately in ourselves, in our consciousness."[28]

In his rejoinder, Pareto begins with a typical example of metaphysical obtuseness: He does *not* believe that "the facts of man's activity are of the same nature as physical facts" because he doesn't know what "nature" may be. He goes on to reiterate various examples from physical science to demonstrate the proper methodology for all disciplines. He wishes to follow the "masters of positive science" rather than mere philosophers. Pareto concludes with a concise summation of the differences between the two men and the two methodologies:

> We experimentalists . . . accept hypotheses not for any intrinsic value they may have but only in so far as they yield deductions which are in harmony with the facts. You, considering the nature of things independently from the rest, establish a certain proposition A, and from it come down to the concrete facts B. We may accept proposition A, but only as a hypothesis, therefore making not the slightest attempt to prove it. . . . Then we see what can be deduced from it. If those deductions agree with the facts we accept the hypothesis, for the time being of course, because we hold nothing as final or absolute.[29]

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[28]Croce, "On the Economic Principle II" (1901), *International Economic Papers* 3 (1953): 198–99.

[29]Pareto, "On the Economic Principle" (1901), *International Economic Papers* 3 (1953): 206.

## Methodological Individualism

Only an individual has a mind; only an individual can feel, see, sense, and perceive; only an individual can adopt values or make choices; only an individual can *act*. This primordial principle of "methodological individualism," central to Max Weber's social thought, must underlie praxeology as well as the other sciences of human action. It implies that such collective concepts as groups, nations, and states do not actually exist or act; they are only metaphorical constructs for describing the similar or concerted actions of individuals. There are, in short, no "governments" as such; there are only individuals acting in concert in a "governmental" manner. Max Weber puts it clearly:

> These collectivities must be treated as solely the resultants and modes of organization of the particular acts of individual persons, since these alone can be treated as agents in a course of subjectively understandable action. . . . For sociological purposes . . . there is no such thing as a collective personality which "acts." When reference is made in a sociological context to . . . collectivities, what is meant is . . . *only* a certain kind of development of actual or possible social actions of the individual persons.[30]

Ludwig von Mises points out that what differentiates purely individual action from that of individuals acting as members of a collective is the different *meaning* attached by the people involved.

> It is the meaning which the acting individuals and all those who are touched by their action attribute to an action, that determines its character. It is the meaning that marks one action as the action of the state or of the municipality. The hangman, not the state, executes a criminal. It is the meaning of those concerned that discerns in the hangman's action an action of the state. A group of armed

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[30]Max Weber, *The Theory of Social and Economic Organization* (Glencoe, Ill.: The Free Press, 1957), quoted in Alfred Schütz, *The Phenomenology of the Social World* (Evanston, Ill.: Northwestern University Press, 1967), p. 199. For an application of methodological individualism to foreign policy, see Parker T. Moon, *Imperialism and World Politics* (New York: Macmillan, 1930), p. 58. For a more general political application, see Frank Chodorov, "Society Are People," in *The Rise and Fall of Society* (New York: Devin-Adair, 1959), pp. 29–37.

> men occupies a place. It is the meaning of those concerned which imputes this occupation not to the officers and soldiers on the spot, but to their nation.[31]

In his important methodological work, Mises's disciple F.A. Hayek has demonstrated that the fallacy of treating collective constructs as directly perceived "social wholes" ("capitalism," "the nation," "the class") about which laws can be discovered stems from the objectivist-behaviorist insistence on treating men from the outside, as if they were stones, rather than attempting to understand their subjectively determined actions.

> It [the objectivist view] treats social phenomena not as something of which the human mind is a part and the principles of whose organization we can construct from the familiar parts, but as if they were objects directly perceived by us as wholes. . . .
>
> There is the rather vague idea that since "social phenomena" are to be the object of study, the obvious procedure is to start from the direct observation of these "social phenomena," where the existence in popular usage of such terms as "society" or "economy" is naively taken as evidence that there must be definite "objects" corresponding to them.[32]

Hayek adds that emphasis on the meaning of the individual act brings out that, "what of social complexes is directly known to us are only the parts and that the whole is never directly perceived but always reconstructed by an effort of our imagination."[33]

Alfred Schütz, the outstanding developer of the phenomenological method in the social sciences, has reminded us of the importance of going back "to the 'forgotten man' of the social sciences, to the actor in the social world whose doing and feeling lies at the bottom of the whole system. We, then, try to understand him in that doing and feeling and the state of mind which induced him to adopt specific attitudes towards his social environment." Schütz adds that "for a theory of action the subjective point of view must be retained in its fullest strength, in default of which such a theory loses its basic foundations, namely its reference to the social world of everyday life and

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[31]Mises, *Human Action*, p. 42.

[32]Hayek, *Counter-Revolution of Science*, pp. 53–54.

[33]Ibid., p. 214.

experience." Lacking such a foundation, social science is likely to replace the "world of social reality" by a fictional nonexisting world constructed by the scientific observer. Or, as Schütz puts it succinctly: "I cannot understand a social thing without reducing it to human activity which has created it, and beyond it, without referring this human activity to the motives out of which it springs."[34]

Arnold W. Green has recently demonstrated how the use of invalid collective concepts has damaged the discipline of sociology. He notes the increasing use of "society" as an entity which thinks, feels, and acts, and, in recent years, has functioned as the perpetrator of all social ills. "Society," for example, and not the criminal, is often held to be responsible for all crime. In many quarters "society" is considered almost demonic, a "reified villain" which "may be attacked at will, blamed at random, derided and mocked with self-righteous fury, [and] may even be overturned by fiat or utopian yearning—and somehow, in some way, buses will still run on time." Green adds that "if on the other hand, society is viewed as people whose insecure social relationships are preserved only by the fealty paid their common store of moral rules, then the area of free choice available in which with impunity to demand, undermine, and wreck, is sharply restricted." Moreover, if we realize that "society" does not itself exist, but is made up only of individual people, then to say that "society is responsible for crime, and criminals are not responsible for crime, is to say that only those members of society who do not commit crime can be held responsible for crime. Nonsense this obvious can be circumvented only by conjuring up society as devil, as evil being apart from people and what they do."[35]

Economics has been rife with fallacies that arise when collective social metaphors are treated as if they were existent objects. Thus, during the era of the gold standard there was occasionally great alarm that "England" or "France" was in mortal danger because "it" was losing gold. What actually happened was that English*men* and French*men* were voluntarily shipping gold overseas and thus threatening the people who ran the banks of those countries with the

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[34]Schütz, *Collected Papers*, vol. 2, pp. 7, 8, 10.

[35]Arnold W. Green, "The Reified Villain," *Social Research* 35 (Winter, 1968): 656, 664. On the concept of "society," see also Mises, *Theory and History*, pp. 250ff.

necessity of meeting obligations to pay in gold which they could not possibly fulfill. But the use of the collective metaphor converted a grave problem of banking into a vague national crisis for which every citizen was somehow responsible.

Similarly, during the 1930s and 1940s many economists proclaimed that in contrast to debts owed overseas, the size of the domestic public debt was unimportant because "we only owe it to ourselves." The implication was that the collective national person owed "himself" money from one pocket to another. This explanation obscured the fact that it makes a substantial difference for every person whether he is a member of the "we" or the "ourselves."

Sometimes the collective concept is treated unabashedly as a biological organism. Thus, the popular concept of economic growth implies that every economy is somehow destined, in the manner of a living organism, to "grow" in some predetermined manner. The use of such analogical terms is an attempt to overlook or even negate individual will and consciousness in social and economic affairs. As Edith Penrose has written in a critique of the use of the "growth" concept in the study of business firms:

> Where explicit biological analogies crop up in economics they are drawn exclusively from that aspect of biology which deals with the unmotivated behavior of organisms . . . have no reason whatever for thinking that the growth pattern of a biological organism is willed by the organism itself. On the other hand, we have every reason for thinking that the growth of a firm is willed by those who make the decisions of the firm . . . and the proof of this lies in the fact that no one can describe the development of any given firm . . . except in terms of decisions taken by individual men.[36]

There is no better summary of the nature of praxeology and the role of economic theory in relation to concrete historical events than in Alfred Schütz's discussion of the economic methodology of Ludwig von Mises:

> No economic act is conceivable without some reference to an economic actor, but the latter is absolutely anonymous; it is not you,

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[36]Edith Tilton Penrose, "Biological Analogies in the *Theory of the Firm*," *American Economic Review* (December 1952): 808.

nor I, nor an entrepreneur, nor even an "economic man" as such, but a pure universal "one." This is the reason why the propositions of theoretical economics have just that "universal validity" which gives them the ideality of the "and so forth" and "I can do it again." However, one can study the economic actor as such and try to find out what is going on in his mind; of course, one is not then engaged in theoretical economics but in economic history or economic sociology. . . . However, the statements of these sciences can claim no universal validity, for they deal either with the economic sentiments of particular historical individuals or with types of economic activity for which the economic acts in question are evidence. . . .

In our view, pure economics is a perfect example of an objective meaning-complex about subjective meaning—complexes, in other words, of an objective meaning—configuration stipulating the typical and invariant subjective experiences of anyone who acts within an economic framework. . . . Excluded from such a scheme would have to be any consideration of the uses to which the "goods" are to be put after they are acquired. But once we do turn our attention to the subjective meaning of a real individual person, leaving the anonymous "anyone" behind, then of course it makes sense to speak of behavior that is atypical. . . . To be sure, such behavior is irrelevant from the point of view of economics, and it is in this sense that economic principles are, in Mises's words, "not a statement of what usually happens, but of what necessarily must happen."[37]

[37]Schütz, *Phenomenology of the Social World*, pp. 137, 245.

# 4

# Praxeology: The Methodology of Austrian Economics

Praxeology is the distinctive methodology of the Austrian School. The term was first applied to the Austrian method by Ludwig von Mises, who was not only the major architect and elaborator of this methodology but also the economist who most fully and successfully applied it to the construction of economic theory.[1] While the praxeological method is, to say the least, out of fashion in contemporary economics—as well as in social science generally and in the philosophy of science—it was the basic method of the earlier Austrian School and also of a considerable segment of the older Classical School, in particular of J.B. Say and Nassau W. Senior.[2]

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Originally appeared in *The Foundations of Modern Austrian Economics*, Edwin Dolan, ed. (Kansas City: Sheed and Ward, 1976), pp. 19–39.

[1]See in particular Ludwig von Mises, *Human Action: A Treatise on Economics* (New Haven, Conn.: Yale University Press, 1949); also see Mises, *Epistemological Problems of Economics*, George Reisman, trans. (Princeton, N.J.: D. Van Nostrand, 1960).

[2]See Murray N. Rothbard, "Praxeology as the Method of the Social Sciences," in *Phenomenology and the Social Sciences*, Maurice Natanson, ed., 2 vols. (Evanston, Ill.: Northwestern University Press, 1973), vol. 2, pp. 323–35; reprinted in this volume as chapter 3; also see Marian Bowley, *Nassau Senior and Classical Economics* (New York: Augustus M. Kelley, 1949), pp. 27–65; and Terence W. Hutchinson, "Some Themes from Investigations into Method," in *Carl Menger and the Austrian School of Economics*, J.R. Hicks and Wilhelm Weber, eds. (Oxford: Clarendon Press, 1973), pp. 15–31.

Praxeology rests on the fundamental axiom that individual human beings act, that is, on the primordial fact that individuals engage in conscious actions toward chosen goals. This concept of action contrasts to purely *reflexive*, or knee-jerk, behavior, which is not directed toward goals. The praxeological method spins out by verbal deduction the logical implications of that primordial fact. In short, praxeological economics is the structure of logical implications of the *fact* that individuals act. This structure is built on the fundamental axiom of action, and has a few subsidiary axioms, such as that individuals vary and that human beings regard leisure as a valuable good. Any skeptic about deducing from such a simple base an entire system of economics, I refer to Mises's *Human Action*. Furthermore, since praxeology begins with a true axiom, A, all the propositions that can be deduced from this axiom must also be true. For if A implies B, and A is true, then B must also be true.

Let us consider some of the immediate implications of the action axiom. Action implies that the individual's behavior is purposive, in short, that it is directed toward goals. Furthermore, the fact of his action implies that he has consciously chosen certain means to reach his goals. Since he wishes to attain these goals, they must be valuable to him; accordingly he must have values that govern his choices. That he employs means implies that he believes he has the technological knowledge that certain means will achieve his desired ends. Let us note that praxeology does not assume that a person's choice of values or goals is wise or proper or that he has chosen the technologically correct method of reaching them. All that praxeology asserts is that the individual actor adopts goals and believes, whether erroneously or correctly, that he can arrive at them by the employment of certain means.

All action in the real world, furthermore, must take place through time; all action takes place in some present and is directed toward the future (immediate or remote) attainment of an end. If all of a person's desires could be instantaneously realized, there would be no reason for him to act at all.[3] Furthermore, that a man acts implies

[3]In answer to the criticism that not all action is directed to some future point in time, see Walter Block, "A Comment on 'The Extraordinary Claim of Praxeology' by Professor Gutierrez," *Theory and Decision* 3 (1973): 381–82.

that he believes action will make a difference; in other words, that he will prefer the state of affairs resulting from action to that from no action. Action therefore implies that man does not have omniscient knowledge of the future; for if he had such knowledge, no action of his would make any difference. Hence, action implies that we live in a world of an uncertain, or not fully certain, future. Accordingly, we may amend our analysis of action to say that a man chooses to employ means according to a technological plan in the present because he expects to arrive at his goals at some future time.

The fact that people act necessarily implies that the means employed are scarce in relation to the desired ends; for, if all means were not scarce but superabundant, the ends would already have been attained, and there would be no need for action. Stated another way, resources that are superabundant no longer function as means, because they are no longer objects of action. Thus, air is indispensable to life and hence to the attainment of goals; however, air being superabundant is not an object of action and therefore cannot be considered a *means*, but rather what Mises called a "general condition of human welfare." Where air is not superabundant, it may become an object of action, for example, where cool air is desired and warm air is transformed through air conditioning. Even with the absurdly unlikely advent of Eden (or what a few years ago was considered in some quarters to be an imminent "postscarcity" world), in which all desires could be fulfilled instantaneously, there would still be at least one scarce means: the individual's time, each unit of which if allocated to one purpose is necessarily not allocated to some other goal.[4]

Such are some of the immediate implications of the axiom of action. We arrived at them by deducing the logical implications of the existing fact of human action, and hence deduced true conclusions from a true axiom. Apart from the fact that these conclusions cannot be "tested" by historical or statistical means, there is no need to test them since their truth has already been established. Historical fact enters into these conclusions only by determining which branch of the theory is applicable in any particular case. Thus, for Crusoe and

[4]See Mises, *Human Action*, pp. 101–02; and esp., Block, "Comment," p. 383.

Friday on their desert island, the praxeological theory of money is only of academic, rather than of currently applicable, interest. A fuller analysis of the relationship between theory and history in the praxeological framework will be considered below.

There are, then, two parts of this axiomatic-deductive method: the process of deduction and the epistemological status of the axioms themselves. First, there is the process of deduction; why are the means verbal rather than mathematical logic?[5] Without setting forth the comprehensive Austrian case against mathematical economics, one point can immediately be made: let the reader take the implications of the concept of action as developed so far in this paper and try to place them in mathematical form. And even if that could be done, what would have been accomplished except a drastic loss in meaning at each step of the deductive process? Mathematical logic is appropriate to physics—the science that has become the model science, which modern positivists and empiricists believe all other social and physical sciences should emulate. In physics the axioms and therefore the deductions are in themselves purely formal and only acquire meaning "operationally" insofar as they can explain and predict given facts. On the contrary, in praxeology, in the analysis of human action, the axioms themselves are known to be true and meaningful. As a result, each verbal step-by-step deduction is also true and meaningful; for it is the great quality of verbal propositions that each one is meaningful, whereas mathematical symbols are not meaningful in themselves. Thus Lord Keynes, scarcely an Austrian and himself a mathematician of note, leveled the following critique at mathematical symbolism in economics:

> It is a great fault of symbolic pseudo-mathematical methods of formalizing a system of economic analysis, that they expressly assume strict independence between the factors involved and lose all their cogency and authority if this hypothesis is disallowed: whereas, in ordinary discourse, where we are not blindly manipulating but know all the time what we are doing and what the words mean, we can keep "at the back of our heads" the necessary reserves and qualifications and the adjustments which we have to make later

[5]For a typical criticism of praxeology for not using mathematical logic, see George. J. Schuller, "Rejoinder," *American Economic Review* 41 (March 1951): 188.

> on, in a way in which we cannot keep complicated partial differentials "at the back" of several pages of algebra which assume that they all vanish. Too large a proportion of recent "mathematical" economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols.[6]

Moreover, even if verbal economics could be successfully translated into mathematical symbols and then retranslated into English so as to explain the conclusions, the process makes no sense and violates the great scientific principle of Occam's Razor: avoiding unnecessary multiplication of entities.[7]

Furthermore, as political scientist Bruno Leoni and mathematician Eugenio Frola pointed out,

> It is often claimed that translation of such a concept as the maximum from ordinary into mathematical language, involves an improvement in the logical accuracy of the concept, as well as wider opportunities for its use. But the lack of mathematical precision in ordinary language reflects precisely the behavior of individual human beings in the real world. . . . We might suspect that translation into mathematical language by itself implies a suggested transformation of human economic operators into virtual robots.[8]

Similarly, one of the first methodologists in economics, Jean-Baptiste Say, charged that the mathematical economists

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[6]John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt, Brace, 1936), pp. 297–98.

[7]See Murray N. Rothbard, "Toward a Reconstruction of Utility and Welfare Economics," in *On Freedom and Free Enterprise*, Mary Sennholz, ed. (Princeton, N.J.: D. Van Nostrand, 1956), p. 227; reprinted in this volume as chapter 17; Rothbard, *Man, Economy, and State*, 2 vols. (Princeton, N.J.: D. Van Nostrand, 1962), vol. 1, pp. 65–66. On mathematical logic as being subordinate to verbal logic, see René Poirier, "Logique," in *Vocabulaire technique et critique de la philosophie*, André Lalande, ed., 6th ed. rev. (Paris: Presses Universitaires de France, 1951), pp. 574–75.

[8]Bruno Leoni and Eugenio Frola, "On Mathematical Thinking in Economics" (unpublished manuscript privately distributed), pp. 23–24; the Italian version of this article is "Possibilita di applicazione della matematiche alle discipline economiche," *Il Politico* 20 (1995).

> have not been able to enunciate these questions into analytical language, without divesting them of their natural complication, by means of simplifications, and arbitrary suppressions, of which the consequences, not properly estimated, always essentially change the condition of the problem, and pervert all its results.[9]

More recently, Boris Ischboldin has emphasized the difference between verbal, or "language," logic ("the actual analysis of thought stated in language expressive of reality as grasped in common experience") and "construct" logic, which is "the application to quantitative (economic) data of the constructs of mathematics and symbolic logic which constructs may or may not have real equivalents."[10]

Although himself a mathematical economist, the mathematician son of Carl Menger wrote a trenchant critique of the idea that mathematical presentation in economics is necessarily more precise than ordinary language:

> Consider, for example, the statements (2) *To a higher price of a good, there corresponds a lower (or at any rate not a higher) demand.*
>
> (2') *If p denotes the price of, and q the demand for, a good, then*
>
> $$q = f(p) \text{ and } \frac{dq}{dp} = f'(p) \leq 0.$$
>
> Those who regard the formula (2') as more precise or "more mathematical" than the sentence (2) are under a complete misapprehension. . . . The only difference between (2) and (2') is this: since (2') is limited to functions which are differentiable and whose graphs, therefore, have tangents (which from an economic point of view are not more plausible than curvature), the sentence (2) is *more general, but it is by no means less precise: it is of the same mathematical precision as* (2').[11]

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[9]Jean-Baptiste Say, *A Treatise on Political Economy* (New York: Augustus M. Kelley, 1964), p. xxvi*n*.

[10]Boris Ischboldin, "a Critique of Econometrics," *Review of Social Economy* 18, no. 2 (September 1960): 11n; Ischboldin's discussion is based on the construction of I.M. Bochenski, "Scholastic and Aristotelian Logic," *Proceedings of the American Catholic Philosophical Association* 30 (1956): 112–17.

[11]Karl Menger, "Austrian Marginalism and Mathematical Economics," in *Carl Menger*, p. 41.

Turning from the deduction process to the axioms themselves, what is their epistemological status? Here the problems are obscured by a difference of opinion within the praxeological camp, particularly on the nature of the fundamental axiom of action. Ludwig von Mises, as an adherent of Kantian epistemology, asserted that the concept of action is *a priori* to all experience, because it is, like the law of cause and effect, part of "the essential and necessary character of the logical structure of the human mind."[12] Without delving too deeply into the murky waters of epistemology, I would deny, as an Aristotelian and neo-Thomist, any such alleged "laws of logical structure" that the human mind necessarily imposes on the chaotic structure of reality. Instead, I would call all such laws "laws of reality," which the mind apprehends from investigating and collating the facts of the real world. My view is that the fundamental axiom and subsidiary axioms are derived from the experience of reality and are therefore in the broadest sense empirical. I would agree with the Aristotelian realist view that its doctrine is radically empirical, far more so than the post-Humean empiricism which is dominant in modern philosophy. Thus, John Wild wrote:

> It is impossible to reduce experience to a set of isolated impressions and atomic units. Relational structure is also given with equal evidence and certainty. The immediate data are full of determinate structure, which is easily abstracted by the mind and grasped as universal essences or possibilities.[13]

Furthermore, one of the pervasive data of all human experience is existence; another is consciousness, or awareness. In contrast to the Kantian view, Harmon Chapman wrote that

> conception is a kind of awareness, a way of apprehending things or comprehending them and not an alleged subjective manipulation of so-called generalities or universals solely "mental" or "logical" in their provenience and non-cognitive in nature.
>
> That in thus penetrating the data of sense, conception also synthesizes these data is evident. But the synthesis here involved,

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[12]Mises, *Human Action*, p. 34.

[13]John Wild, "Phenomenology and Metaphysics," in *The Return to Reason: Essays in Realistic Philosophy*, John Wild, ed. (Chicago: Henry Regnery, 1953), pp. 48, 37–57.

> unlike the synthesis of Kant, is not a prior condition of perception, an anterior process of constituting both perception and its object, but rather a cognitive synthesis *in* apprehension, that is, a uniting or "comprehending" which is one with the apprehending itself. In other words, perception and experience are not the results or end products of a synthetic process *a priori*, but are themselves synthetic or comprehensive apprehension whose structured unity is prescribed solely by the nature of the real, that is, by the intended objects in their togetherness and not by consciousness itself whose (cognitive) nature is to apprehend the real—as it is.[14]

If, in the broad sense, the axioms of praxeology are radically empirical, they are far from the post-Humean empiricism that pervades the modern methodology of social science. In addition to the foregoing considerations, (1) they are so broadly based in common human experience that once enunciated they become self-evident and hence do not meet the fashionable criterion of "falsifiability"; (2) they rest, particularly the action axiom, on universal *inner* experience, as well as on external experience, that is, the evidence is *reflective* rather than purely physical; and (3) they are therefore *a priori* to the complex historical events to which modern empiricism confines the concept of "experience."[15]

Say, perhaps the first praxeologist, explained the derivation of the axioms of economic theory as follows:

> Hence the advantage enjoyed by everyone who, from distinct and accurate observation, can establish the existence of these general facts, demonstrate their connection and deduce their consequences. They as certainly proceed from the nature of things as the laws of the material world. We do not imagine them; they are results disclosed to us by judicious observation and analysis. . . .
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> Political economy . . . is composed of a few fundamental principles, and of a great number of corollaries or conclusions, drawn

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[14]Harmon M. Chapman, "Realism and Phenomenology," in *Return to Reason*, p. 29. On the interrelated functions of sense and reason and their respective roles in human cognition of reality, see Francis H. Parker, "Realistic Epistemology," ibid., pp. 167–69.

[15]See Murray N. Rothbard, "In Defense of 'Extreme Apriorism,'" *Southern Economic Journal* 23 (January 1957): 315–18; included in this volume as chapter 6. It should be clear from the current paper that the term extreme apriorism is a misnomer for praxeology.

> from these principles . . . that can be admitted by every reflecting mind.[16]

Friedrich A. Hayek trenchantly described the praxeological method in contrast to the methodology of the physical sciences and also underlined the broadly empirical nature of the praxeological axioms:

> The position of man . . . brings it about that the essential basic facts which we need for the explanation of social phenomena are part of common experience, part of the stuff of our thinking. In the social sciences it is the elements of the complex phenomena which are known beyond the possibility of dispute. In the natural sciences they can only be at best surmised. The existence of these elements is so much more certain than any regularities in the complex phenomena to which they give rise, that it is they which constitute the truly empirical factor in the social sciences. There can be little doubt that it is this different position of the empirical factor in the process of reasoning in the two groups of disciplines which is at the root of much of the confusion with regard to their logical character. The essential difference is that in the natural sciences the process of deduction has to start from some hypothesis which is the result of inductive generalizations, while in the social sciences it starts directly from known empirical elements and uses them to find the regularities in the complex phenomena which direct observations cannot establish. They are, so to speak, empirically deductive sciences, proceeding from the known elements to the regularities in the complex phenomena which cannot be directly established.[17]

Similarly, J.E. Cairnes wrote:

> *The economist starts with a knowledge of ultimate causes*. He is already, at the outset of his enterprise in the position which the physicist only attains after ages of laborious research. . . . For the discovery of such premises no elaborate process of induction is needed . . . for this reason, that we have, or may have if we choose to turn our attention to the subject, direct knowledge of these causes in our consciousness of what passes in our own minds, and

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[16]Say, *A Treatise on Political Economy*, pp. xxv–xxvi, xlv.

[17]Friedrich A. Hayek, "The Nature and History of the Problem," in *Collectivist Economic Planning*, F.A. Hayek, ed. (London: George Routledge and Sons, 1935), p 11.

> in the information which our senses convey . . . to us of external facts.[18]

Nassau W. Senior phrased it thus:

> The physical sciences, being only secondarily conversant with mind, draw their premises almost exclusively from observation or hypothesis. . . . On the other hand, the mental sciences and the mental arts draw their premises principally from consciousness. The subjects with which they are chiefly conversant are the workings of the human mind. [These premises are] a very few general propositions, which are the result of observation, or consciousness, and which almost every man, as soon as he hears them, admits, as familiar to his thought, or at least, included in his previous knowledge.[19]

Commenting on his complete agreement with this passage, Mises wrote that these "immediately evident propositions" are "of aprioristic derivation . . . unless one wishes to call aprioristic cognition inner experience."[20] To which Marian Bowley, the biographer of Senior, justly comments:

> The only fundamental difference between Mises's general attitude and Senior's lies in Mises's apparent denial of the possibility of using any general empirical data, i.e., facts of general observation, as initial premises. This difference, however, turns upon Mises's basic ideas of the nature of thought, and though of general philosophic importance, has little special relevance to economic method as such.[21]

It should be noted that for Mises it is only the fundamental axiom of action that is *a priori*; he conceded that the subsidiary axioms of the diversity of mankind and nature, and of leisure as a consumers' good, are broadly empirical.

Modern post-Kantian philosophy has had a great deal of trouble encompassing self-evident propositions, which are marked precisely

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[18]John Elliott Cairnes, *The Character and Logical Method of Political Economy*, 2nd ed. (London: Macmillan, 1875), pp. 87–88; italics in the original.

[19]Bowley, *Nassau Senior*, pp. 43, 56.

[20]Mises, *Epistemological Problems*, p. 19.

[21]Bowley, *Nassau Senior*, pp. 64–65.

by their strong and evident truth rather than by being testable hypotheses, that are, in the current fashion, considered to be "falsifiable." Sometimes it seems that the empiricists use the fashionable analytic-synthetic dichotomy, as the philosopher Hao Wang charged, to dispose of theories they find difficult to refute by dismissing them as necessarily *either* disguised definitions *or* debatable and uncertain hypotheses.[22] But what if we subject the vaunted "evidence" of modern positivists and empiricists to analysis? What is it? We find that there are two types of such evidence to either confirm or refute a proposition: (1) if it violates the laws of logic, for example, implies that A = –A; or (2) if it is confirmed by empirical facts (as in a laboratory) that can be checked by many persons. But what is the nature of such "evidence" but the bringing, by various means, of propositions hitherto cloudy and obscure into clear and evident view, that is, evident to the scientific observers? In short, logical or laboratory processes serve to make it evident to the"selves" of the various observers that the propositions are either confirmed or refuted, or, to use unfashionable terminology, either true or false. But in that case propositions that are *immediately* evident to the selves of the observers have at least as good scientific status as the other and currently more acceptable forms of evidence. Or, as the Thomist philosopher John J. Toohey put it,

> *Proving* means *making evident* something which is not evident. If a truth or proposition is self-evident, it is useless to attempt to prove it; to attempt to prove it would be to attempt to make evident something which is already evident.[23]

The action axiom, in particular, should be, according to Aristotelian philosophy, unchallengeable and self-evident since the critic who attempts to refute it finds that he must use it in the process of alleged refutation. Thus, the axiom of the existence of human consciousness is demonstrated as being self-evident by the fact that the

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[22]Hao Wang, "Notes on the Analytic-Synthetic Distinction," *Theoria* 21 (1995); 158; see also John Wild and J.L. Cobitz, "On the Distinction between the Analytic and Synthetic," *Philosophy and Phenomenological Research* 8 (June 1948): 651–67.

[23]John J. Toohey, *Notes on Epistemology*, rev. ed. (Washington, D.C.: Georgetown University, 1937), p. 36; italics in the original.

very act of denying the existence of consciousness must itself be performed by a conscious being. The philosopher R.P. Phillips called this attribute of a self-evident axiom a "boomerang principle," since "even though we cast it away from us, it returns to us again."[24] A similar self-contradiction faces the man who attempts to refute the axiom of human action. For in doing so, he is *ipso facto* a person making a conscious choice of means in attempting to arrive at an adopted end: in this case the end, or goal, of trying to refute the axiom of action. He employs action in trying to refute the notion of action.

Of course, a person may *say* that he denies the existence of self-evident principles or other established truths of the real world, but this mere saying has no epistemological validity. As Toohey pointed out,

> A man may *say* anything he pleases, but he cannot *think* or *do* anything he pleases. He may say he saw a round square, but he cannot *think* he saw a round square. He may say, if he likes, that he saw a horse riding astride its own back, but we shall know what to think of him if he says it.[25]

The methodology of modern positivism and empiricism comes a cropper even in the physical sciences, to which it is much better suited than to the sciences of human action; indeed, it particularly fails where the two types of disciplines interconnect. Thus, the phenomenologist Alfred Schütz, a student of Mises at Vienna, who pioneered in applying phenomenology to the social sciences, pointed out the contradiction in the empiricists' insistence on the principle of empirical verifiability in science, while at the same time denying the existence of "other minds" as unverifiable. But *who* is supposed to be doing the laboratory verification if not these selfsame "other minds" of the assembled scientists? Schütz wrote:

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[24]R.P. Phillips, *Modern Thomistic Philosophy* (Westminster, Maryland: Newman Bookshop, 1934–35), vol. 2, pp. 36–37; see also Murray N. Rothbard, "The Mantle of Science," in *Scientism and Values*, Helmut Schoeck and James W. Wiggins, eds. (Princeton, N.J.: D. Van Nostrand, 1960), pp. 162–65; included in this volume as chapter 1.

[25]Toohey, *Notes on Epistemology*, p. 10; italics in the original.

> It is . . . not understandable that the same authors who are convinced that no verification is possible for the intelligence of other human beings have such confidence in the principle of verifiability itself, which can be realized only through cooperation with others.[26]

In this way, the modern empiricists ignore the necessary presuppositions of the very scientific method they champion. For Schütz, knowledge of such presuppositions is "empirical" in the broadest sense,

> provided that we do not restrict this term to sensory perceptions of objects and events in the outer world but include the experiential form, by which common-sense thinking in everyday life understands human actions and their outcome in terms of their underlying motives and goals.[27]

Having dealt with the nature of praxeology, its procedures and axioms and its philosophical groundwork, let us now consider what the relationship is between praxeology and the other disciplines that study human action. In particular, what are the differences between praxeology and technology, psychology, history, and ethics—all of which are in some way concerned with human action?

In brief, *praxeology* consists of the logical implications of the universal formal fact that people act, that they employ means to try to attain chosen ends. *Technology* deals with the contentual problem of *how* to achieve ends by adoption of means. *Psychology* deals with the question of *why* people adopt various ends and how they go about adopting them. *Ethics* deals with the question of what ends, or values,

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[26]Alfred Schütz, *Collected Papers of Alfred Schütz*, vol. 2: *Studies in Social Theory*, A. Brodersen, ed. (The Hague: Nijhoff, 1964), p. 4; see also Mises, *Human Action*, p. 24.

[27]Alfred Schütz, *Collected Papers of Alfred Schütz*, vol. 1: *The Problem of Social Reality*, Maurice Natanson, ed. (The Hague: Nijhoff, 1962), p. 65. On the philosophical presuppositions of science, see Andrew G. Van Melsen, *The Philosophy of Nature* (Pittsburgh, Penn.: Duquesne University Press, 1953), pp. 6–29. On common sense as the groundwork of philosophy, see Toohey, *Notes on Epistemology*, pp. 74, 106–13. On the application of a similar point of view to the methodology of economics, see Frank H. Knight, "'What is Truth' in Economics," in *On the History and Method of Economics* (Chicago: University of Chicago Press, 1956), pp. 151–78.

people *should* adopt. And *history* deals with ends adopted in the past, what means were used to try to achieve them—and what the consequences of these actions were.

Praxeology, or economic theory in particular, is thus a unique discipline within the social sciences; for, in contrast to the others, it deals not with the *content* of men's values, goals, and actions—not with what they have done or how they have acted or how they should act—but purely with the fact that they *do* have goals and act to attain them. The laws of utility, demand, supply, and price apply regardless of the type of goods and services desired or produced. As Joseph Dorfman wrote of Herbert J. Davenport's *Outlines of Economic Theory* (1896):

> The ethical character of the desires was not a fundamental part of his inquiry. Men labored and underwent privation for "whiskey, cigars, and burglars' jimmies," he said, "as well as for food, or statuary or harvest machinery." As long as men were willing to buy and sell "foolishness and evil," the former commodities would be economic factors with market standing, for utility, as an economic term, meant merely adaptability to human desires. So long as men desired them, they satisfied a need and were motives to production. Therefore economics did not need to investigate the origin of choices.[28]

Praxeology, as well as the sound aspects of the other social sciences, rests on methodological individualism, on the fact that only individuals feel, value, think, and act. Individualism has always been charged by its critics—and always incorrectly—with the assumption that each individual is a hermetically sealed "atom," cut off from, and uninfluenced by, other persons. This absurd misreading of methodological individualism is at the root of J.K. Galbraith's triumphant demonstration in *The Affluent Society* (Boston: Houghton Mifflin, 1958) that the values and choices of individuals are influenced by other persons, and therefore—supposedly—that economic theory is invalid. Galbraith also concluded from his demonstration that these choices, because influenced, are artificial and illegitimate. The fact that praxeological economic theory rests on the universal fact of individual values and choices means, to repeat Dorfman's summary

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[28]Joseph Dorfman, *The Economic Mind in American Civilization*, 5 vols. (New York: Viking Press, 1949), vol. 3, p. 376.

of Davenport's thought, that economic theory does "not need to investigate the origin of choices." Economic theory is not based on the absurd assumption that each individual arrives at his values and choices in a vacuum, sealed off from human influence. Obviously, individuals are continually learning from and influencing each other. As F.A. Hayek wrote in his justly famous critique of Galbraith, "The Non Sequitur of the 'Dependence Effect'":

> Professor Galbraith's argument could be easily employed, without any change of the essential terms, to demonstrate the worthlessness of literature or any other form of art. Surely an individual's want for literature is not original with himself in the sense that he would experience it if literature were not produced. Does this then mean that the production of literature cannot be defended as satisfying a want because it is only the production which provokes the demand?[29]

That Austrian-School economics rests firmly from the beginning on an analysis of the fact of individual subjective values and choices unfortunately led the early Austrians to adopt the term *psychological school*. The result was a series of misdirected criticisms that the latest findings of psychology had not been incorporated into economic theory. It also led to misconceptions such as that the law of diminishing marginal utility rests on some psychological law of the satiety of wants. Actually, as Mises firmly pointed out, that law is praxeological rather than psychological and has nothing to do with the *content* of wants, for example, that the tenth spoonful of ice cream may taste less pleasurable than the ninth spoonful. Instead, it is a praxeological truth, derived from the nature of action, that the first unit of a good will be allocated to its most valuable use, the next unit to the next most valuable, and so on.[30] On one point, and on one point alone, however, praxeology and the related sciences of human action take a stand in philosophical psychology: on the proposition that the human mind, consciousness, and subjectivity exist, and therefore action exists. In this it is opposed to the philosophical base of behaviorism and related doctrines and joined with all branches of classical

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[29]Friedrich A. Hayek, "The Non Sequitur of the 'Dependence Effect,'" in Friedrich A. Hayek, *Studies in Philosophy, Politics, and Economics* (Chicago: University of Chicago Press, 1967), pp. 314–15.

[30]Mises, *Human Action*, p. 124.

philosophy and with phenomenology. On all other questions, however, praxeology and psychology are distinct and separate disciplines.[31]

A particularly vital question is the relationship between economic theory and history. Here again, as in so many other areas of Austrian economics, Ludwig von Mises made the outstanding contribution, particularly in his *Theory and History*.[32] It is especially curious that Mises and other praxeologists, as alleged "a priorists," have commonly been accused of being "opposed" to history. Mises indeed held not only that economic theory does not need to be "tested" by historical fact but also that it *cannot* be so tested. For a fact to be usable for testing theories, it must be a simple fact, homogeneous with other facts in accessible and repeatable classes. In short, the theory that one atom of copper, one atom of sulfur, and four atoms of oxygen will combine to form a recognizable entity called copper sulfate, with known properties, is easily tested in the laboratory. Each of these atoms is homogeneous, and therefore the test is repeatable indefinitely. But each historical event, as Mises pointed out, is not simple and repeatable; each event is a complex resultant of a shifting variety of multiple causes, none of which ever remains in constant relationships with the others. Every historical event, therefore, is heterogeneous, and therefore historical events cannot be used either to test or to construct laws of history, quantitative or otherwise. We can place every atom of copper into a homogeneous class of copper atoms; we cannot do so with the events of human history.

This is not to say, of course, that there are no similarities among historical events. There are many similarities, but no homogeneity. Thus, there were many similarities between the presidential election of 1968 and that of 1972, but they were scarcely homogeneous events, since they were marked by important and inescapable differences. Nor will the next election be a repeatable event to place in a homogeneous class of "elections." Hence no scientific, and certainly no quantitative, laws can be derived from these events.

Mises's radically fundamental opposition to econometrics now becomes clear. Econometrics not only attempts to ape the natural

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[31]See Rothbard, "Toward a Reconstruction," pp. 230–31.

[32]Ludwig von Mises, *Theory and History* (New Haven, Conn.: Yale University Press, 1957).

sciences by using complex heterogeneous historical facts as if they were repeatable homogeneous laboratory facts; it also squeezes the qualitative complexity of each event into a quantitative number and then compounds the fallacy by acting as if these quantitative relations remain constant in human history. In striking contrast to the physical sciences, which rest on the empirical discovery of quantitative constants, econometrics, as Mises repeatedly emphasized, has failed to discover a single constant in human history. And given the ever-changing conditions of human will, knowledge, and values and the differences among men, it is inconceivable that econometrics can ever do so.

Far from being opposed to history, the praxeologist, and not the supposed admirers of history, has profound respect for the irreducible and unique facts of human history. Furthermore, it is the praxeologist who acknowledges that individual human beings cannot legitimately be treated by the social scientist as if they were not men who have minds and act upon their values and expectations, but stones or molecules whose course can be scientifically tracked in alleged constants or quantitative laws. Moreover, as the crowning irony, it is the praxeologist who is truly empirical because he recognizes the unique and heterogeneous nature of historical facts; it is the self-proclaimed "empiricist" who grossly violates the facts of history by attempting to reduce them to quantitative laws. Mises wrote thus about econometricians and other forms of "quantitative economists":

> There are, in the field of economics, no constant relations, and consequently no measurement is possible. If a statistician determines that a rise of 10 percent in the supply of potatoes in Atlantis at a definite time was followed by a fall of 8 percent in the price, he does not establish anything about what happened or may happen with a change in the supply of potatoes in another country or in another time. He has not "measured" the "elasticity of demand" of potatoes. He has established a unique individual historical fact. No intelligent man can doubt that the behavior of men with regard to potatoes and every other commodity is variable. Different individuals value the same things in a different way, and valuations change with the same individuals with changing conditions. . . .
>
> The impracticability of measurement is not due to the lack of technical methods for the establishment of measure. It is due to the absence of constant relations. . . . Economics is not, as . . . positivists repeat again and again, backward because it is not "quantitative."

> It is not quantitative and does not measure because there are no constants. Statistical figures referring to economic events are historical data. They tell us what happened in a nonrepeatable historical case. Physical events can be interpreted on the ground of our knowledge concerning constant relations established by experiments. Historical events are not open to such an interpretation. . . .
>
> Experience of economic history is always experience of complex phenomena. It can never convey knowledge of the kind the experimenter abstracts from a laboratory experiment. Statistics is a method for the presentation of historical facts. . . . The statistics of prices is economic history. The insight that, *ceteris paribus*, an increase in demand must result in an increase in prices is not derived from experience. Nobody ever was or ever will be in a position to observe a change in one of the market data *ceteris paribus*. There is no such thing as quantitative economics. All economic quantities we know about are data of economic history. . . . Nobody is so bold as to maintain that a rise of A percent in the supply of any commodity must always—in every country and at any time—result in a fall of B percent in price. But as no quantitative economist ever ventured to define precisely on the ground of statistical experience the special conditions producing a definite deviation from the ratio A:B, the futility of his endeavors is manifest.[33]

Elaborating on his critique of constants Mises added:

> The quantities we observe in the field of human action . . . are manifestly variable. Changes occurring in them plainly affect the result of our actions. Every quantity that we can observe is a historical event, a fact which cannot be fully described without specifying the time and geographical point.
>
> The econometrician is unable to disprove this fact, which cuts the ground from under his reasoning. He cannot help admitting that there are no "behavior constants." Nonetheless, he wants to introduce some numbers, arbitrarily chosen on the basis of historical fact, as "unknown *behavior constants*." The sole excuse he advances is that his hypotheses are "saying only that these unknown numbers remain reasonably constant through a period of years."[34] Now whether such

[33]Mises, *Human Action*, pp. 55–56, 348.

[34]*Cowles Commission for Research in Economics, Report for the Period, January 1, 1948–June 30, 1949* (Chicago: University of Chicago Press, 1949), p. 7, quoted in Mises, *Theory and History*, pp. 10–11.

> a period of supposed constancy of a definite number is still lasting or whether a change in the number has already occurred can only be established later on. In retrospect it may be possible, although in rare cases only, to declare that over a (probably rather short) period an approximately stable ratio which the econometrician chooses to call a "reasonably" constant ratio prevailed between the numerical values of two factors. But this is something fundamentally different from the constants of physics. It is the assertion of a historical fact, not of a constant that can be resorted to in attempts to predict *future events*.[35] The highly praised equations are, insofar as they apply to the future, merely equations in which all quantities are unknown.[36]
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> In the mathematical treatment of physics the distinction between constants and variables makes sense; it is essential in every instance of technological computation. In economics there are no constant relations between various magnitudes. Consequently all ascertainable data are variables, or what amounts to the same thing, *historical* data. The mathematical economists reiterate that the plight of mathematical economics consists in the fact that there are a great number of variables. The truth is that there are only variables and no constants. It is pointless to talk of variables where there are no invariables.[37]

What, then, is the proper relationship between economic theory and economic history or, more precisely, history in general? The historian's function is to try to explain the unique historical facts that are his province; to do so adequately he must employ all the relevant theories from all the various disciplines that impinge on his problem. For historical facts are complex resultants of a myriad of causes stemming from different aspects of the human condition. Thus, the historian must be prepared to use not only praxeological economic theory but

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[35]Ibid., pp. 10–11.

[36]Ludwig von Mises, "Comments about the Mathematical Treatment of Economic Problems." (Cited as "unpublished manuscript"; published as "The Equations of Mathematical Economics" in the *Quarterly Journal of Austrian Economics* 3, no. 1 (Spring, 2000): 27–32.

[37]Mises, *Theory and History*, pp. 11–12; see also Leoni and Frola, "On Mathematical Thinking," pp. 1–8; and Leland B. Yeager, "Measurement as Scientific Method in Economics," *American Journal of Economics and Sociology* 16 (July 1957): 337–46.

also insights from physics, psychology, technology, and military strategy along with an interpretive understanding of the motives and goals of individuals. He must employ these tools in understanding both the goals of the various actions of history and the consequences of such actions. Because understanding diverse individuals and their interactions is involved, as well as the historical context, the historian using the tools of natural and social science is in the last analysis an "artist," and hence there is no guarantee or even likelihood that any two historians will judge a situation in precisely the same way. While they may agree on an array of factors to explain the genesis and consequences of an event, they are unlikely to agree on the precise weight to be given each causal factor. In employing various scientific theories, they have to make judgments of relevance on which theories applied in any given case; to refer to an example used earlier in this paper, a historian of Robinson Crusoe would hardly employ the theory of money in a historical explanation of his actions on a desert island. To the economic historian, economic law is neither confirmed nor tested by historical facts; instead, the law, where relevant, is applied to help explain the facts. The facts thereby *illustrate* the workings of the law. The relationship between praxeological economic theory and the understanding of economic history was subtly summed up by Alfred Schütz:

> No economic act is conceivable without some reference to an economic actor, but the latter is absolutely anonymous; it is not you, nor I nor an entrepreneur, nor even an "economic man," as such, but a pure universal "one." This is the reason why the propositions of theoretical economics have just that "universal validity" which gives them the ideality of the "and so forth" and "I can do it again." However, one can study the economic actor as such and try to find out what is going on in his mind; of course, one is not then engaged in theoretical economics but in economic history or economic sociology. . . . However, the statements of these sciences can claim no universal validity, for they deal either with the economic sentiments of particular historical individuals or with types of economic activity for which the economic acts in question are evidence. . . .
>
> In our view, pure economics is a perfect example of an objective meaning-complex about subjective meaning-complexes, in other words, of an objective meaning-configuration stipulating the typical and invariant subjective experiences of anyone who acts within

an economic framework. . . . Excluded from such a scheme would have to be any consideration of the uses to which the "goods" are to be put after they are acquired. But once we do turn our attention to the subjective meaning of a real individual person, leaving the anonymous "anyone" behind, then of course it makes sense to speak of behavior that is atypical. . . . To be sure, such behavior is irrelevant from the point of view of economics, and it is in this sense that economic principles are, in Mises's words, "not a statement of what usually happens, but of what necessarily must happen."[38]

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[38]Alfred Schütz, *The Phenomenology of the Social World* (Evanston, Ill.: Northwestern University Press, 1967), pp. 137, 245; also see Ludwig M. Lachmann, *The Legacy of Max Weber* (Berkeley, Calif.: Glendessary Press, 1971), pp. 17–48.

# 5

# Praxeology, Value Judgments, and Public Policy

Ethics is the discipline, or what is called in classical philosophy the "science," of what goals men should or should not pursue. All men have values and place positive or negative value judgments on goods, people, and events. Ethics is the discipline that provides standards for a moral critique of these value judgments. In the final analysis, either such a discipline exists and a rational or objective system of ethics is possible, or else each individual's value judgments are ultimately arbitrary and solely a result of individual whim. It is not my province to try to settle one of the great questions of philosophy here. But even if we believe, as I do, that an objective science of ethics exists, and even if we believe still further that ethical judgments are within the province of the historian or social scientist, one thing is certain: praxeology, economic theory, cannot itself establish ethical judgments. How could it when it deals with the formal fact that men act rather than with the content of such actions? Furthermore, praxeology is not grounded on any value judgments of the praxeologist, since what he is doing is analyzing the fact that people in general have values rather than inserting any value judgments of his own.

What, then is the proper relationship of praxeology to values or ethics? Like other sciences, praxeology provides laws about reality, laws that those who frame ethical judgments disregard only at their peril. In brief, the citizen, or the "ethicist," may have framed, in ways which we cannot deal with here, general ethical rules or goals. But in order to decide how to arrive at such goals, he must employ all the

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relevant conclusions of the various sciences, all of which are in *themselves* value-free. For example, let us suppose that a person's goal is to improve his health. Having arrived at this value—which I would consider to be rational and others would consider purely emotive and arbitrary—the person tries to discover how to reach his goal. To do so, he must employ the laws and findings, value-free in themselves, of the relevant sciences. He then extends the judgment of "good," as applied to his health, on to the means he believes will further that health. His end, the improvement of his health, he pronounces to be "good"; he then, let us say, adopts the findings of medical science that x grams of vitamin C per day will improve his health; he therefore extends the ethical pronouncement of "good"—or, more technically, of "right"—to taking vitamin C as well. Similarly, if a person decides that it is "good" for him to build a house and adopts this as his goal, he must try to use the laws of engineering—in themselves value-free—to figure out the best way of constructing that house. Felix Adler put the relationship clearly, though we may question his use of the term *social* before science in this context:

> The . . . end being given, the ethical formula being supplied from elsewhere, social science has its most important function to discharge in filling in the formula with a richer content, and, by a more comprehensive survey and study of the means that lead to the end, to give to the ethical imperatives a concreteness and definiteness of meaning which otherwise they could not possess. Thus ethical rule may enjoin upon us to promote . . . health, . . . but so long as the laws of hygiene remain unknown or ignored, the practical rules which we are to adopt in reference to health will be scanty and ineffectual. The new knowledge of hygiene which social science supplies will enrich our moral code in this particular. Certain things which we freely did before, we now know we may not do; certain things which we omitted to do, we now know we ought to do.[1]

Praxeology has the same methodological status as the other sciences and the same relation to ethics. Thus, to take a deliberately simple example: if our end is to be able to find gasoline when we pull

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[1]Felix Adler, "The Relation of Ethics to Social Science," in *Congress of Arts and Science*, H.J. Rogers, ed. (Boston: Houghton Mifflin, 1906), vol. 7, p. 678.

up to the service station, and value-free praxeological law tells us—as it does—that, if the government fixes a maximum price for any product below the free-market price, a shortage of that product will develop, then (unless other goals supervene) we will make the ethical pronouncement that it is "bad" or "wrong" for the government to impose such a measure. Praxeology, like the other sciences, is the value-free handmaiden of values and ethics.

To our contention that the sciences, including praxeology, are in themselves value-free, it might be objected that it is values or ethics that direct the *interest* of the scientist in discovering the specific laws of his discipline. There is no question about the fact that medical science is currently far more interested in discovering a cure for cancer than in searching for a cure for some disease that might only have existed in parts of the Ukraine in the eighteenth century. But the unquestioned fact that values and ethics are important in guiding the attention of scientists to specific problems is irrelevant to the fact that the laws and disciplines of the science itself are value-free. Similarly, Crusoe on his desert island may not be particularly interested in investigating the science of bridge building, but the laws of that science itself are value-free.

Ethical questions, of course, play a far smaller role in applied medicine than they do in politics or political economy. A basic reason for this is that generally the physician and his patient agree—or are supposed to agree—on the end in view: the advancement of the patient's health. The physician can advise the patient without engaging in an intense discussion of their mutual values and goals. Of course, even here, the situation is not always that clear-cut. Two examples will reveal how ethical conflicts may arise: first, the patient needs a new kidney to continue to live; is it ethical for the physician and/or the patient to murder a third party and extract his kidney? Second, is it ethical for the physician to pursue medical research for the possible good of humanity while treating his patient as an unwitting guinea pig? These are both cases where valuational and ethical conflicts enter the picture.

In economic and political questions, in contrast, ethical and value conflicts abound and permeate society. It is therefore impermissible for the economist or other social scientist to act as if he were a physician, who can generally assume complete agreement on values and goals with his patient and who can therefore prescribe

accordingly and with no compunction. Since, then, praxeology provides no ethics whatsoever but only the data for people to pursue their various values and goals, it follows that it is impermissible for the economist *qua* economist to make any ethical or value pronouncements or to advocate any social or political policy whatsoever.

The trouble is that most economists burn to make ethical pronouncements and to advocate political policies—to say, in effect, that policy X is "good" and policy Y "bad." Properly, an economist may only make such pronouncements in one of two ways: either (1) to insert his own arbitrary, *ad hoc* personal value judgments and advocate policy clearly on that basis; or (2) to develop and defend a coherent ethical system and make his pronouncement, not as an economist, but as an ethicist, who also uses the data of economic science. But to do the latter, he must have thought deeply about ethical problems and also believe in ethics as an objective or rational discipline—and precious few economists have done either. That leaves him with the first choice: to make crystal clear that he is speaking not as an economist but as a private citizen who is making his own confessedly arbitrary and *ad hoc* value pronouncements.

Most economists pay lip service to the impermissibility of making ethical pronouncements *qua* economist, but in practice they either ignore their own criteria or engage in elaborate procedures to evade them. Why? We can think of two possible reasons. One is the disreputable reason that, if Professor Doakes advocates policy X and basically does so as an economics professor, he will be listened to and followed with awe and respect; whereas if he advocates policy X as plain Joe Doakes, the mass of the citizenry may come to the perfectly valid conclusion that their *own* arbitrary and *ad hoc* value judgments are just as good as his, and that therefore there is no particular reason to listen to him at all. A second and more responsible reason might be that the economist, despite his professed disbelief in a science of ethics, realizes deep down that there is something unfortunate—we might even say *bad*—about unscientific and arbitrary value judgments in public policy, and so he tries desperately to square the circle, in order to be able to advocate policy in some sort of scientific manner.

While squaring this circle is impossible, as we shall consider further, I believe that this putative uneasiness at making arbitrary value judgments is correct. While it is surely admirable (ethical?) for an

economist to distinguish clearly and carefully between the value-free science and his own value judgments, I contend further that it is the responsibility of any scientist, indeed any intellectual, to refrain from any value judgment whatever *unless* he can support it on the basis of a coherent and defensible ethical system. This means, of course, that those economists who, on whatever grounds, are not prepared to think about and advance an ethical system should strictly refrain from any value pronouncements or policy conclusions at all. This position is of course itself an ethical one. But it relates to the ethical system that is the precondition of all science; for, even though particular scientific laws are themselves value-free, the very procedures of science rest on the ethical norm of honesty and the search for truth; that norm, I believe, includes the responsibility to lend coherence and system to all one's pronouncements including valuational ones. I might add in passing that anyone conceding the necessity of honesty in science *ipso facto* becomes willy-nilly a believer in objective ethics, but I will leave that point to the ethical subjectivists to grapple with.[2]

Let me clarify with an example. Henry C. Simons, after trenchantly criticizing various allegedly scientific arguments for progressive taxation, came out flatly in favor of progression as follows:

> The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely.[3]

My point is that, while it was surely admirable for Simons to make the distinction between his scientific and his personal value judgments crystal clear, that is not enough for him to escape censure. He had, at the very least, the responsibility of analyzing the nature and implications of egalitarianism and then attempting to defend it

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[2]See the critique of the inconsistency of the championing of intellectual honesty by the great opponent of objective ethics, Max Weber, in Leo Strauss, *Natural Right and History* (Chicago: University of Chicago Press, 1953), pp. 47–48.

[3]Henry C. Simons, *Personal Income Taxation* (1938), pp. 18–19, cited by Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1953), p. 72.

as an ethical norm. Flat declarations of unsupported value judgments should be impermissible in intellectual, let alone scientific, discourse. In the intellectual quest for truth it is scarcely sufficient to proclaim one's value judgments as if they must be accepted as tablets from on high and not be themselves subject to intellectual criticism and evaluation.

Suppose, for example, that Simons's ethical or esthetic judgment was not on behalf of equality but of a very different social ideal. Suppose that instead he had come out in favor of the murder of all short people, of all adults under five feet six inches in height. And suppose that his sole defense of this proposal were the following:

> The case for the liquidation of all short people must be rested on the case against the existence of short people—on the ethical or aesthetic judgment that the prevailing number of short adults is distinctly evil or unlovely.

One wonders if the reception accorded to Simons's remarks by his fellow economists or social scientists would have been quite the same.[4] Yet, of course, the logic of his stance would have been precisely the same.

More usual is an attempt by the economist to place himself in the status of the physician of our foregoing example, that is, as someone who is merely agreeing to or ratifying the values either of a majority in society or of every person in it. But even in these cases, it must be remembered that the physician is in no sense value-free, though he is simply sharing the value of his patient, and that the value of health is so deeply shared that there is no occasion for making it explicit. Nevertheless, the physician *does* make a value judgment, and, even if every person in society shares the same value and goal, the economist who goes along with such a value is still making a value judgment, even if indeed universally shared. He is still illegitimately going beyond the bounds of the economist *per se*, and his value judgments must still be supported by rational argument.

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[4]Murray N. Rothbard, *Egalitarianism as a Revolt against Nature, and Other Essays* (Washington, D.C.: Libertarian Review Press, 1974), pp. 2–3; also see Rothbard, *Power and Market* (Menlo Park, Calif.: Institute for Humane Studies, 1970), pp. 157–60.

The weakest path to an economist's adoption of social values is to appeal to the majority. Thus, John F. Due commented on the progressive income tax in his text on public finance:

> The strongest argument for progression is the fact that the consensus of opinion in society today regards progression as necessary for equity. This is, in turn, based on the principle that the pattern of income distribution, before taxes, involves excessive inequality (which) can be condemned on the basis of inherent unfairness in terms of the standards accepted by society.[5]

But once again the fact that the majority of society might hold market inequality to be "unfair" does not absolve Due of the fact that, in ratifying that judgment, he himself made that value judgment and went beyond the province of the economist. Furthermore, on scientific standards, the *ad hoc* and arbitrary value judgments of the majority are no better than those of one person, and Due, like Simons, failed to support that judgment with any sort of argumentation. Furthermore, when we ratify the majority, what of the rights or the utilities of the minority? Felix Adler's strictures against the utilitarian ethic clearly apply here:

> Other sociologists frankly express their ideals in terms of quantity and, in the fashion of Bentham, pronounce the greatest happiness of the greatest number to be the social end, although they fail to make it intelligible why the happiness of the greater number should be cogent as an end upon those who happen to belong to the lesser number.[6]

Again, with Due as with Simons, one wonders about the treatment of such a position by the American intellectual community if his imprimatur on the "consensus of opinion in society today" had been applied instead to the treatment of the Jews in Germany in the 1930s.

Just as the physician who advises his client commits himself to the ethic of good health, so the economist who advises a client is *not*, much as he would like to think so, a mere technician who is not committing himself to the value judgment of his client and his client's

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[5]John F. Due, *Government Finance* (Homewood, Ill.: Richard D. Irwin, 1954), pp. 128–29.

[6]Adler, "Relation of Ethics," p. 673.

goals. By advising a steel company on how to increase its profits, the economist is thereby committed to share in the steel entrepreneur's value judgment that his greater profit is a desirable goal. It is even more important to make this point about the economist who advises the State. In so doing, he commits himself to the value judgments, not simply of the majority of society as in the case of Due, but to the value judgments of the rulers of the State apparatus. To take a deliberately dramatic example, let us suppose that an economist is hired by the Nazis to advise the government on the most efficient method of setting up concentration camps. By agreeing to help make more efficient concentration camps, he is agreeing to make them "better," in short, he is committing himself willy-nilly to concentration camps as a desirable goal. And he would, again, still be doing so even if this goal were heartily endorsed by the great majority of the German public. To underscore this point, it should be clear that an economist whose value system leads him to oppose concentration camps might well give such advice to the German government as to make the concentration camps as *inefficient* as possible, that is to sabotage their operations. In short, whatever advice he gives to his clients, a value commitment by the economist, either for or against his clients' goals, is inescapable.[7]

A more interesting variant of the economist's attempt to make value-free value judgments is the "unanimity principle," recently emphasized by James M. Buchanan. Here the idea is that the economist can safely advocate a policy if *everyone* in the society also advocates it. But, in the first place, the unanimity principle is still subject to the aforementioned strictures: that, even if the economist simply shares in everyone else's value judgment, he is still making a value judgment. Furthermore, the superficial attractiveness of the unanimity principle fades away under more stringent analysis; for unanimity is scarcely sufficient to establish an ethical principle. For one thing, the requirement of unanimity for any action or change begins with and freezes the status quo. For an action to be adopted, the justice and ethical propriety of the status quo must first be established, and of course economics can scarcely be prepared to do that.

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[7]Murray N. Rothbard, "Value Implications of Economic Theory," *The American Economist* 17 (Spring, 1973): 38–39; included in this volume as chapter 12.

The economist who advocates the unanimity principle as a seemingly value-free pronouncement is thereby making a massive and totally unsupported value judgment on behalf of the status quo. A stark but not untypical example was the debate in the British Parliament during the early nineteenth century on the abolition of slavery, when early adherents of the "compensation principle" variant of the unanimity principle (which has its own additional and grave problems) maintained that the masters must be compensated for the loss of their investment in slaves. At that point, Benjamin Pearson, a member of the Manchester School, declared that "he had thought it was the slaves who should have been compensated."[8] Here is a striking example of the need in advocating public policy of some ethical system, of a concept of justice. Those ethicists among us who hold that slavery is unjust would always oppose the idea of compensating the masters and would rather think in terms of reparations to compensate the slaves for their years of oppression. But what is there for the value-free economist to say?

There are other grave problems with the compensation principle as a salvaging attempt to make it possible for value-free economists to advocate public policy. For the compensation principle assumes that it is conceptually possible to measure losses and thereby to compensate losers. But since praxeology informs us that "utility" and "cost" are purely subjective (psychic) concepts and therefore cannot be measured or even estimated by outside observers, it becomes impossible for such observers to weigh "social costs" and "social benefits" and to decide that the latter outweigh the former for any public policy, much less to make the compensations involved so that the losers are no longer losers. The usual attempt is to measure psychic losses in utility by the monetary price of an asset; thus, if a railroad damages the land of a farmer by smoke, it is assumed that the farmer's loss can be measured by the market price of the land. But this ignores the facts that the farmer may have a psychic attachment to the land that puts its value far above the market price and that—especially in this kind of situation that does not involve direct action and exchange by the individuals—it is impossible to find out what

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[8]William D. Grampp, *The Manchester School of Economics* (Stanford, Calif.: Stanford University Press, 1960), p. 59; also see Rothbard, "Value Implications," pp. 36–37.

the farmer's psychic attachment to the land may be worth. He may say, for example, that his attachment to the land requires the compensation of $10 million, even though the market price is $100,000, but of course he may be lying. However, the government or other outside observer has no scientific way of finding out one way or another.[9] Furthermore, the existence in the society of just one militant anarchist, whose psychic grievance against government is such that he cannot be compensated for his psychic disutility from the existence of government, is enough by itself to destroy the social-utility and compensation-principle case for any government action whatever. And surely at least one such anarchist exists.

Can praxeological economics, then, say nothing about social utility? Not quite. If we define an "increase in social utility" in the Paretian manner as a situation where one or more persons gain in utility while nobody loses, then praxeology finds a definite, but restricted, role for the concept. But it is a role where social utilities remain unmeasurable and incomparable between persons. Briefly, praxeology maintains that when a person acts, his utility, or at least his ex ante utility, increases; he expects to enjoy a psychic benefit from the act, otherwise he would not have done it. When, in a voluntary free-market exchange, for example, I buy a newspaper from a newsdealer for 15 cents, I demonstrate by my action that I prefer (at least ex ante) the newspaper to the 15 cents, while the newsdealer demonstrates by his action the reverse order of preference. Since each of us is better off by the exchange, both the newsdealer and I have demonstrably gained in utility, while *nothing* has demonstrably happened to anyone else. Elsewhere I have called this praxeological concept "demonstrated preference," in which action demonstrates preference, in contrast to various forms of psychologizing, which tries to measure other persons' value scales apart from action, and to behaviorism, which assumes that such values or preferences do not exist.[10] The compensation principle that

[9]For a further analysis of this question, see Walter Block, "Coase and Demsetz on Private Property Rights: A comment," *Journal of Libertarian Studies* 1, no. 2 (Spring, 1977): 112–15.

[10]Murray N. Rothbard, "Toward a Reconstruction of Utility and Welfare Economics" in *On Freedom and Free Enterprise: Essays in Honor of Ludwig von Mises*, Mary Sennholz, ed. (Princeton, N.J.: Van Nostrand, 1956), pp. 224–32, 243–63; included in this volume as chapter 17.

I have been criticizing rests on the illegitimate psychologizing notion that a scientific economist-observer can know *anything* about someone else's value scale except as it is demonstrated through such action as the purchase or sale of a newspaper. And since the compensation principle is necessarily divorced from demonstrated preference, it cannot be employed by scientific economists. Incidentally, I might note here that "demonstrated preference" is very different from Samuelson's famous concept of "revealed preference," for Samuelson, in illegitimate psychologizing fashion, assumed the existence of an underlying preference scale that forms the basis of a person's action and that remains constant in the course of his actions over time. There is, however, no warrant for the scientific economist to make any such assumption. All we can say is that an action, at a specific point of time, reveals some of a person's preferences *at that time*. There is no warrant for assuming that such preference orderings remain constant over time.[11]

Now since praxeology shows, by the concept of demonstrated preference, that both the newsdealer and I gain in utility from the exchange, and nothing has demonstrably happened to anyone else, we can conclude scientifically, as praxeological economists, that social utility has increased from the sale and purchase of the newspaper—since we have defined social utility in the Paretian manner. It is true, of course, that third parties may well be grinding their teeth in hatred at the exchange. There may be people, for example, who through envy suffer psychic loss because the newspaper dealer and/or I have gained. Therefore, if we employ the Paretian definition of "social utility" in the usual psychologizing sense, we can say nothing about social utility one way or the other. But if we confine the concept to its strict scientific compass in demonstrated preference, then we can state that social utility increases from the exchange. Still further, we may know as historians, from interpretive understanding of the hearts and minds of envious neighbors, that they do lose in utility. But we are trying to determine in this paper precisely what scientific economists can say

[11]Ibid., pp. 228–30; also see Ludwig von Mises, *Human Action: A Treatise on Economics* (New Haven, Conn.: Yale University Press, 1949), pp. 102–04. Samuelson's views may be found, among other places, in Paul A. Samuelson, "The Empirical Implications of Utility Analysis," *Econometrica* 6 (October 1938): 334–56; and *Foundations of Economics* (Cambridge, Mass.: Harvard University Press, 1947), pp. 146–63.

about social utility or can advocate for public policy, and since they must confine themselves to demonstrated preference, they must affirm that social utility has increased.

Conversely, since every act of the State involves coercion, at least the coercion of taxation, and since in its every act there is at least one demonstrable loser in utility, we must also conclude that no act whatever of the State can increase social utility. Here, of course, is another good reason why the economic scientist cannot use the concept of "social utility" to establish any sort of unanimity principle or any other case for government action. It has been pointed out that, similarly, we cannot say that any action of the State *decreases* social utility, at least in the short term, and that too is correct.

We must emphasize, however, that the praxeological conclusion that the free market maximizes social utility is not sufficient to enable the praxeological economist to advocate the free market while abstaining from value judgments or from an ethical system. In the first place, why *should* an economist favor increasing social utility? This in itself requires an ethical or value judgment. And, second, the social-utility concept has many other failings, including the fact that while the envious and the egalitarian or the admirer of coercion *per se* may not be included in the social-utility concept, the contemporary historian knows that he is there, lurking in the wings; it therefore requires an ethical judgment, which cannot be supplied by praxeology, to overrule him. Furthermore, many of the strictures against the unanimity principle apply here too; for example, should we really be eager to preserve the utility of the slaveholder against loss? And if so, why?

Let us now turn to the position of Ludwig von Mises on the entire matter of praxeology, value judgments, and the advocacy of public policy. The case of Mises is particularly interesting, not only because he was a leader in the modern Austrian School and in praxeology, but also because he was, of all the economists in the twentieth century, the most uncompromising and passionate adherent of *laissez-faire* and at the same time the most rigorous and uncompromising advocate of value-free economics and opponent of any sort of objective ethics. How then did he attempt to reconcile these two positions?[12]

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[12]For a posing of this question, see William E. Rappard, "On Reading von Mises," in *On Freedom and Free Enterprise*, Mary Sennholz, ed., pp. 17–33.

Essentially, Mises offered two very different solutions to this problem. The first is a variant of the unanimity principle. Essentially this variant affirms that an economist *per se* cannot say that a given governmental policy is "good" or "bad." However, if a given policy will lead to consequences, as explained by praxeology, that *every one* of the supporters of the policy will agree is bad, then the value-free economist is justified in calling the policy a "bad" one. Thus, Mises wrote:

> An economist investigates whether a measure *a* can bring about the result *p* for the attainment of which it is recommended, and finds that *a* does not result in *p* but in *g*, an effect which even the supporters of the measure *a* consider undesirable. If the economist states the outcome of his investigation by saying that *a* is a bad measure, he does not pronounce a judgment of value. He merely says that from the point of view of those aiming at the goal *p*, the measure *a* is inappropriate.[13]

And again:

> Economics does not say that . . . government interference with the prices of only one commodity . . . is unfair, bad, or unfeasible. It says, that it makes conditions worse, not better, *from the point of view of the government and those backing its interference*.[14]

Now this is surely an ingenious attempt to allow pronouncements of "good" or "bad" by the economist without making a value judgment; for the economist is supposed to be only a praxeologist, a technician, pointing out to his readers or listeners that they will all consider a policy "bad" once he reveals its full consequences. But ingenious as it is, the attempt completely fails. For how could Mises *know* what the advocates of the particular policy consider desirable? How could he know what their value scales are now or what they will be when the consequences of the measure appear? One of the great contributions of praxeology, as I have pointed out above, is that the praxeologist, the economist, doesn't know what anyone's value scales are except as those value preferences are demonstrated by a person's concrete action. In the case of my purchase of the

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[13]Mises, *Human Action*, p. 879.

[14]Ibid., p. 758; italics in the original.

newspaper, historians or psychologists may make more or less informed estimates of the newsdealers' or my value scales through the process of interpretive understanding, but all that the economist can know scientifically and with certainty is the preference relative to 15 cents or the newspaper as demonstrated through concrete action. Mises himself emphasized that

> one must not forget that the scale of values or wants manifests itself only in the reality of action. These scales have no independent existence apart from the actual behavior of individuals. The only source from which our knowledge concerning these scales is derived is the observation of a man's actions. Every action is always in perfect agreement with the scale of values or wants because these scales are nothing but an instrument for the interpretation of a man's acting.[15]

Given Mises's own analysis, then, how can the economist know what the motives for advocating various policies really are or how people will regard the consequences of these policies?

Thus, Mises, *qua* praxeologist, might show that price controls (to use his example) will lead to unforeseen shortages of a good to the consumers. But how could Mises know that some advocates of price controls do not *want* shortages? They may, for example, be socialists, anxious to use the controls as a step toward full collectivism. Some may be egalitarians who prefer shortages because the rich will not be able to use their money to buy more of the product than poorer people. Others may be one of the legion of contemporary intellectuals who are eternally complaining about the excessive affluence of our society or about the great waste of energy; they may all delight in the shortages of goods. Still others may favor price controls, even after learning of the shortages, because they or their political allies will enjoy well-paying jobs or power in a price-control bureaucracy. All sorts of such possibilities exist, and *none* of them is compatible with the assertion of Mises, as a value-free economist, that all supporters of price controls—or of any other government intervention—must concede, after learning economics, that the measure is "bad." In fact, once Mises conceded that even a single advocate of price controls or any other interventionist measure may acknowledge the economic

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[15]Ibid., p. 95.

consequences and still favor it, he could no longer call any of these measures "bad" or "good" or even "appropriate" or "inappropriate" without inserting into his economic policy pronouncements the very value judgments that he himself held to be inadmissible as a scientist of human action.[16] He would no longer be a technical reporter to all advocates of a certain policy but an advocate participating on one side of a value conflict.

Moreover, there is another fundamental reason for advocates of "inappropriate" policies to refuse to change their minds even after hearing and acknowledging the praxeological chain of consequences. For praxeology may indeed show that all types of government policies will have consequences that most people, at least, will tend to abhor. But, and this is a vital qualification, most of these consequences take *time*, some a great deal of time. No economist has done more than Ludwig von Mises to elucidate the universality of time preference in human affairs—the praxeological law that everyone prefers to attain a given satisfaction sooner than later. And certainly Mises, as a value-free scientist, could never presume to criticize anyone's rate of time preference, to say that A's was "too high" and B's "too low." But, in that case, what about the high-time-preference people in society who retort to the praxeologist: "Perhaps this high tax and subsidy policy will lead to a decline of capital; perhaps even the price control will lead to shortages, but I don't care. Having a high time preference, I value more highly the short-run subsidies, or the short-run enjoyment of buying the current good at cheaper prices, than the prospect of suffering the future consequences." And Mises, as a value-free scientist and opponent of any concept of objective ethics, *could not* call them wrong. There is no way that he could assert the superiority of the long run over the short run without overriding the values of the high-time-preference people; and that could not be cogently done without abandoning his own subjectivist ethics.

In this connection, one of Mises's basic arguments for the free market is that, on the market, there is a "harmony of the rightly understood interests of all members of the market society." It is clear from his discussion that he could not merely mean "interests" after

[16]Mises himself conceded at one point that a government or a political party may advocate policies for "demagogic," that is, for hidden and unannounced, reasons (ibid., p. 104*n*).

learning the praxeological consequences of market activity or of government intervention. He also, and in particular, meant people's long-run interests. As he stated, "For 'rightly understood' interests we may as well say interests 'in the long run.'"[17] But what about the high-time-preference folk, who prefer to consult their short-run interests? How can the long run be called "better" than the short run? Why is "right understanding" necessarily the long run?

We see, therefore, that Mises's attempt to advocate *laissez-faire* while remaining value-free, by assuming that all of the advocates of government intervention will abandon their position once they learn of its consequences, falls completely to the ground. There is another and very different way, however, that Mises attempted to reconcile his passionate advocacy of *laissez-faire* with the absolute value-freedom of the scientist. This was to take a position much more compatible with praxeology, by recognizing that the economist *qua* economist can only trace chains of cause and effect and may not engage in value judgments or advocate public policy. In so doing, Mises conceded that the economic scientist cannot advocate *laissez-faire* but then added that as a citizen he can do so. Mises, as a *citizen*, proposed a value system but it is a curiously scanty one. For he was here caught in a dilemma. As a praxeologist he knew that he could not as an economic scientist pronounce value judgments or advocate policy. Yet he could not bring himself simply to assert and inject arbitrary value judgments. And so, as a utilitarian (for Mises, along with most economists, was indeed a utilitarian in ethics, although a Kantian in epistemology), he made only one narrow value judgment: that he desired to fulfill the goals of the majority of the public (happily, in this formulation, Mises did not presume to know the goals of *everyone*).

As Mises explained in his second variant:

> Liberalism (i.e., *laissez-faire* liberalism) is a political doctrine. . . . As a political doctrine liberalism (in contrast to economic science) is not neutral with regard to values and ultimate ends sought by action. It assumes that all men or at least the majority of people are intent upon attaining certain goals. It gives them information about the means suitable to the realization of their plans. The champions of liberal doctrines are fully aware of the fact that their

[17]Ibid., p. 670 and note.

> teachings are valid only for people who are committed to their valuational principles. While praxeology, and therefore economics too, uses the terms happiness and removal of uneasiness in a purely formal sense, liberalism attaches to them a concrete meaning. It presupposes that people prefer life to death, health to sickness . . . abundance to poverty. It teaches men how to act in accordance with these valuations.[18]

In this second variant, Mises successfully escaped the self-contradiction of being a value-free praxeologist advocating *laissez-faire*. Granting in this variant that the economist may not make such advocacy, he took his stand as a citizen willing to make value judgments. But he was not willing, as Simons was, to simply assert an *ad hoc* value judgment; presumably he felt that a valuing intellectual must present some sort of system to justify such value judgments. But for Mises the utilitarian, his system is a curiously bloodless one; even as a valuing *laissez-faire* liberal, he was only willing to make *the one* value judgment that he joined the majority of the people in favoring their common peace, prosperity, and abundance. In this way, as an opponent of objective ethics, and uncomfortable as he must have been with making any value judgments even as a citizen, he made the minimal possible degree of such judgments; true to his utilitarian position his value judgment is the desirability of fulfilling the subjectively desired goals of the bulk of the populace.

A full critique of this position must involve a critique of utilitarian ethics itself, and this cannot be done here. But a few points may be made. In the first place, while praxeology can indeed demonstrate that *laissez-faire* will lead to harmony, prosperity, and abundance, while government intervention leads to conflict and impoverishment,[19] and while it is probably true that most people value the former highly, it is not true that these are their *only* goals or values. The great analyst of ranked value scales and diminishing marginal utility should have been more aware of such competing values and goals. For example, many people, whether through envy or a misplaced theory of justice, may prefer far more equality of income than will be attained on the free market. Many people, *pace* the aforementioned intellectuals, may want less abundance in order to whittle down our

[18]Ibid., pp. 153–54.

[19]Rothbard, *Power and Market*, pp. 194–96.

allegedly excessive affluence. Others, as I have mentioned, may prefer to loot the capital of the rich or the businessman in the short run, while acknowledging but dismissing the long-run ill effects, because they have high time preference. Probably very few of these people will want to push statist measures to the point of total impoverishment and destruction—although this may happen, as in the case of Communist China. But a majority coalition of the foregoing might well opt for *some* reduction in wealth and prosperity on behalf of these other values. They may well decide that it is worth sacrificing a modicum of wealth and efficient production because of the high opportunity costs of not being able to enjoy an alleviation of envy, or a lust for power, or a submission to power, or, for example, the thrill of "national unity," which they might enjoy from a (short-lived) economic crisis.

What could Mises reply to a majority of the public who have indeed considered all the praxeological consequences and still prefer a modicum—or, for that matter, even a drastic amount—of statism in order to achieve some of their competing goals? As a utilitarian, he could not quarrel with the ethical nature of their chosen goals: for he had to confine himself to the *one* value judgment that he favored the majority achieving their chosen goals. The only reply that Mises could make within his own framework was to point out that government intervention has a cumulative effect, that eventually the economy must move either toward the free market or toward full socialism, which praxeology shows will bring chaos and drastic impoverishment, at least to an industrial society. But this too, is not a fully satisfactory answer. While many programs of statist intervention—especially price controls—are indeed cumulative, others are not. Furthermore, the cumulative impact takes such a long time that the time preferences of the majority would probably lead them, in full acknowledgement of the consequences, to ignore the effect. And then what?

Mises attempted to use the cumulative argument to answer the contention that the majority of the public prefer egalitarian measures even knowingly at the expense of a portion of their own wealth. Mises's comment was that the "reserve fund" was on the point of being exhausted in Europe, and therefore that any further egalitarian measures would have to come directly out of the pockets of the masses through increased taxation. Mises assumed that once this became clear, the masses would no longer support interventionist

measures.[20] In the first place, this is no argument against the *previous* egalitarian measures or in favor of their repeal. But secondly, while the masses *might* be convinced, there is certainly no apodictic certainty involved; the masses have in the past and presumably will in the future continue knowingly to support egalitarian and other statist measures on behalf of other goals, despite the knowledge that their income and wealth would be reduced. Thus, as William E. Rappard pointed out in his thoughtful critique of Mises's position:

> does the British voter, for instance, favor confiscatory taxation of large incomes primarily in the hope that it will redound to his material advantage, or in the certainty that it tends to reduce unwelcome and irritating social inequalities? In general, is the urge towards equality in our modern democracies not often stronger than the desire to improve one's material lot?[21]

Rappard also noted that in his own country, Switzerland, the urban industrial and commercial majority of the country have repeatedly, and often at popular referendums, endorsed measures to subsidize the minority of farmers in a deliberate effort to retard industrialization and the growth of their own incomes. The urban majority did not do so in the "absurd belief that they were thereby increasing their real income." Instead, "quite deliberately and expressly, political parties have sacrificed the immediate material welfare of their members in order to prevent, or at least somewhat to retard, the complete industrialization of the country. A more agricultural Switzerland, though poorer, such is the dominant wish of the Swiss people today."[22] The point here is that Mises, not only as a praxeologist but also as a utilitarian liberal, could have no word of criticism against these statist measures *once* the majority of the public take their praxeological consequences into account and choose them anyway on behalf of goals other than wealth and prosperity.

Furthermore, there are other types of statist intervention that clearly have little or no cumulative effect and that may even have very little effect in diminishing production or prosperity. Let us, for

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[20]Mises, *Human Action*, pp. 851–55.

[21]Rappard, "On Reading von Mises," pp. 32–33.

[22]Ibid., p. 33.

example, assume—and this assumption is not very farfetched in view of the record of human history—that the great majority of a society hate and revile redheads, perhaps, to cite Simons again, because they find redheads "evil or unlovely." Let us further assume that there are very few redheads in the society. This large majority then decide that they would like very much to murder all redheads. Here they are; the murder of redheads is high on the value scales of the great majority of the public; there are few redheads so that there will be little loss in production on the market. How could Mises rebut this proposed policy either as a praxeologist or as a utilitarian liberal? I submit that he could not do so.

Mises made one further attempt to establish his position, but it was even less successful. Criticizing the arguments for state intervention on behalf of equality or other moral concerns, he dismissed them as "emotional talk." After reaffirming that "praxeology and economics . . . are neutral with regard to any moral precepts," and asserting that "the fact that the immense majority of men prefer a richer supply of material goods to a less ample supply is a datum of history; it does not have any place in economic theory," he concluded by insisting that "he who disagrees with the teachings of economics ought to refute them by discursive reasoning, not by . . . the appeal to arbitrary, allegedly ethical standards."[23]

But I submit that this will not do; for Mises would have to concede that no one can decide upon *any* policy whatever unless he makes an ultimate ethical or value judgment. But since this is so, and since according to Mises all ultimate value judgments or ethical standards are arbitrary, how then could he denounce these *particular* ethical judgments as "arbitrary"? Furthermore, it was hardly correct for Mises to dismiss these judgments as "emotional," since for him as a utilitarian, reason cannot establish ultimate ethical principles, which can therefore only be established by subjective emotions. It was pointless for Mises to call for his critics to use "discursive reasoning" since he himself denied that discursive reasoning can be used to establish ultimate ethical values. Furthermore, the man whose ultimate ethical principles would lead him to support the free market

[23]Ludwig von Mises, "Epistemological Relativism in the Sciences of Human Action," in *Relativism and the Study of Man*, Helmut Schoeck and James W. Wiggins, eds. (Princeton, N.J.: D. Van Nostrand, 1961), p. 133.

could also be dismissed by Mises as equally "arbitrary" and "emotional," even if he takes the laws of praxeology into account before making his ultimately ethical decision. And we have seen above that the majority of the public very often have other goals which they hold, at least to a certain extent, higher than their own material well-being.

The burden of this paper has been to show that, while praxeological economic theory is extremely useful for providing data and knowledge for framing economic policy, it cannot be sufficient by itself to enable the economist to make any value pronouncements or to advocate any public policy whatsoever. More specifically, Ludwig von Mises to the contrary notwithstanding, neither praxeological economics nor Mises's utilitarian liberalism is sufficient to make the case for *laissez-faire* and the free-market economy. To make such a case, one must go beyond economics and utilitarianism to establish an objective ethics that affirms the overriding value of liberty and morally condemns all forms of statism, from egalitarianism to the murder of redheads, as well as such goals as the lust for power and the satisfaction of envy. To make the full case for liberty, one cannot be a methodological slave to every goal that the majority of the public might happen to cherish.

# 6

# In Defense of "Extreme Apriorism"

The stimulating methodological controversy between Professors Machlup and Hutchison proves that there are sometimes more than two sides to every question.[1] In many ways, the two are debating at cross-purposes: Professor Hutchison is primarily tilting against the methodological (and political) views of Professor Ludwig von Mises; his most serious charge is that Professor Machlup's entire position is, at bottom, an attempt to cloak the Misesian heresy in the garments of epistemological respectability. Professor Machlup's reply, quite properly, barely mentions Mises; for, in fact, their methodological views are poles apart. (Machlup's position is close to the central "positivist" tradition of economic methodology.) But, in the meanwhile, we find that Professor Mises and "extreme apriorism" go undefended in the debate. Perhaps an extreme apriorist's contribution to this discussion may prove helpful.

First, it should be made clear that neither Professor Machlup nor Professor Hutchison is what Mises calls a *praxeologist*, that is, neither believes (a) that the fundamental axioms and premises of economics are absolutely true; (b) that the theorems and conclusions deduced by the laws of logic from these postulates are therefore absolutely true; (c) that there is consequently no need for

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[1]Terence W. Hutchison, "Professor Machlup on Verification in Economics," *Southern Economic Journal* (April 1956): 476–83; Fritz Machlup, "Rejoinder to a Reluctant Ultra-Empiricist," ibid., pp. 483–93.

empirical "testing," either of the premises or the conclusions; and (d) that the deduced theorems could not be tested even if it were desirable.[2] Both disputants are eager to test economic laws empirically. The crucial difference is that Professor Machlup adheres to the orthodox positivist position that the *assumptions* need not be verified so long as their deduced consequents may be proven true—essentially the position of Professor Milton Friedman—while Professor Hutchison, wary of shaky assumptions takes the more empirical—or institutionalist—approach that the assumptions had better be verified as well.

Strange as it may seem for an ultra-apriorist, Hutchison's position strikes me as the better of the two. If one must choose between two brands of empiricism, it seems like folly to put one's trust in procedures for testing only *conclusions* by fact. Far better to make sure that the assumptions also are correct. Here I must salute Professor Hutchison's charge that the positivists rest their case on misleading analogies from the epistemology of physics. This is precisely the nub of the issue. All the positivist procedures are based on the physical sciences.[3] It is physics that knows or can know its "facts" and can test

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[2]The praxeological tradition, though named only recently, has a long and honored place in the history of economic thought. In the first great methodological controversy in our science, John Stuart Mill was the positivist and Nassau Senior the praxeologist, with J.E. Cairnes wavering between the two positions. Later on, the praxeologic method was further developed by the early Austrians, by Wicksteed, and by Richard Strigl, reaching its full culmination in the works of Ludwig von Mises. Mises's views may be found in *Human Action* (New Haven, Conn.: Yale University Press, 1949), and in his earlier *Grundprobleme der Nationalökonomie* [translated into English as *Epistemological Problems of Economics* (Princeton, N.J.: D. Van Nostrand, 1960)]. On the similarity between Senior and Mises, see Marian Bowley, *Nassau Senior and Classical Economics* (New York: Augustus M. Kelley, 1949), chap. 1, esp. pp. 64–65. Lionel Robbins's *Essay on the Nature and Significance of Economic Science* (London: Macmillan, 1932) was emphatically praxeologic, although it did not delve into the more complex methodological problems.

[3]On the differences between the methodologies of praxeology and physics, see Murray N. Rothbard, "Toward a Reconstruction of Utility and Welfare Economics," in *On Freedom and Free Enterprise: Essays in Honor of Ludwig von Mises*, Mary Sennholz, ed. (Princeton, N.J.: D. Van Nostrand, 1956), pp. 226ff.; included in this volume as chapter 17.

its conclusions against these facts, while being completely ignorant of its ultimate assumptions. In the sciences of human action, on the other hand, it is impossible to test conclusions. There is no laboratory where facts can be isolated and controlled; the "facts" of human history are complex ones, resultants of many causes. These causes can only be isolated by theory, theory that is necessarily *a priori* to these historical (including statistical) facts. Of course, Professor Hutchison would not go this far in rejecting empirical testing of theorems; but, being commendably skeptical of the possibilities of testing (though not of its desirability), he insists that the assumptions be verified as well.

In physics, the ultimate assumptions cannot be verified directly, because we know nothing directly of the explanatory laws or causal factors. Hence the good sense of not attempting to do so, of using false assumptions such as the absence of friction, and so on. But false assumptions are the reverse of appropriate in economics. For human action is not like physics; here, the ultimate assumptions are what is clearly known, and it is precisely from these given axioms that the corpus of economic science is deduced. False or dubious assumptions in economics wreak havoc, while often proving useful in physics.[4]

Hence, Professor Hutchison is correct in wishing to establish the assumptions themselves. But these premises do not have to be (indeed, cannot be) verified by appeal to statistical fact. They are established, in praxeology, on a far more certain and permanent basis as definitely true. How, then, are these postulates obtained?

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[4]This holds also for Professor Machlup's "heuristic principles" which area allegedly "empirically meaningful" without being verifiable as true.

I do not wish to deny that false assumptions *are* useful in economic theory, but only when they are used as *auxiliary constructs, not* as premises from which empirical theories can be deduced. The most important such construct is the *evenly-rotating economy*, or "equilibrium." It is not intended that this state be considered as *real*, either actual or potential. On the contrary, the empirically *impossible* ERE is constructed precisely in order to analyze theoretically a state of no-change. Only by analyzing a fictive changeless state can we arrive at a proper analysis of the changing real economic world. However, this is not a "false" assumption in the sense used by the positivists, because it is an absolutely true theory of a changeless state, if such a state could exist.

Actually, despite the "extreme a priori" label, praxeology contains one Fundamental Axiom—the axiom of *action*—which may be called *a priori*, and a few subsidiary postulates which are actually empirical. Incredible as it may seem to those versed in the positivist tradition, from this tiny handful of premises the whole of economics is deduced—and deduced as absolutely true. Setting aside the Fundamental Axiom for a moment, the empirical postulates are: (a) small in number, and (b) so broadly based as to be hardly "empirical" in the empiricist sense of the term. To put it differently, they are so generally true as to be *self-evident*, as to be seen by all to be obviously true once they are stated, and hence they are not in practice empirically falsifiable and therefore not "operationally meaningful." What are these propositions? We may consider them in decreasing order of their generality: (1) the most fundamental—variety of resources, both natural and human. From this follows directly the division of labor, the market, etc.; (2) less important, that *leisure is a consumer good*. These are actually the only postulates needed. Two other postulates simply introduce limiting subdivisions into the analysis. Thus, economics can deductively elaborate from the Fundamental Axiom and Postulates (1) and (2) (actually, only Postulate 1 is necessary) an analysis of Crusoe economics, of barter, and of a monetary economy. All these elaborated laws are absolutely true. They are only *applicable* in concrete cases, however, where the particular limiting conditions apply. There is nothing, of course, remarkable about this; we can enunciate as a law that an apple, unsupported, will drop to the ground. But the law is applicable only in those cases where an apple is actually dropped. Thus, the economics of Crusoe, of barter, and of a monetary economy are applicable when these conditions obtain. It is the task of the historian, or "applied economist," to decide which conditions apply in the specific situations to be analyzed. It is obvious that making these particular identifications is simplicity itself.

When we analyze the economics of indirect exchange, therefore, we make the simple and obvious limiting condition (Postulate 3) that indirect exchanges are being made. It should be clear that by making this simple identification we are not "testing the theory"; we are simply choosing that theory which applies to the reality we wish to explain.

The fourth—and by far the least fundamental—postulate for a theory of the market is the one which Professors Hutchison and

Machlup consider crucial—that firms always aim at maximization of their money profits. As will become clearer when I treat the Fundamental Axiom below, this assumption is by no means a necessary part of economic theory. From our Axiom is derived this absolute truth: that every firm aims always at maximizing its *psychic* profit. This may or may not involve maximizing its *money* profit. Often it may not, and no praxeologist would deny this fact. When an entrepreneur deliberately accepts lower money profits in order to give a good job to a ne'er-do-well nephew, the praxeologist is not confounded. The entrepreneur simply has chosen to take a certain cut in monetary profit in order to satisfy his consumption-satisfaction of seeing his nephew well provided. The assumption that firms aim at maximizing their *money* profits is simply a convenience of analysis; it permits the elaboration of a framework of *catallactics* (economics of the market) which could not otherwise be developed. The praxeologist always has in mind the proviso that where this subsidiary postulate does *not* apply—as in the case of the ne'er-do-well—his deduced theories will not be applicable. He simply believes that enough entrepreneurs follow monetary aims enough of the time to make his theory highly useful in explaining the real market.[5]

We turn now to the Fundamental Axiom (the nub of praxeology): *the existence of human action*. From this absolutely true axiom can be spun almost the whole fabric of economic theory. Some of the *immediate* logical implications that flow from this premise are: the means-ends relationship, the time-structure of production, time-preference, the law of diminishing marginal utility, the law of optimum returns, etc. It is this crucial axiom that separates praxeology from the other methodological viewpoints—and it is this axiom that supplies the critical "a priori" element in economics.

First, it must be emphasized that whatever role "rationality" may play in Professor Machlup's theory, it plays no role whatever for

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[5]I do not mean to endorse here the recent strictures that have been made against the monetary-profit maximization assumption—most of which ignore *long-run* as opposed to short-run maximization.

The curious idea that failure to pursue monetary goals is "irrational," or refutes economics, is similar to the old notion that consumers were being irrational, or "uneconomic," when they preferred to pay higher prices in stores nearer to them, or with a more congenial atmosphere.

Professor Mises. Hutchison charges that Mises claims "all economic action was (or must be) rational."[6] This is flatly incorrect. Mises assumes nothing whatever about the rationality of human action (in fact, Mises does not use the concept at all). He assumes nothing about the wisdom of man's ends or about the correctness of his means. He "assumes" only that men *act*, that is, that they have some ends, and use *some* means to try to attain them. This is Mises's Fundamental Axiom, and it is this axiom that gives the whole praxeological structure of economic theory built upon it its absolute and apodictic certainty.

Now the crucial question arises: how have we obtained the truth of this axiom? Is our knowledge *a priori* or empirical, "synthetic" or "analytic"? In a sense, such questions are a waste of time, because the all-important fact is that the axiom is self-evidently true, self-evident to a far greater and broader extent than the other postulates. For this Axiom is true for all human beings, everywhere, at any time, and could not even *conceivably* be violated. In short, we may conceive of a world where resources are not varied, but not of one where human beings exist but do not act. We have seen that the other postulates, while "empirical," are so obvious and acceptable that they can hardly be called "falsifiable" in the usual empiricist sense. How much more is this true of the Axiom, which is not even conceivably falsifiable!

Positivists of all shades boggle at self-evident propositions. And yet, what is the vaunted "evidence" of the empiricists but the bringing of a hitherto obscure proposition into *evident* view? But some propositions need only to be stated to become at once evident to the self, and the action axiom is just such a proposition.

Whether we consider the Action Axiom "a priori" or "empirical" depends on our ultimate philosophical position. Professor Mises, in the neo-Kantian tradition, considers this axiom a *law of thought* and therefore a categorical truth *a priori* to all experience. My own epistemological position rests on Aristotle and St. Thomas rather than Kant, and hence I would interpret the proposition differently. I would consider the axiom a *law of reality* rather than a law of thought, and hence "empirical" rather than "a priori." But it should be obvious that this type of "empiricism" is so out of step with modern empiricism that

[6]Hutchison, "Professor Machlup on Verification in Economics," p. 483.

I may just as well continue to call it *a priori* for present purposes. For (1) it is a law of reality that is not conceivably falsifiable, and yet is empirically meaningful and true; (2) it rests on universal *inner* experience, and not simply on external experience, that is, its evidence is *reflective* rather than physical;[7] and (3) it is clearly *a priori* to complex historical events.[8]

The epistemological pigeon-holing of self-evident propositions has always been a knotty problem. Thus, two such accomplished Thomists as Father Toohey and Father Copleston, while resting on the same philosophical position, differ on whether self-evident propositions should be classified as "a posteriori" or "a priori," since they define the two categories differently.[9]

From the Fundamental Axiom is derived the truth that everyone tries always to maximize his utility. Contrary to Professor Hutchison,

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[7]See Professor Knight's critique of Hutchison's Significance and Basic Postulates of Economic Theory. Frank H. Knight, "What is Truth in Economics?" *Journal of Political Economy* (February 1940): 1–32.

[8]Professor Hutchison may have had me in mind when he says that in recent years followers of Professor Mises try to defend him by saying he really meant "empirical" when saying "a priori." Thus, see my "Praxeology, Reply to Mr. Schuller," *American Economic Review* (December 1951): 943–44; included in this volume as chapter 7. What I meant is that Mises's fundamental axiom may be called "a priori" or "empirical" according to one's philosophical position, but is in any case *a priori* for the practical purposes of economic methodology.

[9]Thus, Copleston calls self-evident principles "synthetic propositions *a priori*" (though not in the Kantian sense)—synthetic as conveying information about reality not contained logically in previous premises; and *a priori* as being necessary and universal. Toohey virtually obliterates the distinctions and terms self-evident propositions synthetic—a posteriori, because, while being necessary and universals, they are derived from experience. See F.C. Copleston, S.J., *Aquinas* (London: Penguin Books, 1955), pp. 28 and 19–41; John J.H. Toohey, S.J., *Notes on Epistemology* (Washington, D.C.: Georgetown University, 1952), pp. 46–55. All this raises the question of the usefulness of the whole "analytic-synthetic" dichotomy, despite the prominence implicitly given it in Hutchison's "Significance and Basic Postulates of Economic Theory," *Journal of Political Economy* 49 (1934). For a refreshing skepticism on its validity, and for a critique of its typical use to dispose of difficult-to-refute theories as either disguised definitions or debatable hypotheses, see Hao Wang, "Notes on the Analytic-Synthetic Distinction," *Theoria* 21 (Parts 2–3, 1955): 158ff.

this law is not a disguised definition—that they maximize what they maximize. It is true that utility has no concrete content, because economics is concerned not with the content of a man's ends, but with the fact that he has ends. And this fact, being deduced directly from the Action Axiom, is absolutely true.[10]

We come finally to Mises's ultimate heresy in the eyes of Professor Hutchison: his alleged logical deduction of "wholesale political conclusions" from the axioms of economic science. Such a charge is completely fallacious, particularly if we realize that Professor Mises is an uncompromising champion of "Wertfreiheit" not only in economics, but also for all the sciences. Even a careful reading of Hutchison's selected quotations from Mises will reveal no such illegitimate deductions.[11] Indeed, Mises's economics is unrivaled for its avoidance of unanalyzed *ad hoc* value judgments, slipped into the *corpus* of economic analysis.

Dean Rappard has posed the question: how can Mises be at the same time a champion of "Wertfreiheit in economics and of *laissez-faire*" liberalism, a "dilemma" which leads Professor Hutchison to accuse Mises of making political deductions from economic theory?[12]

The following passages from Mises give the clue to this puzzle:

> Liberalism is a political doctrine. . . . As a political doctrine liberalism (in contrast to economic science) is not neutral with regard to values and ultimate ends sought by action. It assumes that all

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[10]See Hutchison, "Professor Machlup on Verification Economics," p. 480. Alan Sweezy fell into the same error when he charged that Irving Fisher's dictum: "each individual acts as he desires," since not meant as a testable proposition in psychology, must reduce to the empty "each individual acts as he acts." On the contrary, the dictum is deducible directly from the Action Axiom, and is therefore both empirically meaningful and apodictically true. See Rothbard, "Toward a Reconstruction of Utility and Welfare Economics," pp. 225–28.

[11]Thus: "Liberalism starts from the pure sciences of political economy and sociology which within their systems make no valuations and say nothing about what ought to be or what is good or bad, but only ascertain what is and how it is." Quoted by Hutchison, "Professor Machlup on Verification Economics," p. 483*n*.

[12]William E. Rappard, "On Reading von Mises," in *On Freedom and Free Enterprise*, M. Sennholz, ed., pp. 17–33.

> men or at least the majority of people are intent upon attaining certain goals. It gives them information about the means suitable to the realization of their plans. The champions of liberal doctrines are fully aware of the fact that their teachings are valid only for people who are committed to their valuational principles. While praxeology, and therefore economics too, uses the terms happiness and removal of uneasiness in a purely formal sense, liberalism attaches to them a concrete meaning. It presupposes that people prefer life to death, health to sickness . . . abundance to poverty. It teaches men how to act in accordance with these valuations.[13]

Economic science, in short, establishes existential laws, of the type: if A, then B. Mises demonstrates that this science asserts that *laissez-faire* policy leads to peace and higher standards of living for all, while statism leads to conflict and lower living standards. Then, Mises as a citizen chooses *laissez-faire* liberalism because he is interested in achieving these ends. The only sense in which Mises considers liberalism as "scientific" is to the extent that people unite on the goal of abundance and mutual benefit. Perhaps Mises is overly sanguine in judging the extent of such unity, but he never links the valuational and the scientific: when he says that a price control is "bad" he means bad not from his point of view as an economist, but from the point of view of those in society who desire abundance. Those who choose contrasting goals—who favor price controls, for example, as a route to bureaucratic power over their fellow men, or who, through envy, judge social equality as more worthwhile than general abundance or liberty—would certainly not accept liberalism, and Mises would certainly never say that economic science proves them wrong. He never goes beyond saying that economics furnishes men with the knowledge of the consequences of various political actions; and that it is the citizen's province, knowing these consequences, to choose his political course.

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[13]Mises, *Human Action*, pp. 153–54; also see pp. 879–81.

# 7

# Praxeology: Reply to Schuller

Rather than prolong my discussion with Mr. Schuller[1] unnecessarily by engaging further in a point-by-point refutation, I think it important to clarify the nature of praxeology and its applicability to historical events.

The fundamental praxeological axiom is that individual human beings act. Praxeology reveals the implications of the concept of "action." Action results from the fact that the individual "actor" believes that there are other states of being preferable to the one in which he is at present, and from his belief that he may take certain steps which will bring him to a more satisfactory state. Given these preferences and "technological" ideas, the individual acts upon them in order to arrive at a more satisfactory state. The preferred state which the actor expects to attain is his "end"; the steps by which the actor attempts to attain his goal are the "means."[2] It is this praxeological concept of action that distinguishes the observed movements of men from those of inorganic matter.[3]

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[1]*American Economic Review* XL, no. 3 (June 1950): 418–22; XLI, no. 1 (March 1951): 181–90.

[2]Although he did not use the term, Professor Talcott Parsons engaged in profound praxeological analysis in his *Structure of Social Action* (Glencoe, Ill.: The Free Press, 1949). Cf., esp. chap. 2, pp. 44–50.

[3]The difficult case of animal behavior, ranging from the lower organisms to the higher primates, cannot be discussed here.

This axiom of action is indisputably an important truth, and must form the basis for social theory. To deny it would be absurdity. How has our knowledge of the truth of this axiom been attained? In this way: an individual reflects, discovers the concept of action and its applicability to all human individuals, analyzes its components, and then sets it forth orally or by the written word. Each individual, upon reflecting on the axiom of action, must agree to its truth and to its importance. It is in this respect that the action axiom must be "universally recognized as true."[4] What name we apply to this method of obtaining knowledge is basically unimportant and involves irrelevant philosophical problems; thus, it may be called "introspective," "empirical," "a priori," or "reflective." The important consideration is that it is certainly a different type of "empiricism" from the study of historical events and is definitely "a priori" to those events, and that such a situation has no parallel in the physical sciences. The physical sciences are not in the fortunate position of positively knowing their fundamental axioms. On the other hand, the physical sciences are in a position to isolate causal factors in experiments. The physical sciences, then, have to arrive at their axioms by hypothesis and by experimental testing of conclusions deduced from these hypothecated axioms. In the "social sciences," the fundamental axioms of praxeology are known from the beginning, so that substantive conclusions may be drawn by means of logical deduction. In human historical events, however, causal factors cannot be experimentally isolated, so that the historian must explain by the use of judgment which praxeological laws apply in the particular situation.

Explanation of the roles of praxeological laws and historical judgment or "understanding" may be provided by the following example: If the supply of a medium of exchange increases; and if the demand for that medium remains the same; then, the purchasing power of that medium will decline. This is a praxeological law. How may an historian apply this law? He must first determine whether or

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[4]Schuller's questioning of the validity of the praxeological axioms and procedures on the basis of the possible inability of the vast majority to grasp them is an old problem for the physical sciences. How can Einstein's theory of relativity be true if the mass of the people cannot understand the demonstration of its validity? Whatever solution physical science has developed for this puzzle may be adopted by praxeology as well.

not a decline in purchasing power (increase in prices) has taken place. This involves difficulties of an historical-statistical nature; it is not a problem for praxeology or for that elaborated division of it known as "economic theory" or "catallactics." Once he has determined that a fall in purchasing power of the medium has taken place, he searches for an explanation by applying the praxeological-catallactic law. He investigates the historical situation to discover whether there has been an increase in the supply of the medium. If he finds a considerable increase in the supply, he is then in a position to assert three truths:

A. It is an historical fact that the purchasing power of medium X has declined to such and such an extent.

B. It is an historical fact that the supply of the medium X has increased to such and such an extent.

C. The praxeological law just mentioned. It is therefore concluded: that a significant cause of the decline, A, was the increase in supply, B.

If he finds no increase in supply, then he deduces that a fall in demand for the medium was the cause of the fall in purchasing power.

Such is an example of what is involved in the work of historical explanation. The work of the "economic theorist," or praxeologist, is to elaborate the laws (such as C) from the various axioms and according to the rules of logic. Clearly, neither Mises nor myself has ever cited "facts as if they provided support for his conclusions and for the axioms, postulates, and logical procedures." I cited facts such as "dollar gaps" not as proof or test, but as illustrations of the workings of praxeological laws in (modern) historical situations. It is a praxeological law that if the government (or any other agency exercising the power of violence) intervenes in the market to establish a valuation of any commodity below what would be the market valuation, a shortage of the commodity develops. Gresham's Law is a subdivision of this law applied to media of exchange, which, in turn, leads to the explanation of the "dollar gap." The historian sees a shortage of dollars in relation to pounds develop in England, and, using praxeological laws, explains it as the consequence of governmental over-valuation of the

pound in relation to the dollar. In no way does he test or "prove" the theory.

How may praxeology be applied to forecasting, to the prediction of future historical events? The process is essentially that of the historian, except that the difficulties are greater. Thus, using the above example, the forecaster may see a considerable increase in the money supply take place. He asserts B; C he knows as a praxeological truth. In order to forecast the probable future course of purchasing power, he must make an estimate of the probable course of the demand for money in the period under consideration. If, on the basis of his judgment, he decides that the relative change in demand will be negligible, he is in a position to predict that the purchasing power of the money unit will decline in that period. With the help of praxeology, his judgment is the best he can offer, but it is still inexact, dependent on the correctness of his estimates—in this case, of the movement in the demand for money. If he wishes to make a quantitative estimate of the change in purchasing power, his estimate is still more inexact, for praxeology can be of no help in this attempt. If his prediction proves erroneous, it is not praxeology that has failed, but his judgment of the future behavior of the elements in the praxeological theorem. Praxeology is indispensable, but it does not provide omniscience. It furnishes laws in the form of: If X, and if Y remains unchanged, then Z. It is up to the historian, and his counterpart, the forecaster, to determine the specific cases in which the law is applicable. It should now be quite clear that there are no praxeological laws of historical development, and that neither Mises nor myself need "reconcile" any "dilemmas" in setting forth such a law. If there were, then the task of the historian would be far easier than it is. Historical events are complex results of numerous causal factors: praxeologic, psychologic, physical, chemical, biological, etc. The historian must determine which science and its laws apply, and, more difficult, the extent to which each causal factor operated in the events he is attempting to explain or predict. Historians will legitimately differ on the order of importance to be attributed to each factor. Thus, various factors, praxeologic-economic, military, moral, and psychologic might be enumerated as causes of the Bolshevik Revolution. But there is no exact, scientific way of deciding the precise extent of importance to be assigned to each factor.

What of the relation between praxeology and economic theory *per se*? Economic theory as has been developed is a component part of praxeology. It is deduced from the apodictic axiom of action, and most of economic theory, including the laws and implications of Uncertainty, Time Preference, the Law of Returns, the Law of Utility, etc. can be deduced directly with no further assumptions. With the help of a very small number of subsidiary axioms which are rather more "empirical" in nature—such as "the disutility of labor"—the rest of economic theory can be deduced.

The categories of praxeology may be outlined as follows:

Praxeology—the general, formal theory of human action:

A. The Theory of the Isolated Individual (Crusoe Economics)
B. The Theory of Voluntary Interpersonal Exchange (Catallactics, or the Economics of the Market)
   1. Barter
   2. With Medium of Exchange
      a. On the Unhampered Market
      b. Effects of Violent Intervention with the Market
      c. Effects of Violent Abolition of the Market (Socialism)
C. The Theory of War—Hostile Action
D. The Theory of Games (e.g., Von Neumann and Morgenstern)
E. Unknown

Clearly, A and B—Economics—is the only fully elaborated part of praxeology. The others are largely unexplored areas.

A concluding word on all the bother about democracy, dictatorship, and government. Clearly, the praxeologist qua praxeologist cannot advocate any course of action. As a citizen, however, he may, along with other citizens, try to decide on the proper course of social policy, and, in making that decision, he will be likely to use the aid of praxeology and call attention to its usefulness. For socio-political problems, praxeology presents the citizen with one great lesson, i.e., that the use of violence for purposes of plunder injures not only the victim (which is self-evident) but, in the long run, the plunderer also. The goal of the good citizen, then, is to try to eliminate, or at

least minimize, violent plunder in the society.[5] The problem of how to arrive at this goal is still unsolved, as a glance at the state of the world today will make dramatically clear. The great problem is how to convince or persuade the would-be plunderer to consult his long-run rather than what he might interpret as his short-run interests. The traditional *laissez-faire* solution was to establish a government that would have an effective monopoly on the means of violence, and would use these means solely to prevent and punish attempts at violence within the society. This largely (although not completely) ended the problem of sporadic social violence, but created a new problem:

> *Quis custodes custodiet*? Who will guard the state itself from using its effective monopoly of violence for plunder? The most ambitious attempt to solve this problem was the "Jeffersonian" one—to establish a government that would be tightly and securely ringed with definite constitutional restrictions to confine it to its "anti-invasive" function, to instill into the people a spirit of perpetual vigilant distrust of the government and particularly the appointed bureaucracy, and to keep the government small and local in order to permit direct popular control and vigilance. In the light of the history of the past century, it is possible that this method is impracticable, and that some other means may have to be found.

Finally, may I state that though I share Schuller's hope that my interpretation of *Human Action* agrees with that of Mises, there is no warrant for any assumption to that effect.

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[5]This is aside from any moral considerations which might also lead the citizen to the goal of eliminating or minimizing the use of violence.

# 8

# The Hermeneutical Invasion of Philosophy and Economics

In recent years, economists have invaded other intellectual disciplines and, in the dubious name of "science," have employed staggeringly oversimplified assumptions in order to make sweeping and provocative conclusions about fields they know very little about. This is a modern form of "economic imperialism" in the realm of the intellect. Almost always, the bias of this economic imperialism has been quantitative and implicitly Benthamite, in which poetry and pushpin are reduced to a single-level, and which amply justifies the gibe of Oscar Wilde about cynics, that they (economists) know the price of everything and the value of nothing. The results of this economic imperialism have been particularly ludicrous in the fields of sex, the family, and education.

So why then does the present author, not a Benthamite, now have the temerity to tackle a field as arcane, abstruse, metaphysical, and seemingly unrelated to economics as hermeneutics? Here my plea is the always legitimate one of self-defense. Discipline after discipline, from literature to political theory to philosophy to history, have been invaded by an arrogant band of hermeneuticians, and now even economics is under assault. Hence, this article is in the nature of a counterattack.

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To begin, the dictionary definition of hermeneutics is the age-old discipline of interpreting the Bible. Until the 1920s or 1930s, indeed, hermeneutics was confined to theologians and departments of religion. But things changed with the advent of the murky German doctrines of Martin Heidegger, the founder of modern hermeneutics. With the death of Heidegger, the apostolic succession of head of the hermeneutical movement fell upon his student, Hans-Georg Gadamer, who still wears this mantle.

The greatest success of the hermeneutical movement has been achieved in recent decades, beginning in the closely related movement of "deconstructionism" in literary criticism. Headed by the French theorists Michel Ricoeur, Paul Ricoeur, and Jacques Derrida, deconstructionism in the Western Hemisphere is led by the formidable English department at Yale University, from which it has spread to conquer most of the English-literature departments in the United States and Canada. The essential message of deconstructionism and hermeneutics can be variously summed up as nihilism, relativism, and solipsism. That is, either there is no objective truth or, if there is, we can never discover it. With each person being bound to his own subjective views, feelings, history, and so on, there is no method of discovering objective truth. In literature, the most elemental procedure of literary criticism (that is, trying to figure out what a given author meant to say) becomes impossible. Communication between writer and reader similarly becomes hopeless; furthermore, not only can no reader ever figure out what an author meant to say, but even the author does not know or understand what he himself meant to say, so fragmented, confused, and driven is each particular individual. So, since it is impossible to figure out what Shakespeare, Conrad, Plato, Aristotle, or Machiavelli meant, what becomes the point of either reading or writing literary or philosophical criticism?

It is an interesting question, one that the deconstructionists and other hermeneuticians have of course not been able to answer. By their own avowed declaration, it is impossible for deconstructionists to understand literary texts or, for example, for Gadamer to understand Aristotle, whom he has nevertheless written upon at enormous length. As the English philosopher Jonathan Barnes has pointed out in his brilliant and witty critique of hermeneutics, Gadamer, not having anything to say about Aristotle or his works, is reduced to reporting his own subjective musings—a sort of lengthy account of "what

Aristotle means to me."[1] Setting aside the hermeneutical problem of whether or not Gadamer can *know* even what Aristotle means to him, we push back the problem another notch. Namely, why in the world should anyone but Gadamer, except possibly his mother or wife, be in the least interested in the question of what Aristotle means to him? And even in the improbable event that we *were* interested in this earth-shattering question, we would in any case be prevented on hermeneutical principles from understanding Gadamer's answer.

Deconstruction and hermeneutics are clearly self-refuting on many levels. If we cannot understand the meaning of any texts, then why are we bothering with trying to understand or to take seriously the works or doctrines of authors who aggressively proclaim their own incomprehensibility?

## Incomprehensibility

Indeed, a crucial point about the hermeneuticians is that, for them, incomprehensibility is a self-fulfilling prophecy. As a colleague of mine ruefully told me: "I have read everything on hermeneutics I can lay my hands on, and I understand no more about it than I did when I first started." Even in a profession—philosophy—not exactly famous for its sparkle or lucidity, one of the most remarkable qualities of the hermeneuticians is their horrendous and incomparably murky style. Stalactites and stalagmites of jargon words are piled upon each other in a veritable kitchen midden of stupefying and meaningless prose. Hermeneuticians seem to be incapable of writing a clear English, or indeed a clear German sentence. Critics of hermeneutics—such as Jonathan Barnes or David Gordon[2]—are understandably moved to satire, to stating or quoting hermeneutical tracts and then "translating" them into simple English, where invariably they are revealed as either banal or idiotic.

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[1]Jonathan Barnes, "A Kind of Integrity Review of Hans-Georg Gadamer," *Philosophical Apprenticeships* (Cambridge, Mass.: MIT Press, 1985); Hans-Georg Gadamer, *The Idea of the Good in Platonic-Aristotelian Philosophy* (New Haven, Conn.: Yale University Press, 1986); *London Review of Books* (November 6, 1986): 12–13.

[2]Barnes, "A Kind of Integrity;" and David Gordon, *Hermeneutics versus Austrian Economics* (Auburn, Ala.: Ludwig von Mises Institute, 1986).

At first, I thought that these German hermeneuticians were simply ill-served by their translators into English. But my German friends assure me that Heidegger, Gadamer et al. are equally unintelligible in the original. Indeed, in a recently translated essay, Eric Voegelin, a philosopher not normally given to scintillating wit, was moved to ridicule Heidegger's language. Referring to Heidegger's master work, *Sein und Zeit* (Being and Time), Voegelin refers to the meaningless but insistent repetition of a veritable philosophical dictionary of phrases as the *Anwesen des Anwesenden* ("the presence of that which is present"), the *Dingen des Dings* ("the thinging of the thing"), the *Nichten des Nichts* ("the nothinging of the nothing"), and finally to the *zeigenden Zeichen des Zeigzeugs* ("the Pointing sign of the pointing implement"), all of which is designed, says Voegelin, to whip up the reader "into a reality-withdrawing state of linguistic delirium."[3]

On Gadamer and the hermeneuticians, Jonathan Barnes writes:

> What, then, are the characteristic features of hermeneutical philosophy? Its enemies will wade in with adjectives like *empty, vapid, dreamy, woolly, rhetorical*. Gadamer himself tells an uncharacteristic story. At the end of a seminar on Cajetan, Heidegger once startled his devoted audience by posing the question: "What is being?" "We sat there staring and shaking our heads over the absurdity of the question." Quite right too, say the enemies of hermeneutics: the question is perfectly absurd. But Gadamer has only a frail sense of the absurd, and his own readers ought to react as he once—but alas, only once—reacted to Heidegger.

Barnes goes on to say that Gadamer admits "that his thought has sometimes been less than pellucid." He further quotes Gadamer as saying:

> Certainly I sometimes spoke over my pupils' heads and put too many complications into my train of thought. Even earlier my friends had invented a new scientific measure, the "Gad," which designated a settled measure of unnecessary complications.

Barnes adds that:

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[3]Eric Voegelin, "The German University and the Order of German Society: A Reconsideration of the Nazi Era," *Intercollegiate Review* 20 (Spring/Summer, 1985): 11.

> Some may prefer to this self-congratulatory little story a remark which Gadamer makes of his younger self: "Despite my title of doctor, I was still a 22-year old boy who thought rather murky thinking, and who still did not really know what was going on."

Barnes adds: "Did the boy ever grow up?"[4]

At this point we may cite Sir Karl Popper on G.W.F. Hegel, who counts along with Friedrich Schleiermacher as at least a great-grandfather of hermeneutics. What Popper lacks in satiric gifts he makes up in the vehemence of the scorn that he heaps upon the legion of his philosophical enemies, real or imagined. After denouncing Hegel's "high-flown gibberish" and "imbecile fancies," Popper quotes with obvious relish the attack on Hegel by his contemporary Schopenhauer as:

> a flat-headed, insipid, nauseating, illiterate charlatan, who reached the pinnacle of audacity in scribbling together and dishing up the craziest mystifying nonsense. This nonsense has been noisily proclaimed as immortal wisdom by mercenary followers and readily accepted as such by all fools, who thus joined into as perfect a chorus of admiration as had ever been heard before.[5]

Why this enormous acclaim and influence exerted by mystifying nonsense? In addition to noting its establishment in the interests of the Prussian state, Popper offers the following explanation:

> For some reason, philosophers have kept around themselves, even in our day, something of the atmosphere of the magician. Philosophy is considered a strange and abstruse kind of thing, dealing with those mysteries with which religion deals, but not in a way which can be "revealed unto babes" or to common people; it is considered to be too profound for that, and to be the religion and theology of the intellectuals, of the learned and wise.[6]

For a final citation on the incomprehensibility of hermeneutics, let us turn to the witty and devastating demolition by H.L. Mencken of Thorstein Veblen, another early protohermeneutician and an institutionalist opponent of the idea of economic law. In the course

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[4]Barnes, "A Kind of Integrity," p. 13.

[5]Karl R. Popper, *The Open Society and its Enemies*, 4th ed. (New York: Harper and Row, 1962), vol. 2, p. 33.

[6]Ibid., p. 30.

of an essay featuring the "translation" into English of Veblen's indecipherable prose, Mencken wrote that what was truly remarkable about Veblen's ideas:

> was the astoundingly grandiose and rococo manner of their statement, the almost unbelievable tediousness and flatulence of the gifted headmaster's prose, his unprecedented talent for saying nothing in an august and heroic manner. . . .
>
> Marx, I daresay, had said a good deal of it long before him, and what Marx overlooked had been said over and over again by his heirs and assigns. But Marx, at this business, labored under a technical handicap; he wrote in German, a language he actually understood. Prof. Veblen submitted himself to no such disadvantage. Though born, I believe, in these States, and resident here all his life, he achieved the effect, perhaps without employing the means, of thinking in some unearthly foreign language—say Swahili, Sumerian or Old Bulgarian—and then painfully clawing his thoughts into a copious and uncertain but book-learned English. The result was a style that affected the higher cerebral centers like a constant roll of subway expresses. The second result was a sort of bewildered numbness of the senses, as before some fabulous and unearthly marvel. And the third result, if I make no mistake, was the celebrity of the professor as a Great Thinker.[7]

## COLLECTIVISM

Marx, in fact, has been hailed by the hermeneuticians as one of the grandfathers of the movement. In 1985, for example, at the annual meeting of the Western Political Science Association in Las Vegas, virtually every paper offered in political theory was a hermeneutical one. A paradigmatic title would be "Political Life as a Text: Hermeneutics and Interpretation in Marx, Heidegger, Gadamer, and Foucault." (Substitute freely such names as Ricoeur and Derrida, with an occasional bow to Habermas.)

I do not believe it an accident that Karl Marx is considered one of the great hermeneuticians. This century has seen a series of devastating setbacks to Marxism, to its pretensions to "scientific truth," and to its theoretical propositions as well as to its empirical assertions

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[7]H.L. Mencken, "Professor Veblen," *A Mencken Chrestomathy* (New York: Alfred A. Knopf, 1949), p. 270.

and predictions. If Marxism has been riddled both in theory and in practice, then what can Marxian cultists fall back on? It seems to me that hermeneutics fits very well into an era that we might, following a Marxian gambit about capitalism, call "late Marxism" or marxism-in-decline. Marxism is not true and is not science, but so what? The hermeneuticians tell us that nothing is objectively true, and therefore that all views and propositions are subjective, relative to the whims and feelings of each individual. So why should Marxian yearnings not be equally as valid as anyone else's? By the way of hermeneutics, these yearnings cannot be subject to refutation. And since there is no objective reality, and since reality is created by every man's subjective interpretations, then all social problems reduce to personal and nonrational tastes. If, then, hermeneutical Marxists find capitalism ugly and unlovely, and they find socialism beautiful, why should they not attempt to put their personal esthetic preferences into action? If they feel that socialism is beautiful, what can stop them, especially since there are no laws of economics or truths of political philosophy to place obstacles in their path?

It is no accident that, with the exception of a handful of contemporary economists—who will be treated further later—every single hermeneutician, past and present, has been an avowed collectivist, either of the left- or right-wing variety, and sometimes veering from one collectivism to another in accordance with the realities of power. Marx, Veblen, Schmoller, and the German Historical School are well known. As for the modern hermeneuticians, Heidegger found it all too easy to become an enthusiastic Nazi once the Nazi regime had been established. And Gadamer had no difficulty whatever adapting either to the Nazi regime (where he was known for having only a "loose sympathy" with the Third Reich) or to the Soviet occupation in East Germany (where, in his own words, he won "the special esteem of the Russian cultural authorities" for carrying out "their directives exactly, even against my own convictions").[8]

## "Openness" and Keeping the "Conversation" Going

Here we must note two variants of the common hermeneutical theme. On the one hand are the candid relativists and nihilists, who

[8]Barnes, "A Kind of Integrity," p. 12.

assert, with an inconsistently absolutist fervor, that there is no truth. These hold with the notorious dictum of the epistemological anarchist Paul Feyerabend that "anything goes." Anything, be it astronomy or astrology, is of equal validity or, rather, equal invalidity. The one possible virtue of the "anything goes" doctrine is that at least everyone can abandon the scientific or philosophic enterprise and go fishing or get drunk. This virtue, however, is rejected by the mainstream hermeneuticians, because it would put an end to their beloved and interminable "conversation." In short, the mainstream hermeneuticians do not like the "anything goes" dictum because, instead of being epistemological anarchists, they are epistemological pests. They insist that even though it is impossible to arrive at objective truth or indeed even to understand other theorists or scientists, that we all still have a deep moral obligation to engage in an endless dialogue or, as they call it, "conversation" to try to arrive at some sort of fleeting quasi-truth. To the hermeneutician, truth is the shifting sands of subjective relativism, based on an ephemeral "consensus" of the subjective minds engaging in the endless conversation. But the worst thing is that the hermeneuticians assert that there is no objective way, whether by empirical observation or logical reasoning, to provide any criteria for such a consensus. Since there are no rational criteria for agreement, any consensus is necessarily arbitrary, based on God-knows-what personal whim, charisma of one or more of the conversationalists, or perhaps sheer power and intimidation. Since there is no criterion, the consensus is subject to instant and rapid change, depending on the arbitrary mind-set of the participants or, of course, a change in the people constituting the eternal conversation.

A new group of hermeneutical economists, eager to find some criteria for consensus, have latched onto a Gestalt-like phrase of the late economist Fritz Machlup, perhaps taking his name very much in vain. They call this criterion the "Aha! principle," meaning that the truth of a proposition is based on the exclamation of "Aha!" that the proposition may arouse in someone's breast. As Don Lavoie and Jack High put it: "We know a good explanation when we see one, and when it induces us to say aha."[9] Somehow I do not find this criterion for truth, or even for consensus, very convincing. For example, many

[9]Don Lavoie and Jack High, "Interpretation and the Costs of Formalism" (unpublished manuscript), p. 14.

of us would find the prospect of being confronted with the option of engaging in endless and necessarily fruitless conversation with people unable to write a clear sentence or express a clear thought to be the moral equivalent of Sartre's *No Exit*. Furthermore, I have a hunch that if someone came up with the proposition: "It would be a great thing to give these guys a dose of objective reality over the head" or at the very least to slam the door on their conversation, that this would elicit many more fervent "Ahas!" than the murky propositions of the hermeneuticians themselves.

The prime moral duty proclaimed by the hermeneuticians is that we must at all times keep the *conversation* going. Since this duty is implicit, it is never openly defended, and so we fail to be instructed why it is our moral obligation to sustain a process that yields such puny and ephemeral results. In keeping with this alleged virtue, the hermeneuticians are fervently and dogmatically opposed to "dogmatism" and they proclaim the supreme importance of remaining endlessly "open" to everyone in the dialogue. Gadamer has proclaimed that the highest principle of hermeneutic philosophy is "holding oneself open in a conversation," which means always recognizing "in advance, the possible correctness, even the superiority of the conversation partner's position." But, as Barnes points out, it is one thing to be modestly skeptical of one's own position; it is quite another to refuse to dismiss *any other* position as false or mischievous. Barnes points out that the modest skeptic:

> recognizes that he himself may always be wrong. Gadamer's "open" philosopher allows that his opponent may always be right. A modest skeptic may . . . indeed, in his modest way, regard the history of philosophy as a ceaseless campaign, marked by frequent defeats and occasional triumphs, against the ever powerful forces of fallacy and falsehood. . . . [W]ith some opponents he will not be "open": he will be quite sure that they are wrong.[10]

The most important hermeneutical philosopher in the United States is Richard Rorty, who, in his celebrated book, *Philosophy and the Mirror of Nature*, devotes considerable space to the prime importance

[10]Barnes, "A Kind of Integrity," p. 13. For a critique of the triumph of the ideal of "openness," see Allan Bloom, *The Closing of the American Mind* (New York: Simon and Schuster, 1987).

of "keeping the conversation going." In his sparkling critique of Rorty, Henry Veatch points out that, to the crucial question of how can we conversationalists ever know which ideals or "cultural posits" (in the Rortian language) are better than others, "Rorty could only answer that, of course, there can't be any such thing as *knowledge* in regard to matters such as these." So, if there is no knowledge and, hence, no objective criteria for arriving at positions, we must conclude, in the words of Veatch, that "although Aristotle may well have taught that 'philosophy begins in wonder,' . . . present-day philosophy can only end in a total conceptual or intellectual permissiveness."[11] In short, we end with the Feyerabendian "anything goes" or, to use the admiring phrase of Arthur Danto in his summary of Nietzsche, that "everything is possible."[12] Or, in a word, total "openness."

But if all things are open, and there are no criteria to guide conversationalists to any conclusions, how will such conclusions be made? It seems to me, following Veatch, that these decisions will be made by those with the superior Will-to-Power. And so it is not a coincidence that leading hermeneuticians have found themselves flexible and "open" in response to the stern demands of state power. After all, if Stalin, Hitler, or Pol Pot enters the "conversational" circle, they cannot be rejected out of hand, for they too may offer a superior way to consensus. If nothing is wrong and all things are open, what else can we expect? And who knows, even these rulers may decide, in a sardonic burst of Marcusean "repressive tolerance," to keep some sort of Orwellian "conversation" going in the midst of a universal gulag.

In all the blather about openness, I am reminded of a lecture delivered by Professor Marjorie Hope Nicholson at Columbia University in 1942. In a critique of the concept of the open mind, she warned: "Don't let your mind be so open that everything going into it falls through."

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[11]Henry Veatch, "Deconstruction in Philosophy: Has Rorty Made It the Denouement of Contemporary Analytical Philosophy?" *Review of Metaphysics* 39 (December 1985): 313–14, 316.

[12]Arthur C. Danto, *Nietzsche as Philosopher* (New York: Columbia University Press, 1980), p. 12; cited in Veatch, "Deconstruction," p. 312.

There is another self-serving aspect to the hermeneutical demands for universal openness. For if nothing—no position, no doctrine—can be dismissed outright as false or mischievous or as blithering nonsense, then they too, our hermeneuticians, must be spared such rude dismissal. Keeping the conversation going at all costs means that these people must eternally be included. And that is perhaps the unkindest cut of all.

If one reads the hermeneuticians, furthermore, it becomes all too clear that typically no one sentence follows from any other sentence. In other words, not only is the style abominable, but there is no reasoning in support of the conclusions. Since logic or reasoning are not considered valid by the hermeneuticians, this procedure is not surprising. Instead, for reasoning the hermeneuticians substitute dozens or scores of books, which are cited, very broadly, in virtually every paragraph. To support their statements, the hermeneuticians will list repeatedly every book that might possibly or remotely relate to the topic. In short, their only argument is from authority, an ancient philosophic fallacy which they seem to have triumphantly revived. For indeed, if there is no truth of reality, if for logic or experience, we must substitute a fleeting consensus of the subjective whims, feelings, or power plays of the various conversationalists, then what else is there but to muster as many conversationalists as possible as your supposed authorities?[13]

Armed with their special method, the hermeneuticians are therefore able to dismiss all attacks upon themselves, no matter how perceptive or penetrating, as "unscholarly." This lofty rebuttal stems from their unique definition of *scholarly*, which for them means ponderous and obscurantist verbiage surrounded by a thicket of broad citations to largely irrelevant books and articles.

So why then have not the distinguished critics of hermeneutics played the game on their opponents' own turf and waded through the mountains and oceans of hogwash, patiently to cite and refute the hermeneuticians point by point and journal article by journal article? To ask that question is virtually to answer it. In fact, we have asked some of the critics this question, and they immediately responded in a heartfelt manner that they do not propose to dedicate

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[13]I am indebted for this point to Sheldon Richman of the Institute for Humane Studies at George Mason University.

the rest of their lives to wading through this miasma of balderdash. Moreover, to do so, to play by the hermeneuticians' own rules, would be to grant them too much honor. It would wrongfully imply that they are indeed worthy participants in our conversation. What they deserve instead is scorn and dismissal. Unfortunately, they do not often receive such treatment in a world in which all too many intellectuals seem to have lost their built-in ability to detect pretentious claptrap.[14]

## Hermeneutical Economics

Economists like to think of their discipline as the "hardest" of the social sciences, and so it is no surprise that hermeneutics—though having conquered the field of literature and made severe inroads into philosophy, political thought, and history—has yet made very little dent in economics. But the economics discipline has been in a state of methodological confusion for over a decade, and in this crisis situation minority methodologies, now including hermeneutics, have begun to offer their wares.

In the economics profession, of course, the practitioners down in the trenches only loosely reflect, or indeed have scarcely any interest in, the small number of methodological reflections in the upper stories of the ivory tower. But these seemingly remote philosophical musings do have an important long-run influence on the guiding theories and directions of the discipline. For approximately two decades, Lionel Robbins's justly famous *The Nature and Significance of Economic Science* was the guiding methodological work of the profession,

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[14]In a witty and perceptive article, the distinguished Yale philosopher Harry Frankfurt calls this phenomenon "bullshit," which he asserts to be a greater enemy to the truth than an outright lie, since a liar recognizes that he is violating the truth whereas the bullshitter does not. Frankfurt writes:

> The contemporary proliferation of bullshit also has deeper sources, in various forms of skepticism which deny that we can have any reliable access to an objective reality and which therefore reject the possibility of knowing how things truly are. These "antirealist" doctrines undermine confidence in the value of disinterested efforts to determine what is true and what is false, and even in the intelligibility of the notion of objective inquiry.

See Harry Frankfurt, "On Bullshit," *Raritan* 6 (Fall, 1986): 99–100.

presenting a watered-down version of the praxeological method of Ludwig von Mises. Robbins had studied at Mises's famous *Privatseminar* at Vienna, and his first edition (1932) stressed economics as a deductive discipline based on the logical implications of the universal facts of human action (for example, that human beings try to achieve goals by using necessarily scarce means). In Robbins's more widely known second edition (1935), the Misesian influence was watered down a bit further, coupled with intimations no bigger than a man's hand of the neo-classical formalism that would hit the profession about the time of World War II.[15] After the war, the older economics was inundated by an emerging formalistic and mathematical neoclassical synthesis, of Walrasian equations covering microeconomics and Keynesian geometry taking care of macro.

Aiding and abetting the conquest of economics by the new neoclassical synthesis was the celebrated article by Milton Friedman in 1953, "The Methodology of Positive Economics," which quickly swept the board, sending Robbins's *Nature and Significance* unceremoniously into the dustbin of history.[16] For three decades, secure and unchallenged, the Friedman article remained virtually the only written portrayal of official methodology for modern economics.

It should be noted that, as in the triumph of the Keynesian revolution and many other conquests by various schools of economics, the Friedman article did not win the hearts and minds of economists in the pattern of what we might call the Whig theory of the history of science: by patient refutation of competing or prevailing doctrines. As in the case of the Mises-Hayek business-cycle theory dominant before Keynes's *General Theory*, the Robbins book was not refuted; it was simply passed over and forgotten. Here the Thomas Kuhn theory of successive paradigms is accurate on the sociology or process of economic thought, deplorable as it might be as a prescription for the development of a science. Too often in philosophy or the social sciences, schools of thought have succeeded each other as whim or fashion, much as one style of ladies' hemlines has succeeded

[15]Lionel Robbins, *An Essay on the Nature and Significance of Economic Science* (London: Macmillan, [1932] 1935).

[16]Milton Friedman, "The Methodology of Positive Economics," in Friedman, *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953).

another. Of course, in economics as in other sciences of human action, more sinister forces, such as politics and the drive for power, often deliberately skew the whims of fashion in their own behalf.

What Milton Friedman did was to import into economics the doctrine that had dominated philosophy for over a decade, namely logical positivism. Ironically, Friedman imported logical positivism at just about the time when its iron control over the philosophical profession in the United States had already passed its peak. For three decades, we have had to endure the smug insistence on the vital importance of empirical testing of deductions from hypotheses as a justification for the prevalence of econometric models and forecasting, as well as a universal excuse for theory being grounded on admittedly false and wildly unrealistic hypotheses For neoclassical economic theory clearly rests on absurdly unrealistic assumptions, such as perfect knowledge, the continuing existence of a general equilibrium with no profits, no losses, and no uncertainty, and human action being encompassed by the use of calculus that assumes infinitesimally tiny changes in our perceptions and choices.

In short, this formidable apparatus of neoclassical mathematical economic theory and econometric models, all rests, from the Misesian point of view, upon the treacherous quicksand of false and even absurd assumptions. This Austrian charge of falsity and unreality, if noticed at all, was for decades loftily rebutted by pointing to Friedman's article and asserting that falsity of assumptions and premises do not matter, so long as the theory "predicts" properly. In its founding years in the early 1930s, the Econometric Society emblazoned on its escutcheon the motto, "Science is prediction," and this was the essence of the Friedman-derived defense of neoclassical theory. Austrians such as Mises and Hayek replied that the disciplines of human action are not like the physical sciences. In human affairs, there are no laboratories where variables can be controlled and theories tested, while (unlike the physical sciences) there are no quantitative constants in a world where there is consciousness, freedom of will, and freedom to adopt values and goals and then to change them. These Austrian contentions were dismissed by neoclassicals as simply posing a greater degree of difficulty in arriving at the human sciences, but not in offering a troublesome difference in kind.

The neoclassical synthesis, however, began, in the early 1970s, to lose its power either to understand or to predict what was going on

in the economy. The inflationary recession that first appeared dramatically in the 1973–74 contraction put an end to a thirty-five-year period of arrogant and unquestioned hegemony by the Keynesian wing of the neoclassical synthesis. For Keynesian theory and policy rested on the crucial assumption that inflationary recession simply cannot happen. At that point, Friedmanite monetarism came to the fore, but monetarism has now come a cropper after making a rapid series of disastrously wrong predictions from the beginning of the Reagan era until the present. But he who lives by prediction is destined to die by prediction.

In addition to these failures of Keynesianism and monetarism, the blunders and errors of econometric forecasting have become too notorious to ignore, and a wealthy and supremely arrogant profession, using ever higher-speed computer models, seems to enjoy less and less ability to forecast even the immediate future. Even governments, despite the assiduous attention and aid of top neoclassical economists and forecasters, seem to have great difficulties in forecasting *their own* spending, much less their own incomes, let alone the incomes or spending of anyone else.

Amid these failures, there has been a chipping away at the neoclassical formalism of Walrasian microeconomics, sometimes by disillusioned leaders operating from within this ruling paradigm.

As a result of these problems and failures, the last ten or fifteen years has seen the development of a classic Kuhnian "crisis situation" in the field of economics. As the positivist neoclassical orthodoxy begins to crumble, competing paradigms have emerged. Sparked also by Hayek's receipt of a Nobel Prize in 1974, Austrian or Misesian economics has enjoyed a revival since then, with numerous Austrians teaching in colleges in the United States and Britain. Recently there have even emerged five or six Austrian graduate programs or centers in the United States.

In a crisis situation, of course, the bad jostles the good in the new atmosphere of epistemological and substantive diversity. No one ever guaranteed that if a hundred flowers should bloom, that they would all be passing fair. On the left, the nontheory of institutionalism has made a bit of a comeback, jostled by "post-Keynesians" (inspired by Joan Robinson) and "humanistic" neo-Marxists who have substituted a vague adherence to "decentralization" and protection of all animal and vegetable life forms for the rigors of the labor theory of value.

Which brings us back to hermeneutics. For in this sort of atmosphere, even the underworld of hermeneutics will vie for its day in the sun. Probably the most prominent hermeneutical economist in the United States is Donald McCloskey, who calls his viewpoint "rhetoric" and whose attack on truth occurs in the name of rhetoric and of the eternal hermeneutical conversation.[17] McCloskey, unfortunately, follows the modern path of rhetoric run hog-wild and divorced from a firm anchor in truth, overlooking the Aristotelian tradition of "noble rhetoric" as the most efficient way of persuading people of correct and true propositions. For Aristotelians, it is only "base" rhetoric that is divorced from true principles.[18] McCloskey is now organizing a center for rhetorical studies at the University of Iowa, which will organize volumes on rhetoric in a number of diverse disciplines.

Much as I deplore hermeneutics, I have a certain amount of sympathy for McCloskey, an economic historian who endured years as a drill instructor and cadre leader in the Friedman-Stigler Chicago School's positivist ranks. McCloskey is reacting against decades of arrogant positivist hegemony, of an alleged "testing" of economic theory that never really takes place, and of lofty statements by positivists that "I do not understand what you *mean*," when they know darn well what you mean but disagree with it, and who use their narrow criteria of meaning to dismiss your argument. In this way, the positivists for a long while were able to read virtually all important philosophical questions out of court and consign them to the despised departments of religion and *belles lettres*. In a sense, the rise of hermeneutics is those departments' revenge, retorting to the positivists that if "science" is only the quantitative and the "testable," then we shall swamp you with stuff that is *really* meaningless.

It is more difficult to excuse the path traveled by the major group of hermeneuticians in economics, a cluster of renegade Austrians

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[17]Donald N. McCloskey, *The Rhetoric of Economics* (Madison: University of Wisconsin Press, 1985). For a comprehensive Misesian critique of McCloskey's work, see the book review essay by Hans-Hermann Hoppe, "In Defense of Extreme Rationalism: Thoughts on Donald McCloskey's *The Rhetoric of Economics*," *Review of Austrian Economics* 3 (1989): 179–214.

[18]Cf. Richard M. Weaver, *The Ethics of Rhetoric* (Chicago: University of Chicago Press) and Larry Arnhart, *Aristotle on Political Reasoning: A Commentary on "The Rhetoric"* (DeKalb: Northern Illinois University Press, 1981).

and ex-Misesians gathered in the Center for Market Processes at George Mason University. The spiritual head of this groupuscule, Don Lavoie, has reached the pinnacle of having his photograph printed in his magazine *Market Process* talking to the great Gadamer.[19] Lavoie has organized a Society for Interpretive Economics (*interpretation* is a code word for hermeneutics) to spread the new gospel, and has had the effrontery to deliver a paper entitled "Mises and Gadamer on Theory and History," which, as a colleague of mine has suggested, is the moral equivalent of my writing a paper entitled "Lavoie and Hitler on the Nature of Freedom."

It must be noted that nihilism had seeped into current Austrian thought before Lavoie and his colleagues at the Center for Market Processes embraced it with such enthusiasm. It began when Ludwig M. Lachmann, who had been a disciple of Hayek in England in the 1930s and who had written a competent Austrian work entitled *Capital and Its Structure* in the 1950s, was suddenly converted by the methodology of the English economist George Shackle during the 1960s.[20] Since the mid-1970s, Lachmann, teaching part of every year at New York University, has engaged in a crusade to bring the blessings of randomness and abandonment of theory to Austrian economics. When Lavoie and his colleagues discovered Heidegger and Gadamer, Lachmann embraced the new creed at the 1986 first annual (and, if luck is with us, the last annual) conference of the Society of Interpretive Economics at George Mason University. The genuine Misesian creed, however, still flourishes at the Ludwig von Mises Institute at Auburn University and in its publications: *Free Market, Mises Review,* and the *Quarterly Journal of Austrian Economics*, which in its first issue included a critique of a quasi-hermeneutical book by two ex-Misesians who claim to have discovered the key to economics in the works of Henri Bergson.[21]

One of the main motivations of the ex-Misesian hermeneuticians is that their horror of mathematics, to which they react as to

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[19]*Market Process* 4 (Fall, 1986): 16.

[20]Ludwig M. Lachmann, *Capital and Its Structure* (London: London School of Economics, 1956). The later, post-Shackelian or nihilist Lachmann may be found in his "From Mises to Shackle: An Essay on Austrian Economics and the Kaleidic Society," *Journal of Economic Literature* 54 (1976).

[21]Thus, see Charles W. Baird, "*The Economics of Time and Ignorance*: A Review," *Review of Austrian Economics* 1 (1987): 189–223.

the head of Medusa, leads them to embrace virtually any ally in their struggle against positivism and neoclassical formalism. And so they find that, lo and behold, institutionalists, Marxists, and hermeneuticians have very little use for mathematics either. But before they totally embrace the desperate creed that the enemy of my enemy is necessarily my friend, our Market Process hermeneuticians should be warned that there may be worse things in this world than mathematics or even positivism. And second, that in addition to Nazism or Marxism, one of these things may be hermeneutics.

And just as Professor McCloskey's history may serve as a partial mitigation of his embrace of hermeneutics, we may go further back and mitigate the sins of the logical positivists. For, after all, the positivists, much as they may be reluctant to admit it, also did not descend upon us from Mount Olympus. They grew up in old Vienna, and they found themselves in a Germanic world dominated by protohermeneutical creeds such as Hegelianism as well as by the young Heidegger, who was even then making his mark. After reading and listening to dialectics and protohermeneutics day in and day out, after being immersed for years in the gibberish that they were told constituted philosophy, is it any wonder that they—including for our purposes Popper as well as Carnap, Reichenbach, Schlick, et al.—should finally lash out and exclaim that the whole thing was meaningless or that they should cry out for precision and clarity in language? Is it also any wonder that the nascent positivists, like McCloskey a half-century later, should go too far and throw out the philosophic baby with the neo-Hegelian bathwater?

In the peroration to his paean to hermeneutical economics, ex-Misesian Richard Ebeling proclaims: "Man loves to talk about himself."[22] But in rebuttal I point to the sage words of the American cultural and political satirist Tom Lehrer. In the 1960s, Lehrer noted that "a lot of people are whining about their 'inability to communicate.'" "It seems to me," Lehrer added, "that if you are unable to communicate, the *least* you can do is to shut up." That, alas, is something that Ebeling and his hermeneutical colleagues have not yet learned to do.

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[22]Richard M. Ebeling, "Hermeneutics and the Interpretive Element in the Analysis of the Market Process," Center for Market Processes Working Paper (Fairfax, Va.: Department of Economics, George Mason University, 1985), p. 45. Cf. Frankfurt, "On Bullshit," p. 100.

## Section Two

# The Austrian School

# 9

# New Light on the Prehistory of the Austrian School

The most notable development in the historiography of the Austrian School in the post-World War II era has been the drastic reevaluation of what might be called its prehistory and, as a corollary, a fundamental reconsideration of the history of economic thought itself. This reevaluation may be summarized by briefly outlining the orthodox pre-war paradigm of the development of economic thought before the advent of the Austrian School. The Scholastic philosophers were brusquely dismissed as medieval thinkers who totally failed to understand the market, and who believed on religious grounds that the just price was one that covered either the cost of production or the quantity of labor embodied in a product. After briefly outlining the bullionist and anti-bullionist discussion among the English mercantilists and lightly touching on a few French and Italian economists of the eighteenth century, the historian of economic thought pointed with a flourish to Adam Smith and David Ricardo as the founders of economic science. After some backing and filling in the mid-nineteenth century, marginalism, including the Austrian School, arrived in another great burst in the 1870s. Apart from the occasional mention of one or two English precursors of the Austrians, such as Samuel Bailey in the early nineteenth century, this completed the basic picture. Typical was the encyclopedic text of Lewis Haney: the Scholastics were described as medieval, dismissed as hostile to trade, and declared believers in the labor and cost-of-production theories of the just price.[1] It is no wonder that in

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[1]Lewis H. Haney, *History of Economic Thought*, 4th ed. (New York: Macmillan, 1949), pp. 106–08.

his famous phrase, R.H. Tawney could call Karl Marx "the last of the Schoolmen."[2]

The remarkably contrasting new view of the history of economic thought burst upon the scene in 1954 in the monumental, though unfinished, work of Joseph Schumpeter.[3] Far from mystical dunderheads who should be skipped over to get to the mercantilists, the Scholastic philosophers were seen as remarkable and prescient economists, developing a system very close to the Austrian and subjective-utility approach This was particularly true of the previously neglected Spanish and Italian Scholastics of the sixteenth and seventeenth centuries. Virtually the only missing ingredient in their value theory was the marginal concept. From them filiations proceeded to the later French and Italian economists. In the Schumpeterian view, the English mercantilists were half-baked, polemical pamphleteers rather than essential milestones on the road to Adam Smith and the founding of economic science. In fact, the new view saw Smith and Ricardo, not as founding the sciences of economics, but as shunting economics onto a tragically wrong track, which it took the Austrians and other marginalists to make right. Until then, only the neglected anti-Ricardian writers kept the tradition alive. As we shall see, other historians, such as Emil Kauder, further demonstrated the Aristotelian (and hence Scholastic) roots of the Austrians amidst the diverse variants of the Marginalist School. The picture is almost the reverse of the earlier orthodoxy.

It is not the purpose of this paper to dwell on Schumpeter's deservedly well-known work, but rather to assess the contributions of writers who carried the Schumpeterian vision still further and who remain neglected by most economists, possibly from a failure to match Schumpeter in constructing a general treatise. The best development of the new history must be sought in fugitive articles and brief pamphlets and monographs.

The other relatively neglected contributions began contemporaneously with Schumpeter. One of the most important, and probably

[2]R.H. Tawney, *Religion and the Rise of Capitalism* (New York: New American Library, 1954), pp. 38–39.

[3]Joseph A. Schumpeter, *A History of Economic Analysis* (New York: Oxford University Press, 1954).

the most neglected, was *The School of Salamanca* by Marjorie Grice-Hutchinson, who suffered in the economics profession from being a professor of Spanish literature. Moreover, the book bore the burden of a misleadingly narrow subtitle: *Readings in Spanish Monetary Theory*.[4] In fact, the book was a brilliant discovery of the pre-Austrian subjective-value-and-utility views of the late sixteenth-century Spanish Scholastics. But first Grice-Hutchinson showed that the works of even earlier Scholastics as far back as Aristotle contained a subjective-value analysis based on consumer wants alongside the competing objective conception of the just price based on labor and costs. In the early Middle Ages, Saint Augustine (354–430) developed the concept of the subjective-value scale of each individual. By the High Middle Ages, the Scholastic philosophers had largely abandoned the cost-of-production theory to adopt the view that the market's reflection of consumer demand really sets the just price. This was particularly true of Jean Buridan (1300–1358), Henry of Ghent (1217–1293), and Richard of Middleton (1249–1306). As Grice-Hutchinson observed:

> Medieval writers viewed the poor man as consumer rather than producer. A cost-of-production theory would have given merchants an excuse for overcharging on the pretext of covering their expenses, and it was thought fairer to rely on the impersonal forces of the market which reflected the judgment of the whole community, or, to use the medieval phrase, the "common estimation." At any rate, it would seem that the phenomena of exchange came increasingly to be explained in psychological terms.[5]

Even Henry of Langenstein (1325–1383), who of all the Scholastics was the most hostile to the free market and advocated government fixing of the just price on the basis of status and cost, developed the subjective factor of utility as well as scarcity in his analysis of price. But it was the sixteenth-century Spanish Scholastics who developed the purely subjective and pro-free-market theory of value. Thus, Luis Saravía de la Calle (c. 1544) denied any role to cost in the determination of price; instead the market price, which is the just

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[4]Marjorie Grice-Hutchinson, *The School of Salamanca: Readings in Spanish Monetary Theory, 1544–1605* (Oxford: Clarendon Press, 1952).

[5]Ibid., p. 27.

price, is determined by the forces of supply and demand, which in turn are the result of the common estimation of consumers on the market. Saravía wrote that, "excluding all deceit and malice, the just price of a thing is the price which it commonly fetches at the time and place of the deal." He went on to point out that the price of a thing will change in accordance with its abundance or scarcity. He proceeded to attack the cost-of-production theory of just price:

> Those who measure the just price by the labor, costs, and risk incurred by the person who deals in the merchandise or produces it, or by the cost of transport or the expense of traveling . . . or by what he has to pay the factors for their industry, risk, and labor, are greatly in error, and still more so are those who allow a certain profit of a fifth or a tenth. For the just price arises from the abundance or scarcity of goods, merchants, and money . . . and not from costs, labor, and risk. If we had to consider labor and risk in order to assess the just price, no merchant would ever suffer loss, nor would abundance or scarcity of goods and money enter into the question. Prices are not commonly fixed on the basis of costs. Why should a bale of linen brought overland from Brittany at great expense be worth more than one which is transported cheaply by sea? . . . Why should a book written out by hand be worth more than one which is printed, when the latter is better though it costs less to produce? . . . The just price is found not by counting the cost but by the common estimation.[6]

Similarly the Spanish Scholastic Diego de Covarrubias y Leiva (1512—1577) a distinguished expert on Roman law and a theologian at the University of Salamanca, wrote that the "value of an article" depends "on the estimation of men, even if that estimation be foolish." Wheat is more expensive in the Indies than in Spain "because men esteem it more highly, though the nature of the wheat is the same in both places." The just price should be considered not at all with reference to its original or labor cost but only with reference to the common market value where the good is sold, a value, Covarrubias pointed out, that will fall when buyers are few and goods are abundant and that will rise under opposite conditions.[7]

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[6]Luis Saravia de la Calle, *Instrucción de mercaderes* (1544), in Grice-Hutchinson, *School of Salamanca*, pp. 79–82.

[7]Ibid., p. 48.

The Spanish Scholastic Francisco García (d. 1659) engaged in a remarkably sophisticated analysis of the determinants of value and utility. The valuation of goods, Garcia pointed out, depends on several factors. One is the abundance or scarcity of the supply of the goods, the former causing a lower estimation and the latter an increase. A second is whether buyers or sellers are few or many. Another is whether "money is scarce or plentiful," the former causing a lower estimation of goods and the latter a higher. Another is whether "vendors are eager to sell their goods." The influence of the abundance or the scarcity of a good brought García almost to the brink, but not over it, of a marginal utility analysis of valuation.

> For example, we have said that bread is more valuable than meat because it is more necessary for the preservation of human life. But there may come a time when bread is so abundant and meat so scarce that bread is cheaper than meat.[8]

The Spanish Scholastics also anticipated the Austrian School in applying value theory to money, thus beginning the integration of money into general value theory. It is generally believed, for example, that in 1568 Jean Bodin inaugurated what is unfortunately called the application of supply-and-demand analysis to money. Yet he was anticipated twelve years earlier by the Salamanca theologian the Dominican Martin de Azpilcueta Navarro (1493–1576), who was inspired to explain the inflation brought about by the importation of gold and silver by the Spaniards from the New World. Citing previous Scholastics, Azpilcueta declared that "money is worth more where it is scarce than where it is abundant." Why? Because "all merchandise becomes dearer when it is in great demand and short supply, and that money, in so far as it may be sold, bartered, or exchanged by some other form of contract, is merchandise and therefore also becomes dearer when it is in great demand and short supply." Azpilcueta noted that

> we see by experience that in France, where money is scarcer than in Spain, bread, wine, cloth, and labor are worth much less. And even in Spain, in times when money was scarcer, saleable goods and labor were given for very much less than after the discovery of

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[8]Francisco García, *Tratado utilisimo y muy general de todos los contractos* (1583), in Grice-Hutchinson, *School of Salamanca*, pp. 104–05.

> the Indies, which flooded the country with gold and silver. The reason for this is that money is worth more where and when it is scarce than where and when it is abundant.[9]

Furthermore, the Spanish Scholastics went on to anticipate the classical-Mises-Cassel purchasing-power parity theory of exchange rates by proceeding logically to apply the supply-and-demand theory to foreign exchanges, an institution that was highly developed by the early modern period. The influx of specie into Spain depreciated the Spanish escudo in foreign exchange, as well as raised prices within Spain, and the Scholastics had to deal with this startling phenomenon. It was the eminent Salamanca theologian the Dominican Domingo de Soto (1495–1560) who in 1553 first fully applied the supply-and-demand analysis to foreign exchange rates. De Soto noted that

> the more plentiful money is in Medina the more unfavorable are the terms of exchange, and the higher the price that must be paid by whoever wishes to send money from Spain to Flanders, since the demand for money is smaller in Spain than in Flanders. And the scarcer money is in Medina the less he need pay there, because more people want money in Medina than are sending it to Flanders.[10]

What de Soto was saying is that as the stock of money increases, the utility of each unit of money to the population declines and vice versa; in short, only the great stumbling block of failing to specify the concept of the marginal unit prevented him from arriving at the doctrine of the diminishing marginal utility of money. Azpilcueta, in the passage quoted above, applied the de Soto analysis of the influence of the supply of money on exchange rates, at the same time that he set forth a theory of supply and demand in determining the purchasing power of money within a country.

The de Soto-Azpilcueta analysis was spread to the merchants of Spain by the Dominican friar Tomás de Mercado (d. 1585), who in 1569 wrote a handbook of commercial morality in Spanish, in contrast to the Scholastic theologians, who invariably wrote in Latin. It

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[9] Martín de Azpilcueta Navarro, *Comentario resolutorio de usuras* (1556), in Grice-Hutchinson, *School of Salamanca*, pp. 94–95.

[10] Domingo de Soto, *De Justitia et Jure* (1553), in Grice-Hutchinson, *School of Salamanca*, p. 55.

was followed by Garcia and endorsed at the end of the sixteenth century by the Salamanca theologian the Dominican Domingo de Bañez (1527–1604) and by the great Portuguese Jesuit Luís de Molina (1535–1600). Writing near the turn of the century, Molina set forth the theory in an elegant and comprehensive manner:

> There is another way in which money may be worth more in one place than in another; namely, because it is scarcer there than elsewhere. Other things being equal, wherever money is most abundant, there will it be least valuable for the purpose of buying and comparing things other than money.
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> Just as an abundance of goods causes prices to fall (the quantity of money and number of merchants being equal), so does an abundance of money cause them to rise (the quantity of goods and number of merchants being equal). The reason is that the money itself becomes less valuable for the purpose of buying and comparing goods. Thus we see that in Spain the purchasing-power of money is far lower, on account of its abundance, than it was eighty years ago. A thing that could be bought for two ducats at that time is nowadays worth 5, 6, or even more. Wages have risen in the same proportion, and so have dowries, the price of estates, the income from benefices, and other things.
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> We likewise see that money is far less valuable in the New World (especially in Peru, where it is most plentiful), than it is in Spain. But in places where it is scarcer than in Spain, there will it be more valuable. Nor will the value of money be the same in all other places, but will vary: and this will be because of variations in its quantity, other things being equal. . . . Even in Spain itself, the value of money varies: it is usually lowest of all in Seville, where the ships come in from the New World and where for that reason money is most abundant.
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> Wherever the demand for money is greatest, whether for buying or carrying goods, . . . or for any other reason, there its value will be highest. It is these things, too, which cause the value of money to vary in course of time in one and the same place.[11]

The outstanding revisionist work on the economic thought of the medieval and later Scholastics is that of Raymond de Roover.

[11]Luís de Molina, *Disputationes de Contractibus* (1601), in Grice-Hutchinson, *School of Salamanca*, pp. 113–14; Tomás de Mercado, *Tratos y contratos de mercaderes* (1569), ibid., pp. 57–58 and Domingo de Bañez, *De Justitia et Jure* (1594), ibid., pp. 96–103.

Basing his work in part on the Grice-Hutchinson volume, de Roover published his first comprehensive discussion in 1955.[12] For the medieval period, de Roover particularly pointed to the early fourteenth-century French Ockhamite Scholastic Jean Buridan and to the famous early fifteenth-century Italian preacher San Bernardino of Siena (1380–1444). Buridan insisted that value is measured by the human wants of the community of individuals and that the market price is the just price. Furthermore, he was perhaps the first to make clear in a pre-Austrian manner that voluntary exchange demonstrates subjective preference, since he stated that the "person who exchanges a horse for money would not have done so, if he had not preferred money to a horse."[13] He added that workers hire themselves out because they value the wages they receive higher than the labor they have to expend.[14]

De Roover then discussed the sixteenth-century Spanish Scholastics, centered at the University of Salamanca, the queen of the Spanish universities of the period. From Salamanca the influence of this school of Scholastics spread to Portugal, Italy, and the Low Countries. In addition to summarizing Grice-Hutchinson's contribution and adding to her bibliography, de Roover noted that both de Soto and Molina denounced as "fallacious" the notion of the late thirteenth-century Scholastic John Duns Scotus (1308) that the just price is the cost of production plus a reasonable profit; instead that price is the common estimation, the interaction of supply and demand, on the market. Molina further introduced the concept of

[12]Raymond de Roover, "Scholastic Economics: Survival and Lasting Influence from the Sixteenth Century to Adam Smith," *Quarterly Journal of Economics* 69 (May 1955): 161–90; reprinted in de Roover, *Business, Banking, and Economic Thought* (Chicago: University of Chicago Press, 1974), pp. 306–35.

[13]Ibid., p. 309.

[14]Raymond de Roover, "Joseph A. Schumpeter and Scholastic Economics," *Kyklos* 10 (1957): 128. De Roover traced the concept of mutual benefit as exhibited in exchange back to Aquinas, who wrote that "buying and selling seem to have been instituted for the mutual advantage of both parties, since one needs something that belongs to the other, and conversely" (ibid.).

competition by stating that competition among buyers will drive prices up, while a scarcity of purchasers will pull them down.[15]

In a later article, de Roover elaborated on his researches into the Scholastic theory of the just price. He found that the orthodox view of the just price as a station-in-life, cost-of-production price was based almost solely on the views of fourteenth-century Viennese Scholastic Henry of Langenstein. But Langenstein, de Roover pointed out, was a follower of the minority views of William of Ockham and outside the dominant Thomist tradition; Langenstein was rarely cited by later Scholastic writers. While some of their passages are open to a conflicting interpretation, de Roover demonstrated that Albertus Magnus (1193–1280) and his great pupil Thomas Aquinas (1226–1274) held the just price to be the market price. In fact, Aquinas considered the case of a merchant who brings wheat to a country where there is a great scarcity; the merchant happens to know that more wheat is on the way. May he sell his wheat at the existing price, or must he announce to everyone the imminent arrival of new supplies and suffer a fall in price? Aquinas unequivocally answered that he may justly sell the wheat at the current market price, even though he added as an afterthought that it would be more virtuous of him to inform the buyers. Furthermore, de Roover pointed to the summary of Aquinas's position by his most distinguished commentator, the late fifteenth-century Scholastic Thomas de Vio, Cardinal Cajetan (1468–1534). Cajetan concluded that for Aquinas the just price is "the one, which at a given time, can be gotten from the buyers, assuming common knowledge and in the absence of all fraud and coercion."[16]

The cost-of-production theory of just price held by the Scotists was trenchantly attacked by the later Scholastics. San Bernardino of Siena, de Roover pointed out, declared that the market price is fair regardless of whether the producer gains or loses, or whether it is

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[15]De Roover, *Business, Banking, and Economic Thought*, pp. 312–14. Elsewhere de Roover noted that the Scotists were a small minority among medieval and later Scholastics, whereas the Scholastics discussed here were in the mainstream of Thomist tradition.

[16]Raymond de Roover, "The Concept of the Just Price: Theory and Economic Policy," *Journal of Economic History* 18 (December 1958): 422–23.

above or below cost. The great early sixteenth-century jurist Francisco de Vitoria (c. 1480–1546), founder of the school of Salamanca, as well as his followers, insisted that the just price is set by supply and demand regardless of labor costs or expenses; inefficient producers or inept speculators must bear the consequences of their incompetence and poor forecasting. Furthermore, de Roover made clear that the general Scholastic emphasis on the justice of "common estimation" (*communis aestimatio*) is identical to "market valuation" (*aestimatio fori*), since the Scholastics used these two Latin expressions interchangeably.[17]

De Roover noted, however, that this acceptance of market price did not mean that the Scholastics adopted a *laissez-faire* position. On the contrary, they were often willing to accept governmental price fixing instead of market action. A few prominent Scholastics, however, led by Azpilcueta and including Molina, opposed all price fixing; as Azpilcueta put it, price controls are unnecessary in times of plenty and ineffective or positively harmful in times of dearth.[18]

In a comment on de Roover's paper, David Herlihy noted that, in the northern Italian city-states of the twelfth and thirteenth centuries, the birthplace of modern commercial capitalism, the market price was generally considered just because it was "true" and "real," if it was "established or utilized without deceit or fraud." As Herlihy summed it up, the just price of an object is its "true value as determined by one of two ways: for objects that were unique, by honest negotiation between seller and purchaser; for staple commodities by the consensus of the marketplace established in the absence of fraud or conspiracy."[19]

John W. Baldwin's definitive account of the theories of just price during the High Middle Ages of the twelfth and thirteenth centuries amply confirmed de Roover's revisionist insight. Baldwin pointed out that there were three important and influential groups of medieval writers: the theologians (whom we have been examining), the Roman lawyers, and the canon lawyers. For their part, the Romanists, joined

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[17]Ibid., p. 424.

[18]Ibid., p. 426.

[19]David Herlihy, "The Concept of the Just Price: Discussion," *Journal of Economic History* 18 (December 1958): 437.

by the canonists, held staunchly to the principle of Roman private law that the just price is whatever is arrived at by free bargaining between buyers and sellers.[20] Baldwin demonstrated that even the theologians of the High Middle Ages before Aquinas accepted the current market price as the just price.[21]

Several years later, de Roover turned to the views of the Scholastics on the broader issue of trade and exchange.[22] He conceded the partial validity of the older view that the medieval Church frowned on trade as endangering personal salvation; or rather that, while trade *can* be honest, it presents great temptation for sin. However, he pointed out that, as trade and commerce grew after the tenth century, the church began to adapt to the idea of the merits of trade and exchange. Thus, while it is true that the twelfth-century Scholastic Peter the Lombard (c. 1100–1160) denounced trade and soldiering as sinful occupations *per se*, a far more benevolent view of trade was set forth during the thirteenth century by Albertus Magnus and his student Thomas Aquinas, as well as by Saint Bonaventure (1221–1274) and Pope Innocent V (1225–1276). While trade presents occasions for sin, it is not sinful *per se*; on the contrary, exchange and the division of labor are beneficent in satisfying the wants of the citizens. Moreover, he early fourteenth-century Scholastic Richard of Middleton developed the idea that both the buyer and the seller gain by exchange, since each demonstrates that he prefers what he receives in exchange what he gives up. Middleton also applied this idea to international trade, pointing out that both countries benefit

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[20]John W. Baldwin, "The Medieval Theories of the Just Price," *Transactions of the American Philosophical Society* (Philadelphia: July 1959); see also the review of Baldwin by A.R. Bridbury, *Economic History Review* 12 (April 1960): 512–14.

[21]In particular, the theologians at the great center at the University of Paris in the early thirteenth century: Alexander of Hales and Aquinas's teacher, Albertus Magnus (ibid., p. 71). Baldwin further pointed out that theological treatment of such practical questions as the just price in the Middle Ages only began with the development of university centers at the end of the twelfth century (ibid., p. 9).

[22]Raymond de Roover, "The Scholastic Attitude toward Trade and Entrepreneurship," *Explorations in Entrepreneurial History* 2 (1963): 76–87; reprinted in de Roover, *Business, Banking, and Economic Thought*, pp. 336–45.

by exchanging their surplus products. Since the merchants and citizens of each country benefit, neither party is exploiting the other.

At the same time, Aquinas and other theologians denounced "covetousness" and love of profit, mercantile gain being only justifiable when directed toward the "good of others"; furthermore, Aquinas attacked "avarice" as attempting to improve one's "station in life." But, as de Roover pointed out, the great early sixteenth-century Italian Thomas Cardinal Cajetan corrected this view by demonstrating that, if this were true, every person would have to be frozen in his current occupation and income. On the contrary, asserted Cajetan, people with unusual ability should be able to rise in the world. In contrast to such northern Europeans as Aquinas, Cajetan was quite familiar with the commerce and upward social mobility in the Italian cities. Furthermore, even Aquinas explicitly rejected the idea that prices should be determined by one's station in life, pointing out that the selling price of any good tends to be the same whether the entrepreneur is poor or wealthy.

De Roover hailed the early fifteenth-century Scholastic San Bernardino of Siena as being the only theologian who dealt in detail with the economic function of the entrepreneur. San Bernardino wrote of the uncommon qualities and abilities of the successful entrepreneur, including effort, diligence, knowledge of the market, and calculation of risks, with profit on invested capital justifiable as compensation for the risk and effort of the entrepreneur. The acceptance of profit was immortalized in a motto in a thirteenth-century account book: "In the name of God and of profit."[23]

De Roover's final work in this area was a booklet on San Bernardino and his contemporary Sant' Antonino (1389–1459) of

[23]De Roover, here and in his other writings, pointed to the great deficiency in Scholastic analysis of the market: the belief that any interest on a pure loan (a mutuum) constituted the sin of usury. The reason is that while the Scholastics understood the economic functions of risk and opportunity cost, they never arrived at the concept of time preference. On the Scholastics and usury, see the magisterial work of John T. Noonan, Jr., *The Scholastic Analysis of Usury* (Cambridge, Mass.: Harvard University Press, 1957); see also Raymond de Roover, "The Scholastics, Usury, and Foreign Exchange," *Business History Review* 41(1967): 257–71.

Florence.[24] In San Bernardino's views of trade and the entrepreneur, the occupation of trade may lead to sin, but so may all other occupations, including that of bishops. As for the sins of traders, they consist of such illicit activity as fraud, misrepresentation of products, the sale of adulterated products, and the use of false weights and measures, as well as keeping creditors waiting for their money after a debt is due. As to trade, there are several kinds of useful merchants, according to San Bernardino: importer-exporters, warehousemen, retailers, and manufacturers.

San Bernardino described the rare qualities and virtues that go into the making of successful businessmen. One is efficiency (*industria*), which includes knowledge of qualities, prices, and costs and ability to assess risks and estimate profit opportunities, which, he declared, "indeed very few are capable of doing." Entrepreneurial ability therefore includes the willingness to assume risks (*pericula*). Businessmen must be responsible and attentive to detail, and trouble and toil are also necessary. The rational and orderly conduct of business, also necessary to success, is another virtue lauded by San Bernardino, as are business integrity and the prompt settlement of accounts.

Turning again to the Scholastic view of value and price, de Roover pointed out that, as early as Aquinas, prices were treated as determined, not by their philosophic rank in nature, but by the degree of the usefulness or utility of the respective products to man and to human wants. As de Roover wrote of Aquinas, "These passages are clear and unambiguous; value depends upon utility, usefulness, or human wants. There is nowhere any mention of labor as the creator or the measure of value."[25] A century before the Spanish Scholastics and a century and a half before the sophisticated formulation of Francisco Garcia, San Bernardino had demonstrated that price is determined by scarcity (*raritas*), usefulness (*virtuositas*), and pleasurability or desirability (*compacibilitas*). Greater abundance of a good will cause a drop in its value and greater scarcity a rise. To

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[24]Raymond de Roover, *San Bernardino of Siena and Sant' Antonino of Florence: The Two Great Economic Thinkers of the Middle Ages* (Boston: Kress Library of Business and Economics, 1967).

[25]Ibid., p. 17.

have value, furthermore, a good must have usefulness, or what we may call "objective utility"; but within that framework, the value is determined by the *complicibilitas*, or "subjective utility," that it has to individual consumers. Again, only the marginal element is lacking for a full-scale pre-Austrian theory of value. Coming to the brink of the later Austrian solution to the classical economists' "paradox of value," San Bernardino noted that a glass of water to a man dying of thirst would be so valuable as to be almost priceless, but fortunately water, though absolutely necessary to human life, is ordinarily so abundant that it commands either a low price or even no price at all.

Correcting Schumpeter's ascription of the founding of subjective utility to Sant' Antonino and observing that he had derived it from San Bernardino, de Roover showed further that recent scholarship demonstrates that Bernardino derived his own analysis almost word for word from a late thirteenth-century Provençal Scholastic, Pierre de Jean Olivi (1248–1298). Apparently, Bernardino did not give credit to Olivi because the latter, coming from another branch of the Franciscan order, was at that time suspected of heresy.[26]

Turning to the concept of the "just price," de Roover made it clear that San Bernardino, following Olivi, held the price of a good or service to be "the estimation made in common by all the citizens of the community" This he held explicitly to be the valuation of the market, since he defined the just price as "the one which happens to prevail at a given time according to the estimation of the market, that is, what the commodities for sale are then commonly worth in a certain place."[27]

Wages were treated by the two Italian friars in the same manner as the prices of goods. For San Bernardino, "The same rules which apply to the prices of goods also apply to the price of services with the consequence that the just wage will also be determined by the forces operating in the market or, in other words, by the demand for labor and the available supply." An architect is paid more than a ditchdigger, asserted Bernardino, because "the former's job requires more intelligence, greater ability, and longer training and that, consequently, fewer qualify.... Wage differentials are thus to be explained

[26]On the originality of Olivi see ibid., p 19.

[27]Ibid., p. 20.

by scarcity because skilled workers are less numerous than unskilled and high positions require even a very unusual combination of skills and abilities."[28] And Sant' Antonino concluded that the wage of a laborer is a price which, like any other, is properly determined by the common estimation of the market in the absence of fraud.

During and after the sixteenth century, the Roman Catholic church and Scholastic philosophy came under increasingly virulent attack, first from Protestants and then from rationalists, but the result was not so much to eliminate any influence of Scholastic philosophy and economics as to mask that influence, since their proclaimed enemies would often fail to cite their writings. Thus, the great early seventeenth-century Dutch Protestant jurist Hugo Grotius (1583–1645) adopted much of Scholastic doctrine, including the emphasis on want and utility as the major determinants of value, and the importance of the common estimation of the market in determining price. Grotius, in fact, explicitly cited the Spanish Scholastics Azpilcueta Navarro and Covarrubias. Even more explicitly following the Spanish Scholastics of the sixteenth century were the Jesuit theologians of the following century, including the highly influential Flemish Jesuit Leonardus Lessius (1554–1623), a friend of Luís de Molina, and the even more influential Spanish Jesuit Cardinal Juan de Lugo (1583–1660), whose treatise was originally published in 1642 and was reprinted many times in the next three centuries. Also explicitly following the Scholastics and the Salamanca School in the seventeenth century was the Genoese philosopher and jurist Sigismundo Scaccia (c. 1618), whose treatise was widely reprinted, as well as Antonio de Escobar (c. 1652), author of a moral manual.

To return to what would be the dominant Protestant trend for later economic thought, Grotius's legal and economic doctrines were followed closely in the later seventeenth century by the Swedish Lutheran jurist Samuel Pufendorf (1632–1694). While Pufendorf followed Grotius on utility and scarcity and the common estimation of the market in determining value and price, and while he certainly consulted the writings of the Spanish Scholastics, it is the rationalist Pufendorf who dropped all citations to these hated Scholastic influences upon his teacher. Hence, when Grotian doctrine was brought

[28]Ibid., pp. 23–24.

to Scotland by the early eighteenth-century professor of moral philosophy at Glasgow Gershom Carmichael (1672–1729), who translated Pufendorf into English, knowledge of Scholastic influences was lost. Hence, with Carmichael's great student and successor Francis Hutcheson, utility began to be weakened by labor and cost-of-production theories of value, until finally by the time Hutcheson's student Adam Smith (1723–1790) wrote the *Wealth of Nations*, pre-Austrian Scholastic influence had unfortunately dropped out altogether. Hence the view of Schumpeter, de Roover, and others that Smith and later Ricardo shunted economics onto a wrong track, which the later marginalists (including the Austrians) had to correct.

Scholastic doctrine had a more lasting influence on economists on the Continent, particularly in Catholic countries. Thus, the brilliant mid-eighteenth-century Italian the Abbé Ferdinando Galiani (1728–1787) is often credited by historians with inventing full-blown the concept of utility and scarcity as the determinants of price. No one wished to stress Scholastic writings in that rationalistic age, but strong Scholastic influence is detectable in Galiani's work, whose section on value even contains an explicit citation to the Salamanca Scholastic Diego Covarrubias y Leiva. Galiani's uncle Celestino, who brought up the youthful economist, had been professor of moral theology before becoming an archbishop and was therefore undoubtedly familiar with the Scholastic literature on the subject, which filled the Italian libraries of the eighteenth century. Galiani's contemporary Italian economist Antonio Genovesi (1712–1769) was also directly influenced by Scholastic thought; he had served as professor of ethics and moral philosophy at the University of Naples.

From Galiani the central role of utility, scarcity, and the common estimation of the market spread to France, to the late eighteenth-century French Abbé Etienne Bonnot de Condillac (1714–1780), as well as to that other great abbé Robert Jacques Turgot (1721–1781). Knowing only Galiani as his predecessor, Turgot echoed the Salamanca School in holding the prices of goods and the value of money, as the result of the "common estimation" of the market, to be built up out of the subjective valuations of individuals in that market. François Quesnay (1694–1774) and the eighteenth-century French physiocrats—often considered to be the founders of economic science—were also heavily influenced by the Scholastics, both in their natural law theory and their emphasis on consumption

and subjective value. Scholastic doctrine even appears in the fiercely anti-Catholic Encyclopédie, including the doctrine of natural law, as well as the analysis of price as determined by the current common estimation of the market. Even during the nineteenth century strong traces of Condillac and Turgot appear in Jean-Baptist Say (1767–1832), who upheld a utility model for the future.[29]

At about the same time as Schumpeter, Grice-Hutchinson, and de Roover published their researches, Emil Kauder set forth a similar revisionist viewpoint. Kauder traced the connection between the Scholastics and Galiani, first to the mid-sixteenth-century Italian politician Gian Francesco Lottini (1512–1572).[30] He showed that Lottini first worked out a rudimentary concept of time preference: that people estimate present wants higher than future. The next link was the late sixteenth-century Italian merchant Bernardo Davanzati (1529–1606), who applied subjective-value theory to money in 1588. Indeed, Schumpeter was soon to point out that Davanzati also solved the "paradox of value," that water is very useful but not valuable on the market because it is highly abundant. Whether or not Davanzati was influenced by San Bernardino is not known.[31] He was followed almost a century later by the Italian mathematics professor Geminiano Montanan (1633–1687). Galiani was then definitely influenced by Davanzati.

Kauder then developed in an original way the great contributions of Galiani. For not only did Galiani comprehensively set forth the familiar theory of utility and scarcity as determinants of price—which lacked only the marginal principle to arrive at the Austrian theory—but he also went on to apply the utility theory to the value of labor and other factors of production. For the value of labor is, in turn, determined by the utility and scarcity of the particular kind of

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[29]On the later influence of the Scholastics, see Schumpeter, *History of Economic Analysis*, pp. 94–106; Grice-Hutchinson, *School of Salamanca*, pp. 59–78; de Roover, *Business, Banking, and Economic Thought*, pp. 330–35; and de Roover, "Joseph A. Schumpeter and Scholastic Economics," pp. 128–29.

[30]Emil Kauder, "Genesis of the Marginal Utility Theory: From Aristotle to the End of the Eighteenth Century," *Economic Journal* 63 (September 1953): 638–50.

[31]Schumpeter, *History of Economic Analysis*, p. 300.

labor being considered. The highly skilled are paid much more than the common laborer, since nature produced only a small number of able men. But not only that; for Galiani it is not labor costs that determine value, but value—and consumer choice—that determines labor cost. Furthermore Galiani touched on a pre-Böhm-Bawerk, time-preference theory of interest, with interest being the difference between present and future money.[32] Turgot then anticipated the Austrians in applying Galiani's utility theory to a detailed analysis of isolated exchange. Turgot, furthermore, as Schumpeter pointed out, developed a time analysis of production and worked out a pre-Austrian general analysis of the law of eventually diminishing returns that was not to be matched until the end of the nineteenth century. Quite justly Schumpeter wrote that "it is not too much to say that analytic economics took a century to get where it could have got in twenty years after the publication of Turgot's treatise had its content been properly understood and absorbed by an alert profession."[33] Instead, as Kauder pointed out, it was left to Condillac to offer a last-ditch and neglected defense of Galiani's utility theory against the rising tide of British cost theory. In Condillac's trenchant phrase, "A thing does not have value because it costs, as people suppose; instead it costs because it has a value.[34]

In a fascinating companion article, Kauder speculated on the persistence of utility-and-subjective-value theory on the Continent, as compared to the rise and dominance of a quantity-of-labor-and-cost-of-production theory in Great Britain.[35] He was particularly intrigued by the fact that the pre-nineteenth-century French and Italian subjectivists were all Catholics (and, of course, he might have

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[32]Kauder, "Genesis of the Marginal Utility Theory," p. 645.

[33]Schumpeter, *History of Economic Analysis*, p. 249, see also ibid., pp. 259–61, 332–33.

[34]Emil Kauder, "Genesis of the Marginal Utility Theory," p. 647. Kauder and Schumpeter also noted the early eighteenth-century French mathematician Daniel Bernoulli (1738), who outside the stream of economic thought developed a mathematical version of the diminishing marginal utility of money (ibid., pp. 647–50; Schumpeter, *History of Economic Analysis,* pp. 302–05).

[35]Emil Kauder, "The Retarded Acceptance of the Marginal Utility Theory," *Quarterly Journal of Economics* 67 (November 1953): 564–75.

added the medieval and sixteenth-century Scholastics as well), while the British economists were all Protestants, or, more precisely, Calvinists. Kauder speculated that it was their Calvinist training that led John Locke and particularly Adam Smith to reject the Continental tradition (Smith knew Turgot and read Grotius) and to emphasize a labor theory of value. The Calvinists believed that work or labor was divine; could not this imprint have led Smith and the others to adopt a labor theory of economic value? Furthermore, Kauder pointed out that until the middle of the eighteenth century the French and Italian universities were dominated by Aristotelian philosophy, particularly as transmitted by the Jesuits and other religious orders. Kauder added that, in contrast to Calvinism, Aristotelian-Thomist philosophy did not glorify work or labor *per se* as divine; work may be necessary, but "moderate pleasure-seeking and happiness"—in short, utility—"form the center of economic actions." Kauder concluded that "if pleasure in a moderate form is the purpose of economics, then following the Aristotelian concept of the final cause, all principles of economics including valuation must be derived from it."[36]

Kauder admitted that his is a conjecture that cannot be proved and also that it does not particularly hold for the nineteenth century. However, he did offer an intriguing explanation for Alfred Marshall's failure to adopt the full marginal utility theory and, instead, his shunting aside of the theory in favor of a recrudescence of Ricardo's objective cost-of-production theory. That explanation lies in Marshall's undoubtedly strong Evangelical and Calvinist background.[37]

Finally, Emil Kauder convincingly demonstrated the direct influence of Aristotelian philosophy on the founders of the Austrian School and contrasted the result with the other marginalist schools of the late nineteenth century. First, in contrast to Jevons and Walras, who believed that economic laws are hypotheses dealing with social quantities, Carl Menger and his followers held that economics investigates, not the quantities of phenomena, but the underlying essences of such real entities as value, profit, and the other economic

[36]Ibid., p. 569.

[37]Ibid., pp. 570–71. These two articles are essentially reprinted in Emil Kauder, *A History of Marginal Utility Theory* (Princeton, N.J.: Princeton University Press, 1965), pp. 3–29.

categories. The belief in underlying essences inherent in superficial appearances is Aristotelian, and Kauder pointed out that Menger studied and cited Aristotle extensively in his methodological work. He also noted the similarities discovered by Oskar Kraus between the Austrian and the Aristotelian theories of imputation. Kauder also pointed out that Menger applied the fundamental Aristotelian distinction between matter and form to economic theory: economic theory deals with the underlying form of events, while history and statistics deal with the concrete matter. The concrete historical cases are the exemplifications of general regularities, the Aristotelian matter that contains potentialities, while the economic laws "are the Aristotelian forms which actualize the potential, that is, they provide the laws and concepts valid for all times and places."[38]

Second, Menger held, in contrast to Jevons and Walras, that economic laws as expressed in mathematical equations are only arbitrary statements; on the contrary, genuine economic laws are "exact," in Menger's terminology meaning fixed laws that describe sequences invariable to time and place. Thus, Menger and the Austrians build up an "eternal structure of economics . . . stripped of all historical peculiarities." In short, Menger and, following him, Böhm-Bawerk were Aristotelian social ontologists, maintaining the absolute and apodictic reality of economic laws. Kauder perceptively pointed out that in contemporary economics, "only von Mises, the most faithful student of the three [Marginalist] pioneers, maintains the ontological character of economics laws. His theory of human action is a 'reflection about the essence of action.' Economic laws provide 'ontological facts.'"[39]

Finally, the Jevons-Walras mathematical method necessarily deals with "functions of interdependent phenomena," whereas, for Menger and the Austrians, economic laws are genetic and causal, proceeding from the utility and the action of the consumer to the market result. As Kauder put it:

> For Marshall, value and cost, supply and demand are interdependent factors whose functional connection can be explained in an

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[38]Emil Kauder, "Intellectual and Political Roots of the Older Austrian School," *Zeitschrift für Nationalökonomie* 17 (December 1957): 411–25.

[39]Ibid., p. 417.

> equation or a geometrical figure. For Wieser, Menger, and especially for Böhm-Bawerk the wants of the consumer are the beginning and the end of the causal nexus. The purpose and the cause of economic action are identical. There is no difference between causality and teleology, claims Böhm-Bawerk. He knew the Aristotelian origin of his argument.[40]

Kauder also pointed out that the characteristically Austrian method of proceeding with words from a Robinson Crusoe model and then proceeding step by step to a fully developed economy accords with the Aristotelian concept of entelechy, in which "the motion from the potentiality to the actualization determines not only the structure of the system but also the presentation of the thoughts."[41]

In attempting to explain the Austrian choice among all the marginalists for philosophical realism and social ontology, Kauder pointed to the late nineteenth-century influences on the Austrian intellectual climate of Aristotle, Thomas Aquinas, and other schools of realistic philosophy. Most influential was Aristotle, who was studied carefully down to the middle of the nineteenth century, and who was often taught in the secondary schools in Austria. And while realism gave way to empiricism in the Austrian School by the turn of the twentieth century, "the Viennese *Schottengymnasium*, the intellectual nursery of many famous Austrians including Wieser, required, even after 1918, the students to read Aristotle's metaphysics in the original Greek."[42] In contrast, of course, the influence of Aristotelian philosophy in Britain or even France during the nineteenth century was virtually nil.

In recent decades, the revisionist scholars have clearly altered our knowledge of the prehistory of the Austrian School of economics. We see emerging a long and mighty tradition of proto-Austrian Scholastic economics, founded on Aristotle, continuing through the Middle

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[40]Ibid., p. 418.

[41]Ibid.

[42]Ibid., p. 420; see also Kauder, *History of Marginal Utility*, pp. 90–100. On Menger as Aristotelian, also see Terence W. Hutchinson, "Some Themes from Investigations into Method," in *Carl Menger and the Austrian School of Economics*, J.R. Hicks and Wilhelm Weber, eds. (Oxford: Clarendon Press, 1973), pp. 17–20.

Ages and the later Italian and Spanish Scholastics, and then influencing the French and Italian economists before and up till the day of Adam Smith. The achievement of Carl Menger and the Austrians was not so much to found a totally new system on the framework of British classical political economy as to revive and elaborate upon the older tradition that had been shunted aside by the Classical School.

# 10

# The Present State of Austrian Economics

In the past two decades, there has been a seeming growth of methodological sophistication in the world of economics. Until the early 1970s, a blind Walrasian formalism held total sway in microeconomics, while a triumphant Keynesianism dominated macro, all held together by an unthinking and arrogant empiricist epistemology of logical positivism. The micro and macro synthesis of the neoclassical paradigm were both embodied and symbolized in the work of Paul Samuelson, while the positivist methodology was enshrined in the famed 1953 article of Milton Friedman and the later work of Mark Blaug.[1]

Since that point, however, the dominant positivist paradigm has been effectively overthrown, to be replaced by a bracing and near-chaotic Kuhnian "crisis situation" in the methodology of economics.

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This paper was delivered at the Tenth Anniversary Scholars' Conference of the Ludwig von Mises Institute, October 9, 1992.

[1]For my purposes, I am ignoring the allegedly wide gulf between the earlier positivists with their "verifiability" criterion and the Popperites and their emphasis on "falsifiability." For those far outside the logical empiricist camp, this dispute has more of the appearance of a family feud than of a fundamental split in epistemology. The only point of interest here is that the Popperites are more nihilistic and therefore even less satisfactory than the original positivists, who at least are allowed to "verify" rather than merely "not falsify."

For a brilliant and incisive discussion and demolition of the logical empiricist contention on many levels, see David Gordon, *The Philosophical Origins of Austrian Economics* (Auburn, Ala.: Ludwig von Mises Institute, 1993).

For the last two decades, a dozen, if not a hundred, schools of economic thought have been allowed to bloom. Unfortunately, however, the orthodox paradigms in macro and especially microeconomics are still dominant, although less aggressively held than before; the crisis situation in methodology has not yet been allowed to trickle down fully to the substantive bread-and-butter areas where economists, after all, earn their livelihood. If methodology is in ferment, however, the rest of the substantive fortress may soon follow.

The deterioration of the dominant neoclassical paradigm starting in the early 1970s has numerous causes. I would contend that the main cause was the abject collapse of the Keynesian System upon the emergence of the first major inflationary recession in 1973–74, an anomalous situation that has marked every recession since. The inflationary recession of the early 1970s[2] was a shock for two reasons: (1) in the Keynesian model, recessions are supposed to be due to underspending, and inflation to overspending; how then could both occur at the same time? And what can fiscal (or even monetary) policy do about it? and (2) intervention and statist planning of fiscal policy and "growth economics" in the 1960s was supposed to have eliminated business cycles forevermore, to bring us, in the naive jargon of the economic Establishment of that day: full employment without inflation. Business cycle courses were purged from graduate curricula; for if business cycles had been rendered obsolete, such courses would only be antiquarian studies of economic history. The severe inflationary recession of 1973–74, followed by a similar and even more severe recession of 1979–82, ended the myth of the disappearance of business cycles.[3] And if planning for growth was seen

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[2]Actually, inflationary recession had first emerged during the 1933–37 inflationary boom, which took place within a deep depression. But since the origins of that depression, in 1929–33, were seemingly not inflationary, this episode was considered anomalous, and irrelevant to future cycles. In addition, prices first began to creep upward, but only slightly, during the 1957–58 recession, an overlooked but important harbinger of things to come. During 1966, there was a recession again without the usual price fall, but this was disregarded because the 1966 episode was not quite deep enough to meet the overly venerated National Bureau criteria for a recession. So the 1973–74 shock came like a bolt from the blue to the profession.

[3]We might even say of the business cycle as the great Etienne Gilson said about natural law: "the natural law always buries its undertakers."

to be flawed and even counter-productive, then perhaps government planning in general had severe problems; it was no coincidence, then, that the 1970s saw the resurgence of free-market economies and of free-market thinking among economists.

I contend, too, that the renaissance of Austrian economics beginning at about the same time was part and parcel of this general disillusion with both Keynesian economics and with government intervention, and part of a resurgence of free-market thinking. The Nobel Prize in economics granted to F.A. Hayek in 1974 has generally been credited with setting the spark for the Austrian revival, and there is much to be said for this thesis, especially considering the superstitious awe and veneration with which the Nobel Prize is regarded by the economics profession. But unless we really believe that the Swedish economists who award the Nobel annually are guided solely by divine inspiration, we must recognize that these gentlemen, too, reflect ideas current in the economics profession in Sweden and in Europe as a whole. After World War II, the Swedish profession, even more than their colleagues of other countries, was notoriously the home of Keynesianism and of econometrics; and the first Nobels, from 1969 through 1973, reflect that bias. It is no accident, then, that Hayek's Nobel prize in 1974, shared ironically with the leftist maverick Gunnar Myrdal, was the first one to be granted to a free-market economist.[4] It is also significant that the first free-market Nobel went to Hayek, not for his later vaporings in "spontaneous order," "knowledge," "evolution," and so on, for which he is unfortunately revered by most current Austrians, but instead for his elaboration of the Misesian business cycle theory which had been prominent in Britain in the 1930s, only to be swept away, in the late 1930s, by its great enemy, the Keynesian Revolution. To grant the first free-market Nobel to the antipode of Keynesian macro-theory cannot be considered a coincidence: it symbolized the end of the unquestioned dominance of the Keynesian-statist paradigm in economics.[5]

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[4]Previous Nobels had been granted to: Keynesian econometricians Ragnar Frisch and Jan Tinbergen, Paul Samuelson, national income statistician Simon Kuznets, Kenneth Arrow and John R. Hicks, and input—output planner Wassily W. Leontief.

[5]Some of us harbor the suspicion that it is no coincidence that Hayek received the prize precisely in 1974, the year after the death of his great

The Austrian revival starting in 1974 has now lasted long enough and taken hold firmly enough to enjoy the luxury of its first published historian, who places central emphasis on the week-long South Royalton, Vermont, Austrian conference in the summer of 1974. Professor Karen Vaughn was a youthful participant, now turned participant-observer, at this conference, but unfortunately her account of that conference and of the revival generally is both biased and totally unsatisfactory. One of the minor purposes of this paper, in the course of a critique of that revival and of the current state of Austrian economics, is to analyze and correct the Vaughn record.[6]

## Paradigms and the Whig Theory of the History of Science

One of the most welcome aspects of the methodological ferment of the past twenty years has been the overthrow of the once-dominant "Whig" notion of the history of a scientific discipline: that it proceeds, onward and upward in linear fashion, testing hypotheses, accumulating knowledge, and discarding the dross, so that scientific knowledge embodied in the latest textbooks and journal articles at point t is always and necessarily greater than at point t-1. This means that since the scientific discipline always knows more, say in 1983 than in 1971 or 1962, that there is no point in reading any part of the discipline except the latest textbooks and journal articles. Oh, there could be an antiquarian point, in 1992, to reading 1956 physics or chemistry, to find out about the history of the earlier period, or to examine how a science grew, or how scientists influenced each other, but there is nothing to learn substantively about the discipline from reading older chemistry or physics.

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mentor, the founder of Austrian business cycle theory, Ludwig von Mises. The Swedish economics profession might have become partially liberated by 1974, but surely not liberated enough to grant the prize to as consistent and uncompromising an ideological and methodological "extremist" as Ludwig von Mises.

[6]Karen I. Vaughn, "The Mengerian Roots of the Austrian Revival," in *Carl Menger and His Legacy in Economics*, Bruce J. Caldwell, ed., Annual Supplement to Vol. 22 of *History of Political Economy* (Durham, N.C.: Duke University Press, 1990): 395–405.

But this sort of naively optimistic view has been rendered obsolete by the brilliant "paradigm" analysis of Thomas Kuhn, who shows that this fanciful tale is far from the truth, even in the physical sciences. Even if we are less relativist than Kuhn, and believe that later paradigms are usually superior to—closer to the truth than—earlier ones, there still can be a severe loss of knowledge in discarding earlier paradigms. At the very least, then, there can well be substantive knowledge gained by exploring earlier paradigms. If this is true even in the physical sciences, *a fortiori* it is even more true in the nonexperimental disciplines such as philosophy and economics, where because of gross error, accident, or ideological or political bias, a later paradigm may well be inferior to earlier ones. There should not even be a presumption, much less a guarantee, of the later the better in the history of economic thought.

And yet, observers of the current Austrian School, as well as participants in it, have unwittingly and unthinkingly returned to Whig habits of thought when discussing or evaluating contributions of the Austrian School. They have unthinkingly assumed that the later the better, that is, that simply because, for example, the works of Don Lavoie or Ludwig M. Lachmann came later in time than those of Ludwig von Mises, that they must be better, or to put it differently, that these later contributions must constitute "development" and "growth" in the field. And yet, if later is not necessarily better, then the new may not at all constitute "growth"; newer may, in fact, constitute error and degeneration from an originally correct paradigm. But if the newer is not necessarily better, it follows that it might even be worse. And if a newer contribution is worse, and there is degeneration, then there must be some criterion or standard of truth with which to compare these temporally different contributions. On the other hand, if we take the fashionably nihilist view and claim that there is no truth, that anything, any methodology, goes, then it follows that contribution A can never be better or worse than contribution B, and then there can be no judgments of merit at all, regardless of the date of the contribution. Indeed, the entire scholarly enterprise may as well be abandoned.

To show how this inconsistency works: Professor Vaughn is horrified because a new work, in 1985, purportedly in Austrian economics, by O'Driscoll and Rizzo was severely criticized by other Austrians. She writes: "By the time of its completion, the book [by

O'Driscoll and Rizzo] broke new ground in developing a coherent Austrian paradigm," and adds: "and consequently was criticized by many Austrians who 'knew' it wasn't faithful to Austrian principles." But does this mean that Vaughn's conception of the scholarly dialogue is that every new book, *because* new, must be above criticism, and that any criticism is somehow illegitimate? Is *that* the way she conceives of the search for truth? And what if the book is *actually* (a) fallacious to the core, and (b) totally violates Austrian principles? Are critics supposed to fall silent, because "Austrian principles" are to enjoy a definition so elastic that anyone should be allowed to call himself an "Austrian" without being subject to criticism or challenge?[7]

It is the contention of this paper, indeed, that several different and clashing paradigms have been allowed to develop and fester, all in the name of "Austrian economics"; that a great deal of confusion and incoherence have resulted; and that this coexistence of contradictory doctrine and proliferation of clutter should be brought to an end. In short, the rubble of Austrian economics must be cleared at last, the turgid undergrowth hacked away, Austrian doctrine re-clarified and truth enshrined, and the proliferation of error and fallacy swept away.

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[7]Vaughn, "Mengerian Roots," p. 401*n*. Also see ibid., p. 397*n*. Amusingly enough, Vaughn talks repeatedly of the O'Driscoll-Rizzo volume "garnering so much criticism" from Austrians without citing the major, indeed the only, place such criticism appeared: the devastating review by Professor Charles W. Baird, "*The Economics of Time and Ignorance*: A Review," *Review of Austrian Economics* 1 (1987): 189–206.

*The Economics of Time and Ignorance* was a fortunately short-lived attempt to replace the Misesian paradigm with Bergsonian irrationalism; its rapid demise was assured by its demolition by Professor Baird. In the course of writing that work, Professor Rizzo, the philosophical leader of the duo, was moving visibly away from the Misesian paradigm. In a Mises centennial volume edited by Israel Kirzner, Rizzo first flirted with the then-fashionable philosophy of science of Imre Lakatos as a replacement for praxeology; in a postscript written a mere six months after the text, Rizzo announced another radical change of mind even further away from Mises. The final result in 1985 was the Bergsonian dead-end. See Mario J. Rizzo, "Mises and Lakatos: A Reformulation of Austrian Methodology," in *Method, Process, and Austrian Economics*, Israel M. Kirzner, ed. (Lexington, Mass.: Lexington Books, 1982), pp. 53–73.

## The New Methodology and the Burgeoning of "Austrian" Fallacies

Part of what has happened to Austrian economics since 1974 was inevitable. Along with growth and flourishing, in numbers of economists, students, and contributions, there is bound to be a proliferation of error and of false leads and byways. That, in a sense, is a healthy development in the history of a science, but *only* if there are corrective forces who will periodically clear the underbrush and sweep away the rubble. That task has unfortunately not yet been done, although part of this necessary process has already begun.[8]

The idea of correction and demolition of error does not sit well with the now reigning paradigm in the epistemology of economics. The Old Methodology, dominant until the 1970s was frankly prescriptive, setting up criteria for valid and invalid theory. The problem with the Old Methodology was not that it presumed to methodological truth and validity, nor that it passed judgment on various methods and theories in economics, but that its criteria were systematically wrong: it was trapped by what Professor Mirowski calls "physics envy" to ape the assumed methodology of physics in the disciplines of human action. The problem with the Old Methodology (dominant until the 1970s) was not that it was prescriptive, but that its prescriptions were dead wrong. Unfortunately, in overturning the tyranny of the Old Methodology, the successful rebels focused not on the invalidity of the prescription but on the fact that any prescriptions were set forth at all. And so the prescriptive baby was thrown out with the positivist bathwater—to be replaced by the New Methodology of anything goes, of allowing all flowers, including noxious weeds, to bloom. The New Methodologists habitually deny that for them "anything goes," but that is precisely what their proclaimed mission—to *understand* and clarify all theories, but never to judge or

[8]See, for example, the demolitions of the fortunately short-lived "hermeneutical tendency" in Austrian economics, by David Gordon, *Hermeneutics vs. Austrian Economics* (Auburn, Ala.: Ludwig von Mises Institute, 1986); Hans-Hermann Hoppe, "In Defense of Extreme Rationalism: Thoughts on Donald McCloskey's *The Rhetoric of Economics*," *Review of Austrian Economics* 3 (1989): 179–214; and Murray N. Rothbard, "The Hermeneutical Invasion of Philosophy and Economics," *Review of Austrian Economics* 3 (1989): 45–59; included in this volume as chapter 8.

denounce them—amounts to. Clearly, the New Methodology is all too congruent with our New Age.[9]

There are two grievous and unwitting contradictions involved in this argument by our New anti-prescriptive Methodologists. In the first place, as we have pointed out in the case of Professor Vaughn, there is a glaring though unacknowledged bit of *prescription*: the Whig view that newer is necessarily better, a view that sits peculiarly in a system that offers no criteria for validity and no suggestion that there is any process or mechanism for learning about or adopting such criteria if they *did* exist. But there is also a deeper contradiction. For the New Methodologists are saying that it is *wrong* for economic methodology to be prescriptive, that it is only right for methodology to describe or clarify within each paradigm. But in that case, the New Methodologists are being very prescriptive indeed: they are saying that it is wrong or bad to say that any methodology is wrong or bad; but what argument, then, do they offer for *their* prescriptiveness? Various old methodological schools, be they positivists, Austrians, or institutionalists, have offered various concrete arguments for their particular prescriptions: for their view that their particular methodologies are right or correct, and the others wrong. But the New Methodologists offer *no argument whatsoever* for their own, sweeping, hidden prescriptiveness: that all prescriptions (except their own) are necessarily bad or incorrect. In short, the New Methodologists offer no argument for their anything-goes prescription—all they have to offer is the *mood* of the moment, of the contemporary culture: the absurd, self-contradictory mood of our "therapeutic," psycho-babbling, anti-"judgmentalist" culture. To state this fact is to reveal the absurd, counter-intuitive, anti-rational, fashionable mood of the New Methodologists—a mood that offers no, and is subject to no, argument, and is therefore simply not to be taken seriously.

My contentions are: that the correct Austrian paradigm is and can only be the Misesian, that is, the paradigm of Misesian *praxeology*; that the competing Austrian paradigms, in particular the

[9]For an incisive discussion of the Old and the New Methodologies, by one of the leading purveyors of the New, see Bruce J. Caldwell, "The Trend of Methodological Thinking," *Ricerche Economiche* 43 (January/June 1989): 8–20.

fundamentally irrational "evolved rules," "knowledge," "plans," and "spontaneous order" paradigm of Hayek and the more extreme "ultra-subjectivist" or nihilist paradigm of Lachmann, have both been fallacious and pernicious; that, as we shall see below in discussing the history of the modern Austrian revival as a *movement*, for various reasons the Misesian paradigm was almost totally cast aside and forgotten; but that now it is resurgent and rapidly becoming dominant and even triumphant within Austrian economics. And in the nick of time. The strong implication of Vaughn and of other anti-Misesian critics is that Misesians simply want Austrian economics to be static, to repeat endlessly Mises's words and ideas by rote. Not so; that this is untrue may be seen in numerous creative developments and advances in Misesian economics over the past thirty years: in particular my own earlier work in monopoly theory, theory of rent, welfare economics, government and the economy, and theory of property rights[10] and more recently by the work of Hans-Hermann Hoppe in the praxeological method, comparative economic systems, taxation, and a praxeological theory of rights; and by the work of Joseph T. Salerno in Mises vs. Hayek on reason, free exchange, and socialist calculation; and of Salerno on the work of Hutt and market coordination of prices as against the Hayekian "coordination of plans." All this, as well as the recent work in the philosophical background of Austrian economics by Barry Smith and David Gordon, are notable and creative advances in developing, elaborating, and making more consistent and hard-edged, the original Misesian paradigm.[11] In addition, there are the papers delivered at this conference,

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[10]Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economic Principles*, 2 vols. (1962; Los Angeles: Nash, 1970); Rothbard, *Power and Market: Government and the Economy* (1970; Kansas City: Sheed Andrews and McMeel, 1977); and Rothbard, *Toward a Reconstruction of Utility and Welfare Economics* (1956; New York: Center for Libertarian Studies, 1977); included in this volume as chapter 17.

[11]See, among others, Hans-Hermann Hoppe, *Praxeology and Economic Science* (Auburn, Ala.: Ludwig von Mises Institute, 1988); Hoppe, *A Theory of Socialism and Capitalism: Economics, Politics, and Ethics* (Boston: Kluwer, 1988); Hoppe, *The Economics and Ethics of Private Properly* (Boston: Kluwer, 1993); Joseph T. Salerno, "Postscript: Why Socialist Economy is 'Impossible,'" in *Ludwig von Mises, Economic Calculation in the Socialist Commonwealth* (1920; Auburn, Ala.: Ludwig von Mises Institute, 1990), pp. 51–71;

as well as literally dozens of other contributions in the *Review of Austrian Economics* and elsewhere on numerous aspects of theory, method, history, and policy.

The desideratum is not to keep Austrian economics static; that can never be true of a growing and developing science. The desideratum is creative advance *within* the correct Misesian paradigm, as well as guarding against degeneration of the discipline into fallacy and error.

## Misesian Praxeology versus Competing Paradigms

It has unfortunately become habitual in summing up Austrian economics, or the Austrian paradigm, to present it as an unconnected grab-bag of separate principles, a laundry-list of various separate traits: In particular, "subjectivism"; "market process" or disequilibrium processes as against equilibrium or end-states; market coordination of plans; methodological individualism; stress on the "unintended consequences" rather than the *intended* consequences of human action; and writing in "literary" style or ordinary language rather than in formal mathematics. As we shall see, this emphasis on the unconnected laundry-list leads almost inevitably into gross error, for it leads to a one-sided overvaluation and therefore mis-emphasis on such particular traits as "subjectivism," "market process," or unintended consequences, thereby unfortunately denigrating such *other* crucial elements of Austrianism as objective reality and its laws, the end-state or equilibrium goals implicit in all human action, and the exercise of reason and therefore the *intended* consequences of such action.

If for no other reason, this disparate laundry-list of Austrian traits should be swept away with one mighty slash of Occam's Razor. For all of them can be integrated into, encompassed by, and deduced from, one central core concept: the Misesian concept of *praxeology*.

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Salerno, "Ludwig von Mises as Social Rationalist," *Review of Austrian Economics* 4 (1990): 26–54; Salerno, "Commentary: The Concept of Coordination in Austrian Macroeconomics," in *Austrian Economics*, Richard Ebeling, ed. (Hillsdale, Mich.: Hillsdale College Press, 1991), pp. 325–43; Barry Smith, "Austrian Economics and Austrian Philosophy," *Austrian Economics: Historical and Philosophical Background*, W. Grassl and Barry Smith, eds. (New York: New York University Press, 1986), pp. 1–36; and Gordon, *Philosophical Origins of Austrian Economics*.

The word praxeology means precisely what its etymology says: the *logic* of (human) *action*. All of economic theory can be deduced from the central axiom that human beings *act*—that they pursue means in order to arrive at ends.[12] One of Mises's central achievements was to realize that this was the methodology of the best economic theory before him, to be the first to systematize that methodology, and then to be the first to construct the entire edifice of economic theory in accordance with this praxeological prescription. Correct theory is based on the true and unrefutable axiom that human beings act, and proceeds by deducing the logical—and therefore true—implications from that formal fact.[13]

Armed with the central core of praxeology, of the implied logic of the existence of human action, let us examine each of the alleged Austrian traits as set forth by non-Misesian Austrians (Hayekians and others).

### *Subjectivism*

Subjectivism stems from the important point that individuals value only subjectively: that goods and resources are evaluated by individual minds, for example, by consumers, and that prices of goods and services are determined only by relative valuations of those goods by all individuals in the market. It is true, also, that Mises helped to purge economics of continuing vestiges of faulty objective value theories, from Ricardian cost and labor-pain theories preserved by Marshall, to the current pretensions to employ and even measure such invalid concepts as objective "social costs," objective "costs and benefits," and objective, measurable "transaction costs." All these concepts are illegitimate.

But, with the shunning and neglect of Mises and praxeology (shunned rather than consciously argued with or refuted), recent Austrian paradigms have allowed "subjectivism" to run riot: to extend from legitimate subjective value theory to a virtual denial of

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[12]The deduction is also aided by a few subsidiary axioms: such as the basic fact that human beings require leisure.

[13]For a statement of praxeology and the construction of an edifice of economic theory according to the praxeological method, see Ludwig von Mises's monumental work *Human Action* (1949, 3rd rev. ed.; Chicago: Henry Regnery, 1963). Also Rothbard, *Man, Economy, and State*.

the objective existence of the real world, of the objective laws of cause and effect, and of the objective validity of deductive logic. In value theory, the non-Misesians, especially the Lachmannians, neglect or deny the objective fact that physical objects are being produced, exchanged, and evaluated, albeit that they are subjectively evaluated by acting individuals.[14] Lachmannians and other pseudo-Austrians must be confronted with the fact that individual human beings exist, that their actions exist, and that the world of which they are a part also exists.

### *Knowledge and Uncertainty*

Intimately connected with the question of subjectivism is the problem of knowledge and uncertainty. Neoclassical economics has locked itself into the absurd view that everyone in the market—consumers, producers, and firms—have *perfect* knowledge: that demands, supplies, costs, prices, products, technologies, and markets are known fully to everyone, or to all relevant individuals. This absurd assumption can only begin to be defended on the positivist, or Friedmanite, view that it is all right to incorporate gross error into one's assumptions so long as correct "predictions" can be made. In the praxeological view, however, quantitative predictions can *never* be made; in fact, it becomes necessary to guard against including error in the chain of axioms and propositions, which must be true at every step of the way. In recent years, the rational expectations theorists have compounded this absurdity even further by claiming that "the market"—as some reified all-knowing entity—has absolute knowledge not only of all present conditions, but also of all *future* demands, costs, products, and technologies: so that the *market* is omniscient about the future as well as the present.[15]

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[14]I find it helpful to regard the market demand-and-supply curves as interactions of a vertical line of an existing stock of things, goods, or resources, being evaluated by a falling demand curve comprised of aggregates of individual ordinal value or preference scales, marked of course by diminishing utility of each unit as the supply of a good increases. The intersection of the vertical supply (or stock) line with the falling demand curve determines the day-to-day market equilibrium price.

[15]More strictly, the rational expectation theorists claim that the *market* has absolute knowledge of the "probability distributions" of all future

The Misesian praxeological view, in contrast, is that knowledge of the present, much less of the future, is never perfect, and that the world in general, and the market in particular, are eternally marked by uncertainty. On the other hand, man obtains knowledge, which one hopes increases over time, of natural laws, and of the laws of cause and effect, which enable him to discover more and better ways of mastering nature and of bringing about his goals ever more effectively. As for uncertainty, it is the task of the entrepreneur to meet that uncertainty by assuming risks, in search of profit and of avoiding loss.[16]

Hence, to the praxeologist, Misesian Man faces the world emphatically knowing some things about his world and not knowing others. He knows absolutely that he and the world, including other people and resources, exist; he knows that natural laws and the laws of cause and effect exist; and that such knowledge cumulates over time. His technological knowledge of what goods will satisfy his wants and of how to acquire them continually increases. And yet he lives in a world of uncertainty, of uncertain future demands, resources, products, prices and costs, all problems which entrepreneurs tackle. Over time, entrepreneurs who are successful in bearing risks and forecasting their particular future will earn profits and expand

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events, any errors being purely random. But this only compounds the problem since the concept of "probability distribution" can only be used for events that are homogeneous, random [path-independent], and infinitely replicable. But the events in the world of human action are almost exactly opposite: they are almost all heterogeneous, not random [path-dependent] and hardly replicable at all. Furthermore, even in the highly unlikely event that these conditions *did* apply, class probabilities could not at all be used to explain or predict events, which is what we face in human life. See Mises, *Human Action*, pp. 106–15; and Richard von Mises, *Probability, Statistics, and Truth* (1928, 2nd ed.; New York: Macmillan, 1957).

[16]Mises incorporated into his praxeology the useful Knightian distinction between insurable *risk* (such as lotteries, gambling on roulette), and uninsurable (because heterogeneous, not random, and not replicable) *uncertainty*, which the entrepreneur bears and for which he earns profit or suffers loss. See Mises, *Human Action*, pp. 289–94. Also see Mises's neglected essay, "Profit and Loss," Ludwig von Mises, *Planning for Freedom and other Essays and Addresses* (South Holland, Ill.: Libertarian Press, 1952), pp. 108–30.

their operations, while poor risk-bearers and forecasters will suffer losses and necessarily shrink their field of activity. Hence, entrepreneurs will tend to be kept on their toes and be successful in most of their forecasts.

The important point in relation to economic theory is that Misesian Man knows the body of economic laws that Misesians have built up; these laws, while absolute, are qualitative and *ceteris paribus* in their nature and cannot themselves forecast the future. Such forecasting can only be an entrepreneurial art, quantitative forecasts that can be helpfully guided though not determined by qualitative praxeological laws. These forecasts must also be guided by insight, by *Verstehen*, into present and future conditions and into the values, preferences, and changing habits of other human actors.

Suppose, for example, that Misesian Man, as forecaster, is trying to estimate how prices in general will behave in the next few years. He is armed with an absolutely true (as Mises would say, *apodictic*), qualitative, law of praxeological economic theory: that if the money supply increases, and people's demand for money remains the same, prices will rise. But, to forecast, he must go beyond such economic laws, and try to estimate: (a) how much, if at all, money will increase in the near future; (b) what will happen to the demand for money; and (c) what, then, will happen to general prices—considering also what is likely to happen to the supply of goods. Misesian Man knows a lot; but he does not know everything and he must try to estimate the future, given various quantitative and qualitative estimates of change. To show the absurdity of the neoclassical (monetarist subdivision) pretension of attempting to establish "scientific" quantitative laws between the money supply and prices, in estimating the course of the money supply in the near future, a person must try to figure out the psychology of, the ideas held by, and the political influence upon, the Federal Reserve Board.

But contrast to this "moderate" uncertainty of Misesian Man, the plight of Lachmannian Man, subject to Lachmann's radical uncertainty and nihilism. Professor Lachmann's favorite mantra, which he would repeat at every opportunity, and which I hold to be the key to his thought, was the following: "the past is, in principle, absolutely knowable; the future is absolutely unknowable." Since the future, for Lachmann, is absolutely unknowable, Lachmannian Man knows no economic law, no law of cause and effect, qualitative or

quantitative. In fact, he can have no *Verstehen* into patterns that are likely to occur in the future. At every moment of succeeding time, Lachmannian Man steps into a trackless void.[17]

Since there are no laws of cause and effect in human action, Lachmannian Man would not be able to take the first step in figuring out what is happening, or likely to happen, with prices. Money? Prices? They can have no relation into the future, qualitative or quantitative, which means they are not causally related at all.

Once again, the Lachmannites have no real arguments in escalating from moderate to absolute uncertainty; they apparently think that repetition suffices for argument. It seems clear to me, on the contrary, that the entire Lachmannian paradigm is nonsense. Putting aside Lachmann's overweighing of the absolute unknowability of *the past* (Do we really *know* with certainty why Caesar crossed the Rubicon?), I know many things about the future with absolute certainty: I know with absolute certainty, for example, that I will never be elected president of the United States. I know, with even greater certainty, if possible, that I will never be named King of England. I submit that I am far more certain about these future events than I am of the reason that Lenin, at Finland Station, was the only Bolshevik to see that skipping several important stages could lead to a successful revolution in Russia.[18]

Since Lachmann denies the possibility of knowing the future at all, and therefore of any economic law, qualitative as well as quantitative, Lachmann and his followers inevitably become mere institutionalists, mere historians of the record of man's past economic activities. Mises

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[17]When pressed, Lachmann, fortunately for Lachmannian Man, conceded that this total ignorance does *not* apply to the laws of the physical world; Lachmannian Man is fortunate that he can rely, *inter alia*, on the law of gravity. It is only laws and patterns in the human sphere that cannot exist for him.

[18]Lachmann's weasel-worded disclaimer, knowable "in principle," is scarcely enough to salvage his naively optimistic view of our knowledge of the past. *In principle*, how can we figure out why Lenin saw something in the Russian concatenation of events that none of the other Bolsheviks, even with very similar world-outlooks, could then see? At bottom, individual uniqueness, whether the uniqueness of the entrepreneur, the inventor, the forecaster of events or the creator, cannot be "explained" in determinist fashion.

would have called Lachmann and the Lachmannians, as he called all other institutionalists, "anti-economists," that phrase meant not merely as an epithet, but also as a deadly accurate summation of what they are about. Since the Lachmannians are opposed to even the possibility of economic theory, they must be set down as no longer economists at all. *Faute de mieux*, I suppose they could be called "historians" except (a) they do very little actual historical work, and (b) as Mises has made clear in his fundamental though much-neglected *Theory and History*[19] to be a good historian you have to be able to use causal theories from various disciplines to help explain unique historical events, and the tools of economic law are indispensable parts of any genuine historian's armamentarium.[20] In a sense, Lachmannians and other institutionalists function as professional anti-economists and "meta-historians," expending their energies denouncing economics and urging other economists to act as historians.[21]

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[19]See Ludwig von Mises, *Theory and History* (1957; Auburn. Ala.: Ludwig von Mises Institute, 1985).

[20]Ludwig M. Lachmann had been a student of Hayek at the London School of Economics in the 1930s and his writings were generally Misesian until the mid-1970s, when he became converted to the nihilism of his old friend and fellow-Hayek student, the Englishman G.L.S. Shackle. Thus, see Lachmann's appreciative review of Mises's *Human Action*, "The Science of Human Action," *Economica* 18 (November 1951): 412–27. Lachmann's outstanding achievement was his Misesian *Capital and Its Structure* (London: London School of Economics, 1956) which, presumably for that reason, is never cited by modern Lachmannians. The watershed date for announcing his conversion to Shackleinism was Ludwig M. Lachmann, "From Mises to Shackle: An Essay on Austrian Economics and the Kaleidic Society," *Journal of Economic Literature* 14 (March 1976): 54–62.

[21]An amusing but instructive event occurred on the occasion of the conference of American Austrians at Windsor Castle in the summer of 1976. Under the good offices of Professor Stephen C. Littlechild of the University of Birmingham, a kind of summit conference was arranged so that some of the American Misesians could meet the English Subjectivist School, as the Shackleians call themselves. The eminent Subjectivists at the meeting included the *doyen* of that school, Shackle himself, as well as Terence W. Hutchison, Jack Wiseman, and Brian Loasby. At one point, the Subjectivists were lamenting that they could not offer a program of graduate economics courses as alternatives to the neoclassical paradigm, since all

### *Knowledge and the Role of the Entrepreneur*

If Lachmannian Man knows nothing, his brother Hayekian Man (the third major paradigm within modern Austrian economics), is better off, but not by very much. Hayek is obsessed by Man's allegedly pervasive and systemic ignorance. Indeed, Hayek's virtually lone argument against government intervention and against socialism is that government planners can know nothing. Since reason can play little or no role in man's affairs, government, or man through government, does not even know enough to establish general legal or constitutional rules for society. These general rules can only emerge from the blind, unconscious forces of "evolution"—the evolved rules that the later, post-Misesian Hayek, (in Hutchison's felicitous term, Hayek II as compared to the Misesian Hayek I) wishes us to worship and follow blindly lest we perish.[22] For Hayekian Man, however, there is a way out: even though he knows virtually nothing, he can painfully learn *through* the processes of the free market, just as in law or constitutions, he can learn to accept the "evolved" rules. In contrast, Misesian Man can not only know and learn, he can do so by exercising his unique human power of *reason*; and *reason*—the body of praxeologically-deduced economic theory—can and does tell him that the market economy works extremely well, while government planning and socialism cannot work at all. Misesian Man knows the virtues of the free market and the devastating flaws of socialism by using his reason. In the case of general rules, Misesian Man would think it absurd to accept all rules simply because they are there, without also correcting them by use of his reason.

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they had produced were a few critical essays but no substantial body of economic theory. I replied in some surprise that there was indeed a great deal of systematic Austrian literature available, including works by Mises, the early Hayek, and my own work, in addition to volumes of Böhm-Bawerk and Frank A. Fetter, among others. The blank looks of incomprehension on the faces of the distinguished Subjectivists were a revelation of the enormous extent of the inherent gulf between Shackleian Subjectivists and Misesians.

[22]Since there can be nothing in social life corresponding to the biological gene, the use of the term "evolution" by Hayek and others to describe historical change simply serves to drape the mantle of pseudo-science upon such change and to smuggle in an unacknowledged and unsupported value-judgment (supported only by the alleged benevolence and necessity of the "evolutionary" process) to sanctify such rules.

The respective attitudes toward human knowledge and human capacity help account for the enormous differences in the various paradigms on the crucial role of the entrepreneur in the market. For Neoclassical Man, there is no need for an entrepreneur, since all men know everything about the market, its past and its future, perfectly; and all curves are tangent, and all things at rest, in the Never-Never Land of long-run general equilibrium. Austrians, in contrast, place great stress on the dynamic role of the entrepreneur, but their visions of that role are very different.

Hayekian Man, the Hayekian entrepreneur, starts by knowing nothing, but he painfully learns about the world and the market *through* the "signals" of the price system. Hayek, and Professor Israel Kirzner after him, habitually speak of the market, of competition on the market, as a "discovery process." In contrast to Lachmann, who thinks there can be no knowledge of the world out there to learn, Hayek-Kirzner see a world of knowledge out there, with the unconscious forces of the market supplying man with that knowledge, through market price and profit-and-loss signals. The Hayek-Kirzner entrepreneur, indeed, is strangely passive; he scarcely acts like an entrepreneur at all. He risks nothing, and he really knows nothing, except what the signals of the price-system teach him, as he and the market economy wend their way toward general equilibrium. In his elaboration of the Hayekian theme, Kirzner sees the only function of the entrepreneur, and his only necessary quality, to exercise "alertness": to catch the market signals earlier than the next guy. In Kirzner's favorite metaphor, a $10 bill lies on the ground. Many people do not see that bill; but the entrepreneur is more alert than his fellows, and so he is the first to see, and to snatch that bill. Superior alertness, alertness to the truth out there, accounts for entrepreneurial profits.

There are many problems with the Kirznerian schema. If superior alertness accounts for entrepreneurial profits, what in the Kirznerian world can account for entrepreneurial losses? The answer is nothing. And yet the crucial aspect of entrepreneurship is that stressed by Mises: that the entrepreneur *takes risks*, that he can make profits by risking resources and through superior forecasting of the future, while suffering losses from inferior forecasting. Yet, there are neither risks nor uncertainty of the future in the Kirznerian world. Kirznerian Man faces not the future but the present; he owns no capital

resources and so he risks no losses; he simply sees present truth before others and alertly possesses it.

In the Misesian world, in contrast, the entrepreneur is not passive but extremely active.[23] He takes risks, and attempts to forecast the future; he grapples with uncertainty. The most important Misesian entrepreneurs, the driving force of the economy, are the capitalist-entrepreneurs, those who own or partially own capital resources and risk them in projects hoping for future returns. And, in the area of knowledge, as professor Salerno has perceptively pointed out, Misesian Man knows a lot about his part of the market—not just prices, but all the *qualitative* knowledge that must also go into production and into risky ventures: the sort of customers he will have, the sort of products they will want, where to buy raw materials and how to transform them, and so on—that is, all the *particular* knowledge that Hayek has talked about in other contexts. The free price-system is vital to the entrepreneur but it is not, as in Hayek-Kirzner, his only source of knowledge.[24]

The Misesian entrepreneur, then, is not a passive, if alert, recipient of "knowledge" provided by the price system. He is a knowledgeable, active, risking, forecasting, man using the price system as an indispensable guide to enable him to *calculate* his costs, and to estimate his future revenues and profits.

As for Lachmannian Man, the entrepreneur may exist, but he loses all significance. In contrast to the Hayek-Kirznerian man, he cannot learn from market signals because he cannot know anything

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[23]For a critique of Kirznerian alertness, see Murray N. Rothbard, "The End of Socialism and the Calculation Debate Revisited," *Review of Austrian Economics* 5, no. 2 (1991): 67; included in this volume as chapter 45. Also see Rothbard, "Professor Hébert on Entrepreneurship," *Journal of Libertarian Studies* 7 (Fall, 1985): 281–85. The latter article was a comment on a paper by Professor Robert Hébert, both written for a tricentennial conference on Cantillon in August 1980. Hébert's discussion on Kirzner's view of entrepreneurship is in Robert F. Hébert, "Was Richard Cantillon an Austrian Economist?," ibid., pp. 272–75. For a further comment on Kirzner and on my paper, see Robert F. Hébert and Arthur N. Link, *The Entrepreneur Mainstream Views and Radical Critiques* (New York: Praeger, 1982), pp. 95–99.

[24]See below, the section on Knowledge and Socialist Calculation.

anyway, even through price signals. Lachmannian Man is totally bereft of knowledge, and his Man in the market economy is scarcely better off than, or knows more than, the Lachmannian socialist planner.[25]

## Market Process and Equilibrium

While the neoclassicist believes, or affects to believe, that the market economy is always in a state of general long-run equilibrium, Austrian economics, from Menger on, indeed from Cantillon on, has concentrated not on equilibrium but on the process by which the market moves toward it. The real world, the day-to-day world of markets, is one where the market is always moving toward equilibrium but never attaining it, since the determinants of market activity: values, resources, technologies, knowledge, products, and so on, are always changing. The Austrians, therefore, concentrate on market processes rather than on the final equilibrium state.

But in contrast to Mises, the Lachmannians, in particular, have thrown out final equilibrium altogether. They regard the entire concept as meaningless. Instead, they virtually use the phrase "market process" as a shibboleth, thereby throwing out not only equilibrium,

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[25]Alexander Gray's hilarious and perceptive strictures on Ricardo's argument against government intervention apply a fortiori to the free-market Lachmannians:

> Such is the Ricardian scheme of distribution; in place of the old harmony of interest, he has placed dissension and antagonism at the heart of things. . . . Gone is the large-hearted optimism of Adam Smith, transmuted into a pessimism that will not be comforted. Yet Ricardo remains immovably non-interventionist. . . . In a world of Ricardian gloom one might ask why there should not be interference. An optimist carolling that God's in His Heaven and that all is right with enlightened self-interest has a right to nail the laissez-faire flag to the mast, but a pessimist who merely looks forward to bad days and worse times ought not in principle to be opposed to intervention, unless his pessimism is so thorough-going as to lead to the conviction that, bad as all diseases are, all remedies for all diseases are even worse. (Alexander Gray, *The Development of Economic Doctrine* [1931; London: Longman, 1980], pp. 171–72)

but the baby of economic theory itself along with the neoclassical bathwater. It is impossible to engage in economic theorizing without employing what Mises called "imaginary constructions" or "thought experiments" (*Gedankenexperimenten*) which function as the praxeologist's unique substitute for the laboratory experiments of the physical sciences. In the laboratory, the scientist holds all other variables constant, while he examines the effect of changing one variable upon another. Since human beings cannot be "held constant," the praxeologist does so in "thought experiments," by means of the famed *ceteris paribus* clause. It is through such reasoning that the economic theorist concludes, for example, that an increase in the supply of money, the demand for money being held constant, will be bound to lower the value (purchasing power) of the monetary unit. In short, the economic theorist postulates an equilibrium, then mentally changes one variable, say the supply of money, keeps all other relevant variables constant, and examines the effect on prices in general. Refusing to employ equilibrium concepts is necessarily destructive of all economic theory or economic law.

*Ceteris paribus* constructions can and do embody reality and economic truth even if the *specific* constructions are not "realistic" in the sense that they are not happening at that particular moment in time. These theories and laws are realistic because they are deduced from the fundamental and absolutely true axiom of human action, that people continually *act* by employing means to try to achieve goals. The laws of monetary theory, for example, that an increase in the supply of money, given the demand for money, will lead to a fall in the value of the monetary unit, are eternally and "apodictically" true, regardless of time and place, provided, of course, that money is being used in the economy. Even if there were no money in the world today, or, more specifically, no monetary inflation, the law or construction in question would still be *true*, only presently not applicable. It is the task of the economic historian or forecaster to *apply* the theory of monetary inflation to any economy where such inflation may exist.[26]

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[26]In his sympathetic discussion of praxeology, Patrick J. O'Sullivan asserts that Mises, as an a priorist, believed that since the fundamental axiom of action is a priori to experience, that the deduced laws are simply true, whereas Hayek and Robbins, believing that the axioms are empirically

Mises put it this way:

> The specific method of economics is the method of imaginary constructions. . . . An imaginary construction is a conceptual image of a sequence of events logically evolved from the elements of action employed in its formation. It is a product of deduction, ultimately derived from the fundamental category of action, the act of preferring and setting aside. . . . Their function is to serve man in a scrutiny which cannot rely upon his senses. . . . The main formula for designing imaginary constructions is to abstract from the operation of some conditions present in actual action. Then we are in a position to grasp the hypothetical consequences of the absence of these conditions and to conceive the effects of their existence. Thus we conceive the category of action by constructing the image of a state in which there is no action [final equilibrium], either because the individual is fully contented and does not feel any uneasiness or because he does not know any procedure from which improvement in his well-being [state of satisfaction] could be expected.[27]

Furthermore, by tossing out equilibrium concepts altogether, and in concentrating only on "market processes," Lachmannians and other non-Misesian Austrians fail to realize that they thereby give up any chance of understanding those "processes" themselves. For these "processes" are really human actions which, unlike the mere motions of stones or atoms, are necessarily purposive and goal-oriented. Therefore, every action on the market must already imply the goal, or end-state, of that action.[28] The action, or "process," already implies the equilibrium state, even if that state is never fully reached.

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derived, believed that the laws had to be consciously *applied* to empirical states of affairs where the conditions hold. But the need for applicability is maintained by Mises as well as the others, and that need is not related to the philosophic status of the fundamental axioms. Thus, while the basic laws of human action can only be applied to those empirical worlds where *human beings exist*, more narrowly deduced laws, such as the laws of monetary theory, can only be applied *to those empirical societies where money is in use*. See Patrick J. O'Sullivan, in *Ricerche Economiche* 43 (January/June, 1989).

[27]Mises, *Human Action*, pp. 236–37.

[28]Professor Hans-Hermann Hoppe illuminated this point in his lecture on monetary theory at the Ludwig von Mises Institute conference on the Federal Reserve at Jekyll Island, in May 1992.

Once again, a crucial difference is the abandonment, by non-Misesians, of the Misesian concept of *action*—action that is necessarily goal or end-state directed, and that is purposive, active, and risktaking. Instead of "equilibrium," these Lachmannians speak of "processes," which connote impersonal motions and mechanisms rather than the conscious choices of persons engaging in goal-directed activity.[29,30] We have seen, in contrast, that equilibrium constructions are indispensable for all *ceteris paribus* economic thinking, for analyzing actions, and for demonstrating the direction in which the economy is necessarily tending. As Mises indicated in the above quote, final equilibrium is also necessary for analyzing the emergence of profit-and-loss in an uncertain world; for such positive or negative returns would not exist in a world of certainty and changeless final equilibrium. The final equilibrium construct also enables the economist to distinguish short-run entrepreneurial profit-and-loss from returns brought about by time-preference, embodied in the "natural" rate of interest, returns which would still continue to exist in a world of certainty and equilibrium.

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[29]The use of "market process" as a mantra was demonstrated by Professor Don Lavoie, a former Misesian who became a Lachmannian and even a "hermeneutician," based on the fashionable Continental philosophy of Heidegger and his student Gadamer. Lavoie established a Center for the Study of Market Processes (CSMP) at George Mason University, and in 1983 the Center established a periodical, *Market Process*. Ludwig Lachmann's major work as a Lachmannian was his volume, *The Market as an Economic Process* (Oxford: Basil Blackwell, 1986). Later, Lavoie organized a Society for Interpretative Economics, which managed to hold one meeting before it folded. It should come as no surprise that Professor Lachmann gave the keynote address at that meeting.

Professor Vaughn concluded her 1990 article on the Austrian revival by hailing the Lavoiean market process approach as the wave of the Austrian future, a view possibly reflecting her position as a board member of the Center. Unfortunately for her prediction, the CSMP minus Professor Vaughn, has now transformed itself into a very different center dedicated to a certain kind of managerial scheme unrelated to economics, let alone to Austrianism or its concerns. Vaughn, "Mengerian Roots," pp. 403–04.

[30]Kirzner, too, has succumbed, naming his latest collection of essays, *The Meaning of Market Process* (New York: Routledge, 1992).

Meanwhile, in contrast to the Lachmannians, the Hayekians have preserved the concept of equilibrium, and the view that entrepreneurs are always moving the economy in an equilibrating direction. But the Hayekians, who include Kirzner, are waging the battle on empiricist rather than praxeological grounds. In other words, the Hayekians claim that the entrepreneurs, in the process of learning from market signals, are in fact moving the economy toward equilibrium. The Lachmannians, of course, claim that entrepreneurs can learn nothing, and that therefore the economy is either moving away from equilibrium, or else in no particular direction. The battle between the two, therefore, is over empirical estimates over rates of speed: the Hayekians claiming that entrepreneurs are learning at a faster pace from the price signals than data are changing, thereby moving the economy toward equilibrium. The Lachmannians, on the other hand, claim that data are changing faster than people can learn (assuming they can learn at all), and that therefore the economy, in fact, is moving away from equilibrium. The dispute is a mere empirical one over rates of speed of change: a dispute which, in the nature of things, can never be resolved.

For the Misesian, on the other hand, the entire dispute is misconceived. The logic of the situation demonstrates that man always acts by using reason to improve his lot; so that his action is always "rational," that is, his actions are always beneficial, always necessarily equilibrating *ex ante*. And the market mechanism is also such that forecasts tend, in general, to pan out as true, so that ex ante decisions become validated *ex post*. But choice, and action, are always *ex ante*, and *ex ante* action on the market is always equilibrating. And *ex ante* considerations are what count in analyzing and explaining human action.[31]

### Coordination: of Plans or Prices?

Wrapped up in its faulty conception of equilibrium is the Hayekian shibboleth about the alleged market function of "coordi-

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[31]For an exposition of action on the market as always equilibrating out of the very nature and logic of action, and for a critique of the empiricists on this issue, see George A. Selgin, *Praxeology and Understanding: An Analysis of the Controversy in Austrian Economics* (Auburn, Ala.: Ludwig von Mises Institute, 1990).

nation of plans." The concept is not to be discovered in Mises, and for good reason. In the first place, in final equilibrium, in the evenly rotating economy toward which the economy tends but never reaches because of continually changing data, there is no change in the endless round and so no change is expected. All subject "plans" are therefore brought into equilibrium, or coordinated, by definition, in final equilibrium. But while Hayekians and Lachmannians quarrel about whether or not people learn from experience and whether the market is equilibrating and coordinating, the entire controversy is misconceived. For while in non-existing final equilibrium plans are coordinated by definition, why should we expect that outside of equilibrium plans, which are necessarily variable and subjective, will *ever* be "coordinated," or brought into equality? In fact, we can say that, given basic data—values, resources, technology—there is far less reason to think that plans will be coordinated than that the market tends toward equilibrium.

Suppose, for example, that we can say that the capital value of a certain firm, in final equilibrium, will be $100 million, based on future returns and the rate of interest, and that therefore, given 1 million shares of outstanding stock of the firm, the "equilibrium" stock price is $100. But even if the data are given or frozen, and we can say that the stock price is tending toward $100, there is no reason to assume that, short of the actual final equilibrium state, that all market participants' plans will be "coordinated" to understand that the equilibrium price is going to be $100. Until the end, there can and will be individuals with varying expectations, bulls and bears, and share price volatility until the final state of rest is reached. In short, while all action is equilibrating by its nature, and the market tends to equilibrium if data are frozen, subjective plans will *never* be "coordinated" until final equilibrium arrives. And since that final state of rest, given the nature of man and of the world, can *never* come to pass, the entire concept of "coordination of plans" should be tossed out as unhelpful, misleading, and false.

But does this mean that the market never "coordinates," that we may never speak of coordination on the market? On the contrary, as Professor Salerno has recently shown, coordination occurs effectively, *and every day*, through the entire price system. Professor Salerno has performed the signal service of reviving William H. Hutt's theory of price coordination and demonstrating that this Huttian concept is

essentially the Misesian view.[32] Not in the Never-Never Land of final equilibrium, but every day in markets, in day-to-day equilibrium, the price system coordinates prices, including wage rates and the prices of other productive factors, so that there is never any shortage or unsold surplus. From day-to-day, then, there may, for various reasons, be *misallocations* of resources, but never shortages and surpluses, so long as prices are free to move.

Suppose, for example, a typical misallocation of agricultural resources takes place during a war. A country gets into war, supplies of agriculture from other areas are cut off, and there is a great increase in demand for the country's agriculture. Food and farm prices rise and farm production expands. Then, when the war is over, the agricultural expansion is seen to be excessive for peacetime, and food and farm prices and wage rates fall. *Even though* there is now "too much" food and too many resources in agriculture to be sustained in peacetime, if prices are free to fall, there is no unsold surplus, either in produce or in labor employment. Even though wartime demand has caused too many resources to move into agriculture, the free price system continues to *coordinate*—to make sure that there are, nonetheless, no shortages or surpluses in the agricultural sector. In the longer run, of course, the losses in agriculture and the especially low wage rates there, will induce resources to move out of agriculture and into other areas, so that prices and wages will move toward equilibrium in all areas. But *at each stage* of the process, the price system coordinates successfully.[33]

### *Knowledge and Socialist Calculation*

It is now universally acknowledged that Ludwig von Mises, allegedly the loser in the famous socialist calculation debate that he launched in 1920, was really right: clearly, socialism cannot calculate, it cannot run a complex modern economic system. But it has

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[32]Salerno, "Commentary: Concept of Coordination," pp. 325–45.

[33]For a brilliant discussion of price and wage consideration, and the contrast with Keynesian assumptions, see William H. Hutt, *The Keynesian Episode: A Reassessment* (Indianapolis, Ind.: Liberty Press, 1979), pp. 135–77, esp. 137–40, 150ff. Also see the earlier W.H. Hutt, *Keynesianism—Retrospect and Prospect* (Chicago: Henry Regnery, 1963), pp. 53–81, esp. 54ff.

only recently become clear, through the insights of Professor Salerno, precisely *why* Mises was right, and also how the Misesian message was systematically distorted, from the 1930s until recent years, by F.A. Hayek and his followers. For Hayek and the Hayekians, obsessed with the alleged "problem of knowledge," have systematically misinterpreted Mises as maintaining solely that the Socialist Planning Board, facing the uncertainty of a dynamic economy, lacks the knowledge enabling it to plan the production and allocate the resources of a socialist economy. In contrast, the market economy, through its price signals, conveys that needed knowledge from and to the various participants in the market economy.

Mises, while not disputing the importance of knowledge and its dissemination through the price system, was, however, arguing a totally different point. From 1920 on, he reasoned as follows: *assume* the best for the Social Planning Board. Assume that, by some magical process, it has been able to discover and *know* absolutely all the value-scales of consumers, all technological methods, and compile an inventory of all resources. Suppose, then, Mises says, we grant total knowledge of all these data to the Socialist Planning Board. It *still* will not be able to calculate, still will not be able to figure out costs and prices, particularly of land and capital goods, and therefore will not be able to allocate resources rationally. The real problem of the Planning Board, then, the major thing denied that Board by absence of a market, is not knowledge but economic calculation.[34]

Thus, to Hayek, *if* the Planning Board could by some magic know, as people come to know through the market, consumer values, technologies, and resources, it could rationally plan and allocate resources fully as well as the market. As usual for Hayek and the Hayekians, the argument for the free market and against statism rests only on an argument from ignorance. But to Mises, the problem for the Planning Board is not knowledge but calculability. As Salerno puts it, the knowledge conveyed by present (or "immediate past") prices rests on values, techniques, and resources of the immediate past. But what acting man is interested in, especially the entrepreneur in committing resources into production and future sale, is

[34]For a survey and discussion of the arguments in the socialist calculation debate, see Rothbard, "The End of Socialism and the Calculation Debate Revisited," pp. 51–76.

*future* prices and future costs. The entrepreneur, who commits present resources, does so because he *appraises*—anticipates and estimates future prices—and allocates resources accordingly. It is, then, the *appraising entrepreneur*, driven by his quest for profits and for avoidance of losses, who can calculate and appraise because a genuine price system exists in the means of production, in land and capital goods, that is, a system of exchanges of privately-owned capital resources. Only such a pricing system allows for calculation.

Salerno points out that for Mises, *knowledge* and *appraisal* on the market are complementary, and have very different natures and functions. Knowledge is an *individual* process, by which each individual entrepreneur learns as much as he can about the largely qualitative nature of the market he faces, the values, products, techniques, demands, configurations of the market, and so on. This process necessarily goes on only in the minds of each individual. On the other hand, the prices provided by the market, especially the prices of means of production, are a *social* process, available to all participants, by which the entrepreneur is able to appraise and estimate future costs and prices. In the market economy, qualitative knowledge can be transmuted, by the free price system, into rational economic calculation of *quantitative* prices and costs, thus enabling entrepreneurial action on the market. As Salerno notes: "competition therefore acquires the characteristic of a quintessentially social process, not because its operation presupposes knowledge discovery [as with Hayek-Kirzner], which is inescapably an individual function, but because, in the absence of competitively determined money prices for the factors of production, possession of literally all the knowledge in the world would not enable an individual to allocate productive resources, economically within the social division of labor."[35]

In short, the entire Hayekian emphasis on ignorance and "knowledge" is misplaced and misconceived. The purpose of human action is not to "know" but to employ means to achieve goals. As Salerno perceptively summarizes Mises's position:

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[35]Salerno, "Postscript: Why a Socialist Economy is 'Impossible'," in Ludwig von Mises, Economic Calculation in a Socialist Commonwealth (Auburn, Ala.: Ludwig von Mises Institute, 1990), pp. 60–61. Also see Rothbard, "The End of Socialism and the Calculation Debate Revisited," pp. 51–71.

> The price system is not—and praxeologically cannot be—a mechanism for economizing and communicating the knowledge relevant to production plans [the Hayekian position]. The realized prices of history are an accessory of appraisement, the mental operation in which the faculty of understanding is used to assess the quantitative structure of price relationships which corresponds to an anticipated constellation of economic data. Nor are anticipated future prices tools of knowledge; they are instruments of economic calculation. And economic calculation is not the means of acquiring knowledge, but the very prerequisite of rational action within the setting of the social division of labor. It provides individuals, whatever their endowment of knowledge, the indispensable tool for attaining a mental grasp and comparison of the means and ends of social action.[36]

Mises's own avowal of the roots of his inquiry into the socialist problem has, until recently, been overlooked in the story of the social calculation debate. It has generally been assumed, understandably, that Mises's 1920 article arose solely out of curiosity about the arrival of socialism with the advent of the Bolshevik Revolution.

Actually, the main impetus for the study, as Mises has revealed, was the work he did on his monumental *Theory of Money and Credit* (1912). In the process of accomplishing the feat of integrating the theory of money into general marginal utility theory (deducing macro from micro, as it would now be put), Mises realized that, contrary to the earlier Austrians, the market does not impute *values* directly from consumer preferences to productive factors. Value-scales or preferences, Mises realized, were purely ordinal, a matter of choosing or setting aside; whereas market money prices were quantitative and cardinal. Only *money prices* can be imputed and not values directly. It was in ruminating on the ways and means that the market turns the qualitative into the quantitative that Mises arrived at his insight into the reasons that calculation under socialism would be "impossible."[37]

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[36]Joseph T. Salerno, "Ludwig von Mises as Social Rationalist," *Review of Austrian Economics* 4 (1990): 44. Also see ibid., pp. 26–54. These two profound and subtle articles by Salerno are indispensable to the entire Mises vs. Hayek discussion.

[37]Mises says in his memoirs:

Until the recent rehabilitation and new explanation of Mises's position on socialist calculation by Professor Salerno, Mises's viewpoint had been systematically obscured by modern Austrians as well as by non-Austrians in the debate. Thus, Professor Karen Vaughn, in a Hayekian summary of the calculation debate in the early 1980s, does not even mention Mises's profound contributions in *Human Action*. In an earlier paper, Vaughn did even more: she actually sneered that "Mises's so-called final refutation in *Human Action* is mostly polemic and glosses over the real problems."[38]

Professor Israel Kirzner, on the other hand, takes a diametrically opposite view: that the greatness of the Mises position in *Human Action* is that it joins Hayek in taking a "dynamic" view of the socialist problem, as against the "static" view in Mises's classic 1920 article. In reality, Mises's position was equally "dynamic" or "static" throughout; he simply elaborated his older position in *Human Action*. Actually, as Salerno points out, the "later" Mises, in *Human Action* explicitly *denies* that the key to the calculation problem under socialism is

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> They [the socialists] failed to see the very first challenge: How can economic action that always consists of preferring and setting aside, that is, of making unequal valuations, be transformed into equal valuations, by the use of equations? Thus the advocates of socialism came up with the absurd recommendation of substituting equations of mathematical catallactics, depicting an image from which human action is eliminated, for the monetary calculation in the market economy. (Ludwig von Mises, *Notes and Recollections* [Spring Mills, Penn.: Libertarian Press, 1978], p. 112)

Also see the discussion in Murray N. Rothbard, *Scholar, Creator, Hero* (Auburn, Ala.: Ludwig von Mises Institute. 1988), pp. 35–38, and especially, Rothbard, "The End of Socialism and the Calculation Debate Revisited," pp. 64–65. Also see Mises, *Human Action*, pp. 327–30, p. 696; Salerno, "Mises as Social Rationalist," pp. 39–40, and Salerno, "Why a Socialist Economy is 'Impossible," pp. 60–61.

[38]Dr. David Gordon has pointed out to me that, just as Mises showed, by his regression theorem, that money can only arise on the market out of a non-monetary good under barter, so money on the market is needed to transform ordinally ranked subjective values into money prices which are indispensable for imputations of productivity and for economic calculation by entrepreneurs.

that "all human action points to the future and the future is always uncertain." This is the Hayek-Kirzner way of conceiving the problem, since, outside of static equilibrium and in a dynamic, changing world, knowledge of the future is always uncertain. But no, says Mises, socialism suffers from

> quite a different problem. . . . We do not deal with the problem of whether or not the [socialist] director will be able to anticipate future conditions. What we have in mind is that the director cannot calculate from the point of view of his own present value judgments and his own present anticipation of future conditions, whatever they may be. If he invests today in the canning industry, it may happen that a change in consumers' tastes . . . will one day turn his investment into a malinvestment. But how can he find out today how to build and equip a cannery most economically?
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> Some railroad lines constructed at the turn of the century would not have been built if the people had at that time anticipated the impending advance of motoring and aviation. But those who at the time built railroads knew which of the various possible alternatives for the realization of their plans they had to choose from the point of view of their appraisements and anticipations and of the market prices of their day in which the valuations of the consumers were reflected. It is precisely this insight that the [socialist] director will lack. He will be like a sailor on the high seas unfamiliar with the methods of navigation.[39]

### *Reason: Exchange, Intention, and Design*

At the core of the constellation of crucial differences between the Misesian and Hayekian paradigms is their respective attitudes toward human reason. Man, affirms Mises after Aristotle, is the uniquely rational animal; reason is man's unique and essential instrument to find out what his needs and preferences are, and to discover and employ the means to achieve them. Mises's stress on

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[39]Mises, *Human Action*, p. 700. Also see Rothbard, "The End of Socialism and the Socialist Calculation Debate Revisited," pp. 67–68; and Israel M. Kirzner, "The Economic Calculation Debate: Lessons for Austrians," *Review of Austrian Economics* 2 (1988): 1–18. Kirzner's error seems to be tied to his non-Misesian view of the entrepreneur: not as an appraiser of prices and costs, but as someone who is alert to uncertain knowledge of the future.

action, on acting man, therefore necessarily stresses the vital importance of human reason. Misesian Man acts, and therefore consciously selects goals, and decides how to pursue them.

Hayek's entire work, on the contrary, is devoted to a denigration of human reason. As David Gordon has pointed out, Hayek virtually assumes that human beings act *unconsciously*—of course, a contradiction in terms—and therefore that they neither know nor think nor choose. Therefore, their actions do not require understanding; hence Hayek's emphasis that the best that can be done is rely on a blind and unconscious adherence to evolved rules.[40]

Thus, Mises's view of why men participate in the basic form of market interaction-exchange, which also implies participating in the social division of labor. Harking back to the insight of the Scholastics, beginning at least with the great fourteenth-century French philosopher and scientist John Buridan, Mises saw that a man participates in an exchange because he sees that he will benefit more from the good or service received, than the good or service he has to give up. Here is the root of the basic subjective-utility, or Austrian, insight: men engage in exchange because and only because they subjectively prefer what they will receive in exchange to what they give up. Hence, also, Mises's conclusion on how to preserve and maintain the great *oecumene,* the mighty network, or system, of voluntary, mutually beneficial exchanges that constitute the free-market economy: The mass of the public must learn, must be educated to understand, the vast importance of maintaining and preserving that free market from aggression and coercive interference. They must understand that on preserving and expanding that market network, or oecumene, depends the flourishing and prosperity of the human race: whereas interference with that network can only lead to world-wide misery and impoverishment.[41] It is not, of course, that Mises believes that men will always listen to reason, or follow its dictates; it is simply that, insofar as men act at all, they are capable of following reason, and that pursuing such a course is literally the last best hope for mankind.

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[40]See in particular, David Gordon, "The Origins of Language: A Review," *Review of Austrian Economies* 2 (1989): 245–51.

[41]On Mises on the indispensable role of reason in exchange, and the contrast with Hayek, see the illuminating article by Salerno, "Ludwig von Mises as Social Rationalist," pp. 26–54.

One of the remarkable features of Hayek's character was his deviousness in expressing any disagreement with his old friend and mentor. Thus, it was only five years after Mises's death, on the occasion of writing a Foreword to the new edition of Mises's Socialism, that Hayek was able to express his harsh disagreement with Mises's rationalist view of why men exchange. Mises had written that he "regards all social cooperation [exchange] as an emanation of rationally recognized utility, in which all power is based on public opinion." But now, in his Foreword written after Mises's death, Hayek writes: "I had always felt a little uneasy about that statement of basic philosophy, but only now can I articulate why I was uncomfortable with it." Hayek then adds patronizingly:

> The extreme rationalism of this passage, which as a child of his time he could not escape from, and which he perhaps never fully abandoned, now seems to me factually mistaken. It certainly was not rational insight into its general benefits that led to the spreading of the market economy.[42]

But the point of Mises's "extreme" passage is this: for each particular exchange, each individual only participates in it because he acts consciously, and his reason tells him that he will be better off from making this exchange than from not making it. He will benefit from what

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[42]Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (1936; Indianapolis, Ind.: Liberty Fund, 1981), p. 418; F.A. Hayek, "Foreword," in *Socialism*, p. xxiii. Also see Peter G. Klein, "Introduction," *The Fortunes of Liberalism: The Collected Works of F.A. Hayek* (Chicago: University of Chicago Press, 1992), vol. 4, pp. 12–13; Hayek, *Fortunes of Liberalism*, p. 142.

Hayek's deviousness while Mises was alive may be seen in his 1937 article, "Economics and Knowledge," which marked his turn from a Misesian to a Popperian methodology (that of his old Viennese friend Karl Popper); apparently, the article was meant as an oblique attack on Mises for his allegedly Walrasian-neoclassical approach, and meant as a way to subtly shift Mises to an empiricist, Popperian approach. So oblique was the article, however, that Mises himself misinterpreted it as a Misesian attack on the neoclassicals, and current historians and scholars of the Austrian School are split on what Hayek's article *really meant*. It is interesting to note that what Hayek really meant about very many things is virtually a cottage industry for doctoral students, whereas it is rare that people have to puzzle over what Mises "really meant." See Klein, "Introduction," pp. 10–41.

he receives compared to what he gives up, and he will do better than from any other alternative exchange. All that this reasoning implies is conscious action. As for the free market economy in general, Mises's theory of government reflects the keen insight of David Hume: that no government, however powerful or coercive, can, in the long run, rule by force alone; that since force, in the long run, lies with the majority of the ruled rather than with the minority of the ruling elite, to maintain their rule the ruling elite must persuade the majority to give it their support. In other words, in the long run, ideas held by the people rule, for good or for ill. Ideas trump brute force. Far from being unrealistic "extreme rationalism," the remarkable internal collapse of Communist rule in the Soviet Union and Eastern Europe has borne dramatic testimony to the truth of Mises's position.[43]

In the passage in which he deprecates Mises's position, however, Hayek comes up with no counter-argument of his own. If "rational" ideas—in the sense of consciously-held rather than necessarily correct ideas—do not account for the adoption of a market economy, as well as the swing away from it in the twentieth century, what in the world does? Hayek hints that man "chooses" the market economy "only in the sense that he has learned to prefer something that already operated." Again, Hayek stresses blind habit or custom. Clearly habit plays a role, but if that were all, what accounts for the twentieth-century shift away from the market economy, and, finally, for the internal collapse of the Communist politico-economic system? Hayek's emphasis on unconscious habit or rule-following thus leaves out critical parts of the answer: such as (a) how do these rules or institutions get adopted in the first place; and (b) how do they ever change, often suddenly? To fall back, as Hayek does, on "evolution" as the sole

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[43]There has been general agreement that Mises's claim of the "impossibility" of socialism has been vindicated, with panels at annual economics meetings devoted to the theme of "Mises was Right." See among others, Stephen Boehm, "The Austrian Tradition: Schumpeter and Mises," in *Neoclassical Economic Theory, 1870 to 1930*, K. Hennings and W. Samuels, eds. (Boston: Kluwer Academic Publishers, 1990), p. 231. There has been no recognition, however, of the Communist collapse vindicating Mises's position on the long-run dominance of the ideas of the public in government.

answer to the first question not only misapplies the very concept of evolution, which requires the existence of genes and mutations; it also fails spectacularly to account for sudden changes in those rules or in society's acceptance of them. Most glaringly, Hayek's implicit assumption of human unconsciousness violates the basic fact which we all know from our own experience as axiomatic: that human beings are indeed conscious, and that they therefore act and choose rather than move or "are moved" in an unconscious, robotic, or unmotivated manner.[44]

Hayek presents three crucial concepts as ways of highlighting his reliance on human blindness and irrationality: "spontaneous order"; the "*unintended* consequences of human action"; and the product of "human action, but not human design."

We need not tarry on the phrase "spontaneous order," except to note that the word "spontaneous," once again, connotes lack of thought, activity that is not consciously chosen, but rather purely reflexive and tropistic. It would have been far more accurate to use a term such as "voluntary," which would at least focus on voluntarily chosen, rather than coerced, actions.

The latter two concepts, of course, are simply variants of each other. All actions have consequences; and Hayek is anxious to

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[44]How to reconcile Hayek's dominant "anti-rationalist" position with another strain in his thought: the power of ideas in the long-run to effect social change, and his call for a "trickle-down" strategy of converting top scholars and philosophers to classical liberal views, who will in turn eventually convert lesser professors, who will in turn convert general intellectuals, journalists, and "dealers in second-hand ideas?" See, in particular. Hayek's "The Intellectuals and Socialism," first published in the *University of Chicago Law Review* 16 (Spring, 1949), and reprinted in Hayek, *Studies in Philosophy, Politics, and Economics* (Chicago: University of Chicago Press, 1967), pp. 178–94.

There are, it seems, three possible ways to explain this anomaly. First, that it is characteristic of Hayek's intellectual inconsistency and muddle. Second, that it still reflects the more rationalist Hayek I, since it was written in the 1940s, and before the development of his "evolutionary" position. And third, that Hayek sees the only role of ideas as a minority intellectual elite being able to rise above the general torpor and unconsciousness—but that the very best the elite can do is to urge everyone, including themselves, to follow evolved rules blindly.

emphasize, at every turn, the alleged importance of the unintended rather than intended consequences, thus showing the trivial importance of conscious human action. Humans may act in some sense, but their conscious actions are unimportant, since they do not bring about desired, "designed," or intended effects. Mises's analysis, on the contrary, rests squarely upon the Aristotelian insight into action, in which they are shown to be *intentional*, thinking and action always being guided toward an object. People act all the time, in a large number of respects; we assume that, most, or almost all of the time, people's actions bring about their *intended* results. If they did not, the people would not continue to repeat them. Hayek's own emphasis on habit or custom, indeed, proves the Aristotle—Mises rationalist point: for the habitual repetition means that these actions have repeatedly been successful in bringing about a person's goals. Thus, if someone lives in Long Island, and every morning takes a train to Penn Station, and then a bus to his job, reversing the process in the evening, his success in grasping cause-and-effect relations and in bringing about his intended consequences leads him to keep repeating these activities.

Furthermore, since all human actions are goal-directed, are *intentional*, if we do not absolutely know whether or not a person intended the consequences of his actions, we have to *presume* that he did, unless it can be demonstrated otherwise. Obviously, if a business investor or speculator has suffered losses, these losses were not intended, but apart from such cases the presumption must stay with intention.[45]

Perhaps the best case for stress on unintended consequences comes from analyzing the motive of exchange on the free market and was best expressed in the famous quote from *The Wealth of Nations*:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their

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[45]Owing to the income tax code, the losses may well have been intended, in order to reduce one's level of taxable income. But in that case, detailed investigation into the facts would overturn the common-sense presumption that losses would not be intended from the start.

> self-love, and never talk to them of our own necessities but of their advantages.[46]

To translate this passage into our current concerns: the butcher and the baker's actions result in the *intended* consequences of yielding them a profit, but, more importantly for society, they result in the *unintended* consequences of benefiting consumers, indeed society as a whole, in the most efficient possible manner.

This is surely an important and valid point, so far as it goes. But, we might wonder: why the rush to *celebrate* unintended consequences? Wouldn't it have been better if these pro-consumer or pro-general standard of living consequences had been understood and *intended* by the actors as well? To put it another way: the butcher, baker, and so on desire and intend the consequences of their production yielding them a satisfying profit. But suppose that they are informed, by economists and others, that their actions *also* have the effect of helping the rest of society and the general standard of living? Wouldn't they *then* come to intend this general welfare as well, even

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[46]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Campbell and A. Skinner, eds. (Indianapolis, Ind.: Liberty Classics, 1981), vol. 1, pp. 26–27. It should be noted that Smith was anti-rationalist as well, if for rather different reasons. Smith was concerned to purge economic theory of all subjective utility considerations, so he had to discard mutual benefit as the reason for exchange. Indeed, in contrast to Mises's insight that the division of labor (the base of exchange) stems from the diversity and inequality of talents and interests among men, Smith maintained that all people and children are originally almost totally the same, and that the existing division of labor and of occupation willy-nilly pushes them into specialization and differences of interest. As Smith puts it: "the very different genius which appears to distinguish men of different professions . . . is not . . . so much the cause, as the effect of the division of labor."

If for Smith, the diversity and inequality of talent is not the root cause of the division of labor but the effect, what in the world is the root cause? Smith, like many social scientists who do not know the cause of a human phenomenon, falls back on some sort of built-in "instinct": or, as he put it, "a certain propensity in human nature" which has no regard for utility, but is instead, "a propensity to truck, barter, and exchange one thing for another," ibid., pp. 25, 28. Or, as Smith rather absurdly put it: "without disposition to truck, barter, and exchange, every man must have procured to himself every necessary and convenience of life which he wanted," ibid., p. 29.

conceding that their own self-interest would still be their primary goal? Wouldn't they be likely, at the very least, to feel better and happier about their own activities, knowing now that they benefit the body of consumers as well as themselves? How could such knowledge *hurt*?

It might be countered that the butcher and baker might well feel better; but apart from that, knowledge of the unintended consequences would have no effect upon their concrete actions on the market. But, on the contrary, knowledge that they are helping the general welfare might well affect their operations rather strongly. Consider the following case: a brilliant entrepreneur is engaged in productive activities. But he has absorbed the general cultural position that by maximizing his profits he is in some way injuring his fellow man. As a result, to assuage his conscience, he deliberately takes actions that will lower his profits—not eliminate them altogether, but lower them from what he considers to be an "extreme" or even "unconscionable" height.

The entrepreneur then reads Mises or some other hard-core free-market economist or journalist. He learns, to his amazement and relief, that the greater the amount of his profits the *more* he is helping consumers, society as a whole, and his fellow man. Happily, he casts off the guilt that had been plaguing him and changes his actions to engage in a happy and welfare-enhancing maximization of profits.

This is surely not an outlandish case, and it shows why it is better to shed light, to replace ignorance by knowledge, and thereby to show the entrepreneur all the foreseeable consequences of his actions. His actions will now be adjusted to the fact that all their consequences are conscious and intentional. Not only is there nothing wrong with this process, but the life of the entrepreneur and of society will both be improved. Hayek to the contrary notwithstanding, knowledge remains better than ignorance.[47]

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[47]There is another point: for any particular butcher or baker, the outside observer—the outside economist or social scientist—does not really *know* if he has been enlightened by Misesian or other free-market writers, or not. The observer may have his suspicions, but suspicions are not knowledge. Ironically, for Hayek or Hayekians to assume without evidence that all butchers, bakers, and so on are ignorant of free-market theory is to arrogantly claim knowledge that they do not, in fact ultimately cannot, have. Perhaps it is the Hayekians, not the Misesians, who suffer from *hubris*.

And finally, there is another vitally important point, which ties back into the argument about how an exchange economy, the free market economy, must be established and sustained. For spreading knowledge of the happy though currently unintended consequences of their actions may not only alter the actions of unintended consequences; they might imbue the mass of the public, regardless of their occupation, with an appreciation of the enormous benefits of the free-market lattice-work throughout society, and of the horrendous consequences of government interference in that web of the free-market economy. To educate in order to make currently unintentional consequences intentional may well be the only possible route to the salvation of mankind. Truth, understanding, reason, is surely the way to save the free market, not urging blind submission to rules that might not even be appropriate to a market economy.

Another grave problem with the Hayekian doctrine is that the spontaneous order design concept not only exalts blind rules and unconscious action in the market economy; it lets the State off the hook as well. For this emphasis means that not only market actions with beneficent consequences but also State actions with evil consequences are equally unconscious. This means that State acts, instead of being the result of conscious lobbying and the seeking of subsidy and special privilege, simply grew "spontaneously," like Topsy. No one is to blame for State actions: no motives, no goals, no lobbying, no self-seeking exploitation of taxpayers or competitors. Just as John R. Seeley, in his apologetics for the British empire, claimed it did not expand consciously but only "in a fit of absence of mind," so the Hayekian mindset, applied to State action, removes guilt or even understanding from analysis of the historical process.

Letting evil off the hook was indeed the origin of Hayek's cherished unintended consequences, or human action-not-human design concept. Hayek points out that Adam Ferguson, sociologist and old friend and colleague of Adam Smith in the eighteenth century Scottish Enlightenment, coined the concept "the result of a human action, but not the execution of any human design."[48] What Hayek does not tell us, however, is that Ferguson did not originally employ

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[48]F.A. Hayek, "The Results of Human Action but not of Human Design," in *Studies in Philosophy, Politics, and Economics*, p. 96.

the concept to analyze the market, or language, or any similar social process. As a young Presbyterian minister, Ferguson, along with his friend, the Reverend Alexander Carlyle, was reeling from the shock of the near-triumph of the Catholic Jacobite Rising of 1745, in which the Jacobites conquered Scotland, and were finally defeated by the Hanoverian troops in northern England. Ferguson and the others were confronted with this grave theological problem: how could God permit the evil Catholics to come so near to triumph? They concluded that while the Catholics, of course, were consciously evil, pursuing evil goals, they were unconsciously being used by God for his own good purposes: namely, to shake the Presbyterian Church of Scotland—God's Church—out of its lethargy, and to renew its devotion to its true purposes. In short, all events in human history, even if seemingly motivated by evil, are all *unconsciously* working toward good. Out of apparent evil, good: that is God's Providential plan. This truly dangerous doctrine leads straight, of course, to the Whig Theory of History: that whatever is, is right; and that which was, was right. Everything in history moves toward the good, is progressive; there can be no evil or wrong turn in history.[49]

In short: Hayek returns, with a burst, to the Whig theory of history and to a conservatism that justifies all institutions as "evolved," as part of some presumably beneficent pattern, even though God has now dropped out of the picture. Not only Hayek was influenced deeply by Ferguson; so too was a young graduate philosophy student at the University of Tübingen, G.W.F. Hegel, and his colleagues. Hegel systematized the Ferguson insight into his "dialectic," by which history, through its "cunning of reason," moves inexorably according to its divine plan: always bringing good, and a higher stage, out of apparent evil and conflict. Karl Marx, as a Left Hegelian, was to atheize that dialectic. Hayek is in odd, and not particularly wise, company.[50,51]

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[49]See the illuminating work by Richard B. Sher, *Church and University in the Scottish Enlightenment* (Princeton, N.J.: Princeton University Press, 1985), pp. 40–44.

[50]On Hegel and Marx, see Murray N. Rothbard, "Karl Marx: Communist as Religious Eschatologist," *Review of Austrian Economics* 4 (1990): 132–38.

In his incisive contrast of Mises's "social rationalism" with Hayek's irrationalist emphasis on "spontaneous order," Professor Salerno trenchantly points out that in the Misesian view, man cannot rely on spontaneous "unintended" consequences for successful social change. On the contrary, if men fail to understand rationally the destructive consequences of State intervention, that is, they fail to understand the beneficence of the free market economy, they are likely to wreck the *oecumene,* destroy capitalism, and return the economy to poverty and barbarism. The division of labor and human prosperity, then, necessarily rest on adoption by the public of the ideology of *laissez-faire*. If they adopt interventionism, on the other hand, the resulting "social maladjustment, which is inspired by fallacious ideology, carries in its wake the possibility of social disintegration and is more likely the greater the degree to which the consequences of human actions are unintended, or to use Mises's term, "unwitting." Salerno continues, following Mises, that "to the extent that social norms, policies, and institutions are 'undesigned,' are not completely and correctly thought out in advance and accounted for in a logically consistent ideology, to that extent does the continued existence of society become problematic." But then, "if social disintegration may occur 'spontaneously,' due to an ignorance of the remoter consequences of social action, social progress can only be assured by the widespread adoption of an ideology of social life which consciously and correctly accounts for these consequences. This ideology is [*laissez-faire*] liberalism."[52]

Ignorant and "spontaneous" action, then, is far more likely to be like a child's or a savage's destruction of fine china than providing a beneficent and flourishing market economy. Directly contrasting Mises and Hayek, Salerno concludes that

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[51]Hayek's praise of the common law as spontaneous and undesigned overlooks the fact that individual judges were consciously discovering, elaborating and applying fundamental legal principles. Reason and design were therefore dominant in common law. The fact that this reason and these laws were not imposed by a sovereign State but elaborated out of long-held legal principles is not relevant to Hayek's claim.

[52]Joseph T. Salerno, "Ludwig von Mises as Social Rationalist," *Review of Austrian Economics* 4 (1990): 50–51.

> the rationalist [Misesian] view of social evolution, therefore, is not one of placid and automatic improvement insured by "unintended" consequences, "undesigned" institutions, "tacit" knowledge and "natural selection" of rules of conduct. Social rationalism implies, instead, that human history is the outcome of a conflict between ideologies, which are consciously formulated and adopted by reasoning human beings. Whether an epoch is characterized by social progress, social retrogression, or even social disintegration depends upon which particular ideologies have become current and which individuals have attained ideological "might" defined by as "the power to influence other people's choices and conduct."[53]

It would seem that the most plausible case for Hayek's spontaneous, anti-rational anti-design theory of social life is the advent and development of language. Surely, language, at least, grew like Topsy, and was not rationally created? But, in an instructive essay, David Gordon has shown that recent research has plausibly resurrected the eighteenth-century Enlightenment view of Condillac, as well as of Thomas Reid and Lord Monboddo, that language was consciously created, out of gesture, and, Gordon adds, that gesture was reinforced by play. Gordon also points out that the Enlightenment view was driven out of circulation by the German Romantics, led by Johann Christian Herder, who were concerned to establish their bizarre view that German is the "highest" language by maintaining that it could only have emerged from the ineffable, unconscious, and noble German soul.[54,55]

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[53]Ibid., p. 52.

[54]David Gordon, "The Origins of Language: A Review," pp. 245–51. Gordon particularly discusses two recent works: G.A. Wells, *The Origins of Language* (Peru, Ill.: Open Court, 1987), and J.N. Hattiangadi, *How is Language Possible?* (Peru, Ill.: Open Court, 1987). Also see Hans Aarsleff, *From Locke to Saussure* (Minneapolis: University of Minnesota Press, 1982), for a critical view of the German Romantics on language.

[55]In addition, the Erlangen School of philosophy has emphasized the origin of mathematics and physics in the conscious apprehension of, for example, length, or numbers, in real world objects. See Paul Lorenzen, *Constructive Philosophy* (Amherst: University of Massachusetts Press, 1987).

Similar to the language question is the odd view that folk poetry or music was not consciously created by individuals, but grew unconsciously out of the wisdom of the folk. See H.L. Mencken, "Folk-Literature, a

Salerno also adds the important point taken from Mises that even language contains an important ideological, and hence conscious, component. Salerno quotes from Mises's *Theory and History* that language is "the precipitate of a people's ideological controversies, of their ideas concerning issues of pure knowledge and religion, legal institutions, political organizations, and economic activities. . . In learning their meaning the rising generation are initiated into the mental environment in which they have to live and to work. This meaning of the various words is in continual flux in response to changes in ideas and conditions." Some entire languages, notably modern Gaelic and secular Hebrew, were even deliberate creations and recreations out of ideological will and determination.[56]

It is instructive to contrast the twists and turns of error and fallacy in Hayek's concept of *unintended* consequences, including its paean to ignorant and unconscious action, with Mises's superficially similar but very different stress on *remote or unseen* consequences of human action. For, rather than Hayek's relying on spontaneity, or glorifying unconscious action and its unintended consequences, Mises was urgently concerned to have everyone grasp and *understand* the remote and unseen consequences of their actions, a grasp which they can only attain by means of reason, in this case by praxeological reasoning.

Thus, the Misesian economist Henry Hazlitt, in his best selling *Economics in One Lesson*, makes the centerpiece of his book Frédéric Bastiat's "broken window fallacy."[57] A nasty kid hurls a rock and breaks a window. The immediate common-sense reaction is for the onlookers to deplore the action of the kid, and lament the fact that

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Review of Louise Pound, *Poetic Origins and the Ballad*," in *A Mencken Chrestomathy* (New York: Alfred A. Knopf, 1949), pp. 471–72. Writes Mencken: "German folksong, the loveliest in the world used to be credited to a mysterious native talent in the German yokelry, but scientific investigation reveals that some of the songs regarded as especially characteristic of the folk-soul were actually written by the director of music at the University of Tübingen, Professor Dr. Friedrich Silcher," ibid., p. 472. Also see Ludwig von Mises, *Theory and History*, pp. 188–89.

[56]Ibid., pp. 227–32; Salerno, "Mises as Social Rationalist," p. 53.

[57]Henry Hazlitt, *Economics in One Lesson* (New York: Harper and Bros., 1946).

the storekeeper will now have to pay a considerable amount of money to repair the window. But then comes the proto-Keynesian, the Broken Window Fallacy-monger, the second-level sophisticate sneering at the common herd. "No, no, you don't understand," he proclaims: "that kid's action is really good for the economy, because the storekeeper will now spend money on the glazier to repair the window, providing employment for the glazier's workers, and stimulating the economy. The common-sense view, as usual, is wrong." But then the economist, the Mises-Hazlitt-Bastiat economist, comes on the scene and rebuts the Broken Window Fallacy-monger. "No, this fool sees only the money that the storekeeper spends on the glazier. But what he does not see is far more important: the money the storekeeper would have spent, had he not suffered loss to his property, either on consumer goods, or on expanding his business. That unseen stimulus is lost. So: the storekeeper is worse off because of the kid's action, and the economy and society suffer." Common-sense is vindicated by the third-level farseeing economist. As in so many areas of political economy, we see an alliance on behalf of truth of the common-sense member of the public with the genuine economist, uniting against the sophistries of the second-level pseudo-intellectual and pseudo-economist.

## Non-Misesian Macroeconomics: Genuine Money or Counterfeiting?

Professor Erich Streissler, in his discussion of the contributions of Menger and his students, stressed correctly that these were largely in microeconomics. But then he added that Menger "bequeathed to his school a peculiar horror of macroconomic concepts." Commenting on Streissler's paper, Professor Robert Hébert properly took Streissler to task, pointing in particular to Ludwig von Mises as the creator of a peculiarly Austrian form of macroeconomics, building macro concepts upon individualist micro foundations. In particular, Mises integrated monetary theory, and the theory of the value of money, into micro marginal utility, as well as supply and demand theory.[58] Hébert

[58]Erich Streissler, "Menger, Böhm-Bawerk, and Wieser: The Origins of the Austrian School," in *Neoclassical Economic Theory, 1870 to 1930*, K. Hennings and W. Samuels, eds. (Boston: Kluwer Academic Publishers, 1990), p. 170; Robert E. Hébert, "Commentary," ibid., pp. 190–200.

might have added that Mises then built upon that monetary theory in forging his masterful theory of the business cycle. In his early years Hayek (or Hayek I), elaborated upon Mises's cycle theory, in work which later won him the Nobel.[59] Surely, there are no fields that would now be considered more "macro" than monetary and business cycle theory.[60] And yet, Hayek II spent very little time in this area, and the Hayekians and Lachmannians none at all. Kirzner spends all of his time on micro and devotes none to the macro area. The same is true of all of the Lachmann followers, who have not so much bothered to refute the Misesian monetary or business cycle theory as they have ceased to refer to or deal with it.

The only Austrians who have dealt with money or business cycle theory, indeed, have been Misesians: among them, in the 1920s and 1930s, Hayek I, Fritz Machlup, Gottfried Haberler, and Lionel Robbins, and, in the years since World War II, Hazlitt, Salerno, Hoppe, Walter Block, and the present writer. The "honor" of macro-economic concepts, in fact, applies only to the various non-Misesians, who have no macro theory of any kind.[61]

There is one unfortunate exception to this rule. In 1976, after Hayek succumbed to *hubris* upon winning the Nobel Prize, he opened the Pandora's Box of money-crankism by offering a bizarre scheme for private competing currencies.[62] The only common point

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[59]In particular, F.A. Hayek, *Monetary Theory and the Trade Cycle* (1933; New York: Augustus M. Kelley, 1966), a translation of a book published in Vienna in 1929; and *Prices and Production* (London: Routledge and Kegan Paul, 1935).

[60]A case could easily be made that Böhm-Bawerk's superb capital-structure theory was "macro" as well as "micro."

[61]In his unpublished comment on my article on "Austrian Definitions of the Supply of Money" at the Windsor Castle Austrian conference in September 1976, indeed, Israel Kirzner took the nihilist line that it was impossible to define the supply of money, since it was an aggregative concept. It is, on the contrary, a happy aggregate of homogeneous units, whether of dollars or gold ounces. Murray N. Rothbard, "Austrian Definitions of the Supply of Money," in *New Directions in Austrian Economics*, Louis Spadaro, ed. (Kansas City: Sheed Andrews and McMeel, 1978), pp. 143–56; included in this volume as chapter 39.

[62]F.A. Hayek, *Denationalization of Money: The Argument Refined* (1976, 3rd ed.; London: Institute of Economic Affairs, 1990).

with his master Mises's view of money was narrowly political: both were opposed to Central Bank control of the money supply. But, apart from that, Hayek violated the rule for valid monetary theory that he himself had adumbrated as Hayek I: that it must, like Mises's theory, be deduced from, and therefore integrated with, a sound general micro theory.[63] Instead, Hayek's doctrine was totally cut off from general economic theory and from Mises's monetary theory as well.

Hayek's scheme of private individuals or banks issuing their own currencies—a scheme which he himself, in more sober moments, would have dismissed as absurdly "constructivist"—was not so much adopted as coming to serve as inspiration or jumping-off point for other money-crank schemes, which have proliferated ever since. They range from private currencies to schemes for private banks freely inflating credit on top of gold currency reserves. As these proposals have multiplied, however, gold has inevitably dropped out or been pushed out of the picture. Later plans range from banks inflating notes or deposits on top of Federal Reserve Notes even after the Fed has been abolished; gold being a mere shadow helping to prop up the system; and finally schemes where banks clear each others' notes indefinitely with no possibility of the poor public's being able to redeem its way out of bank money. Finally, standard or "high powered" money disappears altogether, and inflationary banks merely redeem their notes and deposits in the equally phony notes and deposits of other inflating banks."[64,65]

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[63]Thus, Hayek I wrote: For "Trade cycle theory . . . as for any other theory, there are only two criteria of correctness. Firstly, it must be deduced with unexceptionable logic from the fundamental notions of the theoretical system; and secondly, it must explain by a purely deductive method those phenomena with all their peculiarities which we observe in the actual cycles." F.A. Hayek, *Monetary Theory and the Trade Cycle*, pp. 32–33.

[64]Among the culprits are Lawrence White, George Selgin, Kevin Dowd, David Glasner, F. Capie, Leland Yeager, Robert Greenfield, and Richard Timberlake. Even Milton Friedman has lately defended bimetallism, thereby implicitly repudiating the correct monetarist analysis of that system. For critiques of some of these offerings, see Murray N. Rothbard, "The Myth of Free Banking in Scotland," *Review of Austrian Economics* 2 (1988): 229–45; included in this volume as chapter 46; Rothbard, "The Case for a Genuine Gold Dollar," in *The Gold Standard: Perspectives in the*

Money-crankism is a common phenomenon of the last two centuries and, as every professor of money and banking who has received lengthy and passionate letters written in crayon on the subject can attest, it always involves schemes for radical expansion of the supply of money. The proposed monetary inflation can either be governmental, or, if proposed by the libertarian-inclined, it can be private. Economically, it makes no real difference, except that empowering every private person to print as much money as possible would bring hyper-inflationary disaster even more quickly.

The first grave fallacy and departure from Misesian doctrine, committed by many of these schemes, not least by Hayek's, is to ignore the fundamental Regression Theorem, which Mises built as a logical law upon Carl Menger's historical insight. To function as a *money*, an entity *must* have emerged on the free market out of barter, as a particularly marketable commodity selected on the market as a medium for virtually all exchanges.[66] Nothing can be originally adopted as money by government fiat, or by some sort of social contract; it must originate as a strictly market phenomenon. Nothing can be adopted as a money, as a medium of exchange, unless it had

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*Austrian School*, Llewellyn H. Rockwell, Jr., ed. (1985; Auburn, Ala.: Ludwig von Mises Institute, 1992), pp. 1–17; included in this volume as chapter 41; and Rothbard, "Aurophobia: or, Free Banking on What Standard?," *Review of Austrian Economics* 6, no. 1 (1992): 97–108; included in the volume as chapter 47.

[65]This would be a "libertarian" version of the condition that Professor Paul Cantor, in his stimulating paper, points out: "That is what it meant to have a currency backed by gold—a paper/banknote was redeemable in terms of a real commodity, namely gold, something that had independent value. But in the modern era of fiat money, a banknote just represents another banknote. One dollar bill can merely be exchanged for another dollar bill, but such a transaction has no point anymore, once no real commodity backs the currency. In the modern paper money system, money does not represent anything outside itself; money only represents itself." Paul A. Cantor, "Hyperinflation and Hyperreality: Thomas Mann in Light of Austrian Economics," *Review of Austrian Economics* 7, no. 1 (1994): 3–29. Retired banker John Exter likes to refer to fiat money instruments as "IOU nothings."

[66]For a welcome appreciation of Mises's achievement, see Hébert, "Commentary," pp. 191–95.

a pre-existing purchasing-power as a non-monetary good. Even if Hayek were allowed to issue his proposed private tickets called *ducats* redeemable in nothing but other ducats—which I think he should legally be allowed to do—no one would accept it as money. It would only have a severely limited value as a curiosity, yet another monument to man's folly. All of the new currency plans, private or public, commit the same grave fallacy.

The other group of plans—which build private banking schemes upon existing currencies—at least do not violate the Regression Theorem. Instead, they take one step further than the State has done in recent centuries: build on pre-existing gold money by eventually converting paper tickets once redeemable in gold into fiat standards of their own. Unfortunately, as the Regression Theorem makes clear, once a paper ticket has won market acceptance by piggy-backing on gold as a redeemable ticket, the government can use its coercive powers to keep the paper in play indefinitely as irredeemable fiat money. The second group of pseudo-Austrian plans propose to construct inflationary private banking schemes on top of existing fiat paper, eventually even getting rid of standard paper money altogether.

Apart from the Regression Theorem, both sets of schemes would institute disaster on a large scale. There are two sets of fallacies committed by all of these proposals. Building on the insights of the Ricardians and the Currency School, as well as on continental monetary theory since the Scholastics, Mises demonstrated that, given the existence of money in the economy, every supply of money is optimal. In short, even though the value, or purchasing power, of money is, like all other goods or services, determined by its supply and demand, there is one crucial difference between money and all other goods. All other goods and services, whether consumer or producer goods or resources, help to alleviate natural scarcity; therefore, other things being equal, any increase in these goods is a net social benefit, easing natural scarcity. But that is not true for money, since the only function of money is to facilitate exchange, to furnish a general medium of exchange and hence a unit of economic calculation. But money performs such a function optimally and fully, regardless of the supply available. An increase in the quantity of money cannot alleviate scarcity and cannot provide a social benefit: it could only dilute the purchasing power of each money unit. An increase in supply can only dilute the exchange effectiveness of each dollar or franc or whatever is the monetary unit.

Any scheme for inflating the money supply, whether private or public, can only redistribute income and wealth, cripple or destroy the unit of calculation indispensable to a modern economy, weaken incentives to save, and generally cripple and eventually destroy the economic system.[67] The eventual end is hyperinflation and economic disaster.

The second basic problem is politico-economic. Any free-market economy must necessarily rest on devotion to the sanctity of private property. It is obvious that rampant theft or fraud can only gravely cripple property rights and the free, prosperous economy that emerges from them. For a free society to survive and flourish, property rights must be defended. Most of this defense must occur by incorporation of the supreme value of property rights into the value systems of the broad mass of the public. That can only be accomplished and sustained when the opinion and value molding groups and institutions in society: notably, intellectuals, academics, media, and churches—sustain and promote that value system. When they systematically fail to do so, as we have seen all too clearly in this century, we are all in deep trouble. The frontline of defense against what should generally be a minority of violators of property are the specific institutions of law, police, and courts. Regardless of how these institutions are set up and financed, their defense or protection function is extremely important.

Libertarians, in their zeal for privatizing government functions, tend to forget one vital truth: that *some* functions of government, such as the Internal Revenue Service or providing concentration camps for dissenters, deserve to be abolished rather than privatized. To put it another way: we must not forget that government is not the only organization that can and does commit crimes. Private persons and organizations, and not only governments, can and do commit robbery, assault, kidnapping, and murder. We must not forget that not *every* private action deserves our uncritical blessing. The relevance of this seemingly evident truth is that among the crimes private persons commit are fraud, embezzlement, and many forms of

[67]If money consists of a precious metal, say gold, then while an increase in the supply of gold has no beneficial monetary effect in society, it does confer a benefit by decreasing the scarcity of gold for non-monetary uses, such as jewelry or dentistry.

theft. One of those forms is forgery, or counterfeiting, in which theft is committed by the forger or counterfeiter who corrupts the marketplace by passing off a fake as the real thing.

Counterfeiting of art despoils the buyers and owners of the art, as well as the painter or his estate, and the owners of the genuine article. But counterfeiting of money wreaks more general havoc. In a society where gold is the only form of money, a person can acquire gold in only three ways: (a) selling a good or service in exchange for a part of the existing gold stock; (b) receiving gold as a charitable gift or bequest; and (c) mining new gold out of the ground. All of these are productive ways of obtaining gold, whether it be through exchange, new gold production, or someone receiving a gift or inheritance granted by another person. But counterfeiting, for example, dressing a base metal to look like gold, despoils not only the particular seller but the entire market economy. The counterfeiter, so long as his crime is not detected, is able to extract unearned income and wealth from producers without their knowledge, to exploit the producers for his benefit, and to lower the purchasing power of the gold unit to everyone in society. But at least there is hope, when counterfeiting is illegal, that it will be discovered and rooted out and the culprits apprehended and stopped.

But when government or its creature, the Central Bank, becomes the legalized counterfeiter, the counterfeit is not only fully detected but bailed by public opinion, often guided and molded by the counterfeiters themselves, as wise economic statesmanship. Then, there is no way to guard the guardians, and the counterfeiter is turned loose to prey on society and inflate at will. The result will be a process of continuing and even accelerating monetary and therefore price inflation.

Such is roughly the course of modern monetary history, particularly in the twentieth century—a history of statism and volatile rates of debasement of the currency unit by the legalized counterfeiters. The result is a veritable and increasingly chaotic Age of Inflation. What is desperately needed is to abolish the counterfeiting. That was the proposal stemming from Mises's insight into the inevitably destructive effects of paper money and fractional reserve banking. Instead, what our pseudo-Austrian economists propose to do is not to abolish counterfeiting, but to privatize it—to open up the counterfeiting process to "free" private competition.

One of Mises's favorite quotes on money and banking was from Thomas Tooke: "free trade in banking is tantamount to free trade in swindling." Tooke and Mises, of course, were referring to fractional reserve banking, in which banks pledge to redeem on demand receipts to non-existent money in their vaults. These bank notes or deposits are just as much counterfeit as warehouse receipts to non-existent grain, fake receipts that look like genuine warehouse receipts to grain, which were loaned out by grain elevators until recent decades—until, that is, the practice of fractional-reserve issues of receipts in grain, was outlawed and cracked down on.

The champions of free competition in counterfeiting retort that this is simply the market at work, that the market registers a "demand" for more expanded credit, and that the private bankers, these Kirznerian entrepreneurs, are simply "alert" to such market demands. Well, of course, there is *always* a "demand" for fraud, and embezzlement, on the "market," and there will always be plenty of "alert" swindlers who are eager and willing to furnish a supply of these items. But if we define the "market" not simply as a supply of desired goods and services, but as a supply of such goods *within* a framework of inviolate property rights, then we see a very different picture. To paraphrase William Graham Sumner, when A supplies B with a good or service, that is a genuine and unexceptionable market transaction. A is supplying what B demands. But when A and B put their heads together to swindle C, D, and E, that is a horse of a very different color, and surely not a market transaction in the same voluntary sense.

Following a perceptive suggestion of Dr. David Gordon, let us examine a slightly different kind of fractional reserve banking. Instead of issuing deposits or notes which function like counterfeit warehouse receipts to cash, let us assume that these banks actually print dollar bills made up to look like the genuine article, replete with forged signatures by the Treasurer of the United States. The banks print these bills and lend them out at interest. If they are then criticized for what everyone would concede to be forgery and counterfeiting, why cannot these banks reply as follows: "Well, look, we have genuine, non-counterfeit cash reserves of 10 percent in our vaults. As long as people are willing to trust us, and accept these bills as equivalent to genuine cash, what is wrong with that? We are only engaged in a market transaction, no more no less so than any other

fractional reserve banking." And what indeed is *wrong* about the statement that cannot be applied to any case of fractional reserve banking? If counterfeiting *per se* is deplorable and to be outlawed, then the same standards must be applied to its surrogate, fractional reserve banking, which is currently legal and which would run rampant in the "free-banking" heaven of our non-Misesian pseudo-Austrians. Conversely, these free-bankers must then be willing to accept the legality of every person and every bank issuing outright forgeries or counterfeits and simply printing paper dollar bills, which would not be illegal if some "reserve" or other in genuine bills were actually maintained. And if the free bankers must be willing to accept outright "free" counterfeiting of dollar bills, then they also must be willing to endorse its immediate consequences in wildly runaway inflation.

Monetary policy is evidently a strange field, for it is an area where no one, from the writers of crayoned letters on up to F.A. Hayek, seems to be afraid to engage in flights of Utopian fancy, or what Hayek would ordinarily deride as "constructivism." So I might as well do the same, with the important difference that my proposal lies within the strict bounds of property rights, genuine market commodity money, and Misesian monetary theory.

Ludwig von Mises saw that, once various marketable commodities are chosen on the market to be media of exchange and then to be general media of exchange termed "money," there is an inexorable market tendency for *one* commodity money to win out in each society. In every society where they were available, gold and silver soon became the only commodities that survived as moneys, with the relatively more abundant silver used as coins for smaller transactions and the relatively rare gold coins for larger transactions. In each society and country, gold and silver coins circulated at various units of weight determined by the market; generally, the unit of account, the unit used to calculate business accounts, profits or assets, as well as people's incomes, was the weight of gold or of silver, as denominated in the language of each country. As countries proliferated and discovered each other, the gold and silver coins of the various countries tended to exchange according to their precious metal content, for example, if the U.S. dollar was *defined* as 1/20 of a gold ounce, and the French franc at 1/100 of a gold ounce, then the "exchange rate" of dollars to francs would naturally be at the ratio of their respective

weights: five francs to one dollar. Gold and silver ratios, on the other hand, would tend to be set on the market at the current ratio of the purchasing powers of gold and silver, as determined by the supplies of and demands for the two metals.

Over the centuries, however, governments have interfered with, and crippled, the natural process toward international metallic money. Governments seized the command post of the economy by nationalizing the coin minting function and then facilitated their own debasement of standards of weights of coin by shifting emphasis from the unit of gold or silver weight to *tale*, or the *name* itself. By shifting the monetary unit from, say, the dollar as 1/20 of a gold ounce to the dollar itself, the government could repeatedly debase, or lighten, the gold weights of the currency unit. The English "pound sterling," as its name indicates, used to be worth, indeed used to be defined as, one pound weight of silver; it has now been debased to approximately one half an ounce of silver. Almost as destructive, and facilitating the processes of debasement, was the insistence of most governments on fixing the exchange rate, that is, the price, of silver and gold, that is, instituting "bimetallism." This bimetallic fixed ratio, usually set initially at the ratio determined by world market prices, inevitably departed from it more strongly as time went on. Gresham's Law went into effect and caused sudden shortages of the artificially undervalued metal along with inflows and surpluses of the artificially overvalued one. In a truly free market, government would not fix exchange rates, but would allow countries and societies throughout the market to select media of exchange and units of account: this is what is called "parallel standards" of gold, silver, and possibly other metals, and what has also been called "free metallism."[68]

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[68]On parallel standards, see Mises, *Theory of Money and Credit* (New Haven, Conn.: Yale University Press, 1951), pp. 179ff. On how they worked in medieval and early modern Europe and how bimetallism interfered with them, and provided occasions for debasement, see Luigi Einaudi, "The Theory of Imaginary Money from Charlemagne to the French Revolution," in *Enterprise and Secular Change*, F.C. Lane and J.C. Riemersma, eds. (Homewood, Ill.: Irwin, 1953), pp. 229–61. On "free metallism," see two works by William Brough, *Open Mints and Free Banking* (New York: Putnam, 1898), and *The Natural Law of Money* (New York: Putnam, 1894).

A genuine free market in money, then, would allow the market to select whatever metals it wishes as media of exchange and units of account, without government attempts to fix the exchange rates between them.[69]

But one would expect that the world free market, the mighty network of voluntary exchange that Mises called an oecumene, would, if unrestricted and given its head, move eventually toward one monetary metal.[70] And, whether it be one or two metals, the currency units would eventually transcend the independent or quasi-independent names given by states, to form a world-wide unity of simple units of weight. The entire world, we might expect, as state interference into the market *oecumene* disappears will speak and reckon no longer in "dollars," or "francs," or "marks," but only in gold ounces or gold grams. That sort of world was, indeed, the attainable dream of many of the economists and statesmen of the nineteenth century, the classic century of the gold standard. In a series of

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[69]Comparing the return to gold coin in Europe after half a millennium in the mid-thirteenth century, in Florence and in Genoa, Professor Lopez, a proud Genoese, writes:

> Florence, like most medieval states, made bimetallism and trimetallism [copper] a base of its monetary policy. . . . Genoa, on the contrary, in conformity with the principle of restricting state intervention as much as possible, did not try to enforce a fixed relation between coins of different metals . . . basically, the gold coinage of Genoa was not meant to integrate the silver and bullion coinages but to form an independent system. (Robert Sabatino Lopez, "Back to Gold, 1252," *Economic History Review* [April 1956]: 224.

[70]On Mises and the oecumene, Joseph T. Salerno, "Ludwig von Mises as Social Rationalist," pp. 26–54, esp. 27–36. Salerno writes of the Misesian oecumene,

> As the final and full fruition of social evolution driven by the cosmic ontological principle of division of labor, the "oecumene" embraces all of humanity cooperating in hyperspecialized production processes. At any point in history, the evolving oecumene is the "rational and intended" outcome of an intersubjective process, whose purpose is the amelioration of scarcity. It exists not as a thing unto itself, but as a complex of social relations which emerges from a common orientation of individual

international monetary conferences, which contrasted to twentieth-century ones by not seeking more global government monetary control but greater expression of a unified free market, there were attempts to reach this goal. The idea was first to adjust existing exchange rates slightly to make them multiples of one another, facilitating a phasing out of names and a growing use of explicit units of gold weight in every country. Unfortunately, the vexed silver problem obstructed any agreement, until of course World War I swept away any search for a genuine international metallic money.[71]

Since World War I, unfortunately, the quest for inter-central bank cooperation, for international monetary coordination, has been a search for a form of monetary internationalism diametrically opposed to the thrust of the nineteenth century. Instead of a search for a world money uncontrolled and unhampered by any State, we see repeated attempts to achieve a form of world governmental coordinated paper inflation. The ultimate Keynesian dream is moving ever closer: to establish a world economic government with a World Reserve Bank issuing a new world paper currency to be called the *bancor* after Keynes, the *unita* after Harry Dexter White, the *phoenix* after the London *Economist*, or whatever. Then, all nations of the world believe they could inflate together, keeping exchange rates fixed and also avoiding the kind of monetary reserve crisis that laid low the phony British-run "gold" standard of the late 1920s, as well as the phony "gold"-tainted Bretton Woods system after World War II. Then, there will be nothing to stop the smooth run of worldwide inflation—until, of course, the market takes the play away from the depreciating world paper currency and the world goes through the fearful holocaust of a worldwide runaway inflation.

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> human actions, that is, to use the social division of labor as the means to attain individual goals. Because such relations thus emanate from the will, they must be daily affirmed and recreated in human thought and action. (Ibid., p. 31)

[71]See the detailed account in the much neglected work, Henry B. Russell, *International Monetary Conferences* (New York: Harper, 1898). Also see Frederick A.P. Barnard, *The Metric System of Weights and Measures* (New York: Columbia College, 1872), who treats the problem of international unification of monetary units in an appendix as a subset of the problem of unifying all metric measures.

But let us return from this grisly scenario to my projected and hoped-for worldwide free market, the interconnected and prospering *oecumene*. We can project what will happen to this market if it is allowed to evolve without government distortion or interference. We can project, then, a future worldwide free economy, using only metallic money, with the entire world using one unit of weight of gold as money, both as a medium of exchange and as a unit of account. All reckoning will take place in terms of gold ounces or grams, which cannot constitute the world stock of money. It is possible that silver will continue to be a metallic money for smaller denomination transactions, but we can imagine that the market's quest for efficiency will eventually lead to one metallic money. Money will then be fully private, with no government intrusion, for the gold will both be mined and minted by private firms. (There is no reason to assume that only government is qualified to mint coins. In fact, considering its record of continuing debasement, government is scarcely qualified to mint coins at all.)

A "free market" also means no government interference whatever in the economy. It means that private individuals and firms are free to earn money and profits, and that they are also free to lose. There can be no genuine freedom to choose without a corollary freedom to lose. No firm may be considered "too big to fail." And so a free market in money necessarily means the abolition of central banking and of so-called deposit "insurance." Banks must be free to fail.

Indeed, a "free market" necessarily implies total respect for and protection of private property. But this means that rights of private property must always be preserved. This implies not only a cracking down on assault and murder, but also on all forms of theft and fraud, including counterfeiting. Counterfeiting must be prosecuted fully by the law and, more than that, must be scorned and condemned by public opinion. As an advocate of 100 percent reserve banking, of full gold backing for all bank notes and deposits, I recognize that it would be difficult for government to police the banks, banks being notably ingenious in discovering market ways of getting around government regulations. One hundred percent banking must be enforced, not by administrative regulations, but by the legal system. While investigative snoops can hunt down counterfeit warehouse-receipts, it would be far simpler and more effective to crack down immediately and totally on any failure of a bank to pay in full on demand. First, as the Jacksonians wanted, but were never able to get through the Whig-dominated Congress in the late 1830s, at the first

sign of such non-payment, the bank must be declared insolvent and its assets liquidated. But, second, these fractional-reserve bankers must be treated not as mere entrepreneurs who made unfortunate business decisions but as counterfeiters and embezzlers who should be cracked down on by the full majesty of the law. Forced repayment to all the victims plus substantial jail terms should serve as a deterrent as well as to mete out punishment for this criminal activity.

I envision the free-market world of the future, then, as one of purely metallic worldwide money. Increases of bank money will not be tolerated and will be treated as the counterfeiting and the invasion of property rights that they really are. The money supply, then, will grow only slowly, concomitant with the slow growth in the stock of the world's gold. The scourge of inflation will finally be lifted from the world; prices will fall, and the more productive the economy, and the more the increase in the supply of goods, the more prices will fall, the cost of living will decline, and the greater will be the increase in the standard of living for everyone. And without fractional reserve banking, there will be no more booms and busts, no more terrible malinvestments, distortions, and shocks of euphoria and distress brought about by business cycles. Investment will be limited to voluntary savings, and therefore there will be no periodic outbreaks of unsound investments that will have to be liquidated by recession. The world *oecumene* will at last be secured by the money required for freedom: a metallic money, produced by the market and the value of which is decided totally by the market and not at all by government.

Consumers and the economy will be immeasurably freer and sounder, and the only ones who will lose from the development of this market *oecumene* are the special interest groups who benefit from government and bank-controlled inflation and who constitute the ruling power elites in our increasingly state-dominated economy.

## Epilogue: The Modern Austrian Revival

Professor Karen Vaughn's brief history of the modern Austrian "revival" as a participant-observer is, first of all, a strictly biased account from the Hayekian/Lachmannian point of view. The Vaughn treatment is yet another variant of the Whig theory of the history of thought, this time from a Lachmannian perspective. Being Whiggish, Vaughn's history has to be fitted into the Procrustean mold of early fumblings, improvement, and, at each step of the way,

onward and upward into the light, it begins then, in post-World War II America, with Mises as the admitted carrier of the Austrian tradition; to be improved upon and superseded by Hayek; and then finally, to be crowned by the upward march of nihilist Lachmannia, creative gropings by O'Driscoll and Rizzo, and finally even Lachmann's "narrow" destructionism surpassed by glimpses of a grand and noble new theory, emphasizing "biological evolution," and culminating in the work of several young graduate students of Professor Don Lavoie. In particular, the two works cited by Vaughn as blazing the path toward a grand new Austrian paradigm consist of two articles published in Lavoie's minor and now defunct journal, *Market Process*.

Professor Vaughn leaves out some significant facts from her starry-eyed account. One is that she herself was on the board of Lavoie's Center for the Study of the Market Process, and that she therefore was engaging in a certain amount of special pleading.

In any case: how did our Whiggish neo-Austrian fare in her attempt to capture the historical process, her form of institutionalist Austrianism? In short, how well did she predict the near-term Austrian future? The answer is: not very well. Professor Vaughn's article was written for a conference on the Austrian tradition in economics held in the spring of 1989. In the less than four years that have elapsed since then, the entire Austrian world has changed dramatically. Well, it is a fast-moving world out there, if not quite the "kaleidic" one perceived by Ludwig Lachmann. Since her article was written, the Lachmannian Society for Interpretive Economics, founded by Professor Lavoie, has come and gone, the journal *Market Process* has disappeared, and the Center for the Study of the Market Process has virtually left economics. My own prediction, I dare say better founded than Professor Vaughn's, is that, with the passing away of Professor Lachmann, and more particularly, the loss of interest in economics by its funding source, Lachmannia and the Lavoiean variants will quickly disappear from the scene. Not being a Whig historian, this development does not unsettle me in the least.[72]

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[72]In her latest discussion of Austrian economics, Vaughn, while quietly and necessarily abandoning the Lavoiean project and dropping all references to it, is still searching for some mixture of "evolution" and institutionalism as the way out for Austrian economics. Karen I. Vaughn, "The Problem of Order in Austrian Economics: Kirzner vs. Lachmann," *Review of Political Economy* 4, no. 3 (1992): 251–74.

Let us return to Professor Vaughn's history of the Austrian revival. In order to praise the later developments, she is forced to disparage the earlier ones, particularly the noble struggle of Ludwig von Mises and even more those of us who have continued in the older and therefore allegedly discredited Misesian paths. Part of her form of Whig mythology is that Hayek must be painted as far superior to Mises. So we have Mises grudgingly hailed as single-handedly preserving the Austrian School in the United States in the 1940s, 50s, and 60s. She disparages Mises as an outsider to academia, as not being able to secure an official teaching position because of his "outspoken antistatist views," and because of his unfortunate "emphatic style." She is forced to admit that while Hayek, whom she claims to be "ultimately . . . more important in shaping the Austrian revival," actually emigrated to the United States in the 1940s, and while Hayek taught at the same time at the University of Chicago, it was unaccountably "his older colleague Mises who was responsible for bringing Austrian economics to America."[73]

What she fails to mention, since it would correct her deprecation of Mises, is that Hayek too, despite his definitely *un*emphatic style, could not find an official academic post in the United States, and that *his* salary, too, was financed by the William Volker Fund, the same organization that financed Mises's professorial post because it "knew of [Mises's] lifelong antistatist fight." The Volker Fund financed Hayek's professorial position for the same reason.

Moreover, the reason why Hayek did not help spark an Austrian revival in the United States, despite his years of teaching at Chicago, is that Hayek was not the sort of teacher to ignite or inspire student interest. Hayek was barred from teaching economics at the University of Chicago by the economics department, and so he had to teach at the Committee on Social Thought, a charmingly interdisciplinary graduate department, but whose PhDs, being outside orthodox department lines, were not exactly designed for scholarly careerism. But more important than that: Hayek did not have the personality as a teacher to inspire students or disciples. Unlike Mises, who was unfailingly charming and devoted to spurring productivity among his

[73]Vaughn, "Mengerian Roots," p. 396.

students, Hayek was cool and aloof, only answering specific questions put to him by his doctoral students, and never engaging them in conversation or discussion. Hence, Hayek did not help spark an Austrian revival. Also, as Vaughn briefly admits, Hayek had not yet come up with his "evolutionary" and other philosophic studies. His first alleged masterwork, *The Constitution of Liberty*, published in 1960, was political philosophy rather than economics, and it was a political philosophy that properly carried no weight, being generally demolished by such Austrian critics as his student Ronald Hamowy.

Finally, Hayek retired from the University of Chicago in 1961, and since Chicago refused to pay him a pension since it had never paid him a salary, Hayek was forced to leave the United States and go to Germany, where be was able to draw a salary at the University of Freiburg. From 1961 on, Hayek no longer resided in the United States, and this important fact, curiously omitted from Vaughn's account, played an important role in Hayek's not being central to the Austrian revival which Vaughn dates from the South Royalton Conference in 1974.[74] As Vaughn points out, Hayek's coincidental receiving of the Nobel prize later in the fall of 1974 clearly ignited a general and continuing interest in and study of Hayek and the entire Austrian tradition.

Historical accuracy compels me to take up Professor Vaughn's comparative treatment of Professor Kirzner and myself, undoubtedly the two most productive American students of Mises, both of whom had published important Austrian works before the South Royalton year of 1974. I, she says, was "Mises's faithful interpreter to the radical libertarian fringe . . . young people, many of them free-market radicals who had discovered the work of Mises and who had listened to the Austrian folklore at Murray Rothbard's knee."[75] So here I am, in Professor Vaughn's account, a preacher of Misesian folklore to youthful free-market libertarians. In the meanwhile, while I was dispensing Misesian folklore to bedazzled youth, what was Professor

[74]Vaughn attributes the alleged neglect of Hayek at the South Royalton conference to the fact that I "did not think much of Hayek's politics or economics." Very true, except that I had no control over the papers of the two other major participants: Israel Kirzner and Ludwig M. Lachmann. Vaughn, "Mengerian Roots," p. 402*n*.

[75]Ibid., p. 399.

Kirzner doing? He, "against overwhelming odds, attempted to carry on Mises's work in the context of the mainstream academic community."[76]

There are two fundamental flaws with Vaughn's historical account, convenient though it may be for her own Whiggish folklore of Up from Mises to Lachmann and Lavoie. One is, that I too, was an academic. At the time of South Royalton, I was a professor of economics at the Polytechnic Institute of Brooklyn; perhaps, bedazzled youth that she may have been at the time, she did not realize that I was not a full-time folklorist. The second deals with Professor Kirzner's role. While Kirzner is a distinguished scholar and contributor to the Austrian tradition, even though he too has strayed from Mises in later years, he was scarcely, at that point, a heroic struggler for Austrianism against its academic enemies. In fact, Israel Kirzner kept a very low Austrian profile at New York University. I myself became friendly with someone who had received a PhD under Kirzner in the late 1960s, and he had no idea whatever what Austrian economics was or that his doctoral mentor was connected with it.

Vaughn mentions that the Institute for Humane Studies sponsored the week-long scholarly Austrian conference at South Royalton, as well as two others in the next two years, one at the University of Hartford, which she does not name, and one at Windsor Castle, England; important volumes of papers emerged from both the South Royalton and Windsor Castle conferences.

But then Vaughn does not raise the question: what in the world happened to these annual high-level scholarly conferences, that did so much to advance the Austrian School's discipline and interest in Austrian economics? What happened is that these conferences disappeared, since the major funding source, whom I refer to as The Donor, shifted his focus of interest. The shift was away from Misesian radicalism and consistency, both in Austrian economics, notably praxeology, and in political economy, in the form of consistent *laissez-faire*. By the late 1970s, The Donor decided that what Vaughn refers to as Mises's "outspoken antistatist views" and "emphatic style" were too candid and uncompromising to be palatable to the Powers That Be or respectable to other funding sources, the federal

[76]Ibid.

government, or the leaders of academia. For all of these reasons, The Donor, followed by the eager recipients of his largess, decided to set up moderate think tanks for public policy and to dilute Austrian economics to become respectable and non-threatening to academia. In academia, he thereby encouraged various outreaches: to Marxists, to hermeneuticians and deconstructionists, indeed to anyone and everyone put off by Ludwig von Mises's intransigent devotion to truth and to liberty. Hence, no more scholarly Austrian conferences, but only fellowships and programs promoting non- or anti-Misesian views in the name of Austrian economics.

If Professor Vaughn were *really* interested in chronicling a battle for Austrian truth "against overwhelming odds," she would ponder the tremendous achievement of Llewellyn H. Rockwell, Jr., in founding the Ludwig von Mises Institute ten years ago. For Lew Rockwell founded the Institute with no endowment, no pledges, no Big Daddy. All he had was the gleam of a lifelong idea: to found an institute dedicated to Ludwig von Mises and promoting the Misesian paradigm in Austrian economics. In fact, Big Daddy, the aforesaid Donor, was furious at Rockwell's plan to found the Mises Institute, and had the unmitigated gall to "order" him not to do so. When Lew went ahead despite this order, The Donor engineered a determined boycott, both of the Institute, and of the later establishment of the only scholarly Austrian journal, *The Review of Austrian Economics*.

There is good news to report at this Tenth Anniversary Conference of the Mises Institute. In the first place, this scholarly conference in Austrian economics continues the Windsor Castle tradition; let us hope it is the first of many. And second, The Donor has lost interest in Austrian economics and in ideology. The Mises Institute's stunningly successful summer conference, its "Mises University," is just about the only instructional summer conference remaining in Austrian economics. And as we have developed more and more outstanding Misesians, the Misesian paradigm has not only revived as a result of the Mises Institute's success: it is now virtually the only paradigm left in the field. Instead of the Whiggish history of a straight line onward and upward from Mises to the students of Lavoie, what we have is a three phase history, a zig-zag history of clashing paradigms and ideologies. The first phase was The Revival, beginning in the summer and fall of 1974 with the South Royalton Austrian conference and the award to Hayek of the Nobel Prize; but this expansion phase ended sometime in the late 1970s, after Windsor Castle,

and was succeeded by Phase II, a decline and degeneration of Austrian economics away from the Misesian paradigm and into various fallacious variants and deviations. But then, as the Mises Institute got under way in the 1980s, Phase III, the Renaissance, developed, culminating in the recent successes of the Mises Institute, the pull-out from the field by The Donor, and the subsequent triumphal restoration of the Misesian paradigm. The difference from the late 1970s is that the Misesian paradigm is now established on a higher level than two decades ago; not only are there far more younger Misesians, and bound to be still more in the years ahead; not only are the "middle generation" of renegade anti-Misesians fading away, but of course Misesians have learned more in these two decades, ever honing and sharpening our Misesian knowledge in the course of waging struggles against these deviations and fallacies.

And so the truly good news of this Tenth Anniversary Conference of the Mises Institute is that I stand here, and the conference itself bears witness, to proclaim victory, to announce, at long last, the triumph of the Misesian paradigm in the Austrian home that Mises himself created. The great Ludwig von Mises could ask for no greater tribute.

# 11

# Ludwig von Mises and the Paradigm for Our Age

Unquestioningly the most significant and challenging development in the historiography of science in the last decade is the theory of Thomas S. Kuhn. Without defending Kuhn's questionable subjectivist and relativistic philosophy, his contribution is a brilliant sociological insight into the ways in which scientific theories change and develop.[1] Essentially, Kuhn's theory is a critical challenge to what might be called the "Whig theory of the history of science." This "Whig" theory, which until Kuhn was the unchallenged orthodoxy in the field, sees the progress of science as a gradual, continuous, ever-upward process; year by year, decade by decade, century by century, the body of scientific knowledge gradually grows and accretes through the process of framing hypotheses, testing them empirically, and discarding the invalid and keeping the valid theories. Every age stands on the shoulders of and sees further and more clearly than every preceding age. In the Whig approach, furthermore, there is no substantive knowledge to be gained from reading, say, nineteenth-century physicists or seventeenth-century astronomers; we may be interested in reading Priestley or Newton or Maxwell to see how creative minds work or solve problems, or for insight into the history of the period; but we can never read them to learn something about science which we didn't know already. After all, their contributions are, almost by definition, incorporated into the latest textbooks or treatises in their disciplines.

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[1]Philosophically, Kuhn tends to deny the existence of objective truth and therefore denies the possibility of genuine scientific progress. Thomas S. Kuhn, *The Structure of Scientific Revolutions*, 2nd ed. (Chicago: University of Chicago Press, 1970).

Many of us, in our daily experience, know enough to be unhappy with this idealized version of the development of science. Without endorsing the validity of Immanuel Velikovsky's theory, for example, we have seen Velikovsky brusquely and angrily dismissed by the scientific community without waiting for the patient testing of the open-minded scientist that we have been led to believe is the essence of scientific inquiry.[2] And we have seen Rachel Carson's critique of pesticides generally scorned by scientists only to be adopted a decade later.

But it took Professor Kuhn to provide a comprehensive model of the adoption and maintenance of scientific belief. Basically, he states that scientists, in any given area, come to adopt a fundamental vision or matrix of an explanatory theory, a vision that Kuhn calls a "paradigm." And whatever the paradigm, whether it be the atomic theory or the phlogiston theory, once adopted the paradigm governs all the scientists in the field without being any longer checked or questioned—as the Whig model would have it. The fundamental paradigm, once established, is no longer tested or questioned, and all further research soon becomes minor applications of the paradigm, minor clearing up of loopholes or anomalies that still remain in the basic vision. For years, decades or longer, scientific research becomes narrow, specialized, always within the basic paradigmatic framework.

But then, gradually, more and more anomalies pile up; puzzles can no longer be solved by the paradigm. But the scientists do not give up the paradigm; quite the contrary, increasingly desperate attempts are made to modify the particulars of the basic theory so as to fit the unpleasant facts and to preserve the framework provided by the paradigm. Only when anomalies pile up to such an extent that the paradigm itself is brought into question do we have a "crisis situation" in science. And even here, the paradigm is never simply discarded until it can be replaced by a new, competing paradigm which appears to close the loopholes and liquidate the anomalies. When this occurs, there arrives a "scientific revolution," a chaotic period

[2]On the sociology of the reception of Velikovsky in the scientific community, see Alfred de Grazia, "The Scientific Reception Systems," in *The Velikovsky Affair*, Alfred de Grazia, ed. (New Hyde Park, N.Y.: University Books, 1966), pp. 171–231.

during which one paradigm is replaced by another, and which never occurs smoothly as the Whig theory would suggest. And even here, the older scientists, mired in their intellectual vested interests, will often cling to the obsolete paradigm, with the new theory only being adopted by the younger and more flexible scientists. Thus, of the co-discoverers of oxygen in the late eighteenth century, Priestley and Lavoisier, Joseph Priestley never, till the day he died, conceded that he had in fact discovered oxygen; to the end he insisted that what he had discovered was merely "dephlogisticated air," thus remaining within the framework of the phlogiston theory.[3]

And so, armed with Kuhn's own paradigm of the history of scientific theories, which is now in the process of replacing the Whig framework, we see a very different picture of the process of science. Instead of a slow and gradual upward march into the light, testing and revising at each step of the way, we see a series of "revolutionary" leaps, as paradigms displace each other only after much time, travail, and resistance. Furthermore, without adopting Kuhn's own philosophical relativism, it becomes clear that, since intellectual vested interests play a more dominant role than continual open-minded testing, it may well happen that a successor paradigm is less correct than a predecessor. And if that is true, then we must always be open to the possibility that, indeed, we often know less about a given science now than we did decades or even centuries ago. Because paradigms become discarded and are never looked at again, the world may have forgotten scientific truth that was once known, as well as added to its stock of knowledge. Reading older scientists now opens up the distinct possibility that we may learn something that we haven't known—or have collectively forgotten—about the discipline. Professor de Grazia states that "much more is discovered and forgotten than is known," and much that has been forgotten may be more correct than theories that are now accepted as true.[4]

If the Kuhn thesis is correct about the physical sciences, where we can obtain empirical and laboratory tests of hypotheses fairly easily, how much more must it be true in philosophy and the social sciences, where no such laboratory tests are possible! For in the disciplines

[3]Kuhn, *The Structure of Scientific Revolutions*, pp. 53–56.

[4]De Grazia, "The Scientific Reception Systems," p. 197.

relating to human action, there are no clear and evident laboratory tests available; the truths must be arrived at by the processes of introspection, "common sense" knowledge, and deductive reasoning, and such processes, while arriving at solid truths, are not as starkly or compellingly evident as in the physical sciences. Hence, it is all the more easy for philosophers or social scientists to fall into tragically wrong and fallacious paradigms and thus to lead themselves down the garden path for decades, and even centuries. For once the sciences of human action adopt their fundamental paradigms, it becomes much easier than in the physical sciences to ignore the existence of anomalies, and therefore easier to retain erroneous doctrines for a very long time. There is a further well-known difficulty in philosophy and the social sciences which makes systematic error still more likely: the infusion of emotions, value judgments, and political ideologies into the scientific process. The angry treatment accorded to Jensen, Shockley, and the theorists of inequalities of racial intelligence by their fellow scientists, for example, is a case in point. For underlying the bulk of the scientific reception of Jensen and Shockley is that even if their theories are true, they should not say so, at least for a century, because of the unfortunate political consequences that may be involved. While this sort of stultifying of the quest for scientific truth has happened at times in the physical sciences, it is fortunately far less prevalent there; and whatever the intellectual vested interests at stake, there was at least no ideological and political buttressing for the phlogiston theory or the valence theory in chemistry.

Until recent decades, philosophers and social scientists harbored a healthy recognition of vast differences between their disciplines and the natural sciences; in particular, the classics of philosophy, political theory, and economics were read not just for antiquarian interest but for the truths that might lie there. The student of philosophy read Aristotle, Aquinas, or Kant not as an antiquarian game but to learn about answers to philosophical questions. The student of political theory read Aristotle and Machiavelli in the same light. It was not assumed that, as in the physical sciences, all the contributions of past thinkers have been successfully incorporated into the latest edition of the currently popular textbook; and it was therefore not assumed that it was far more important to read the latest journal article in the field than to read the classical philosophers.

In recent decades, however, the disciplines of human action—philosophy and the social sciences—have been frantically attempting to ape the methodology of the physical sciences. There have been many grave flaws in this approach which have increasingly divorced the social sciences from reality: the vain substituting of statistics for laboratory experimentation, the adoption of the positivistic hypothesis-testing model, the unfortunate conquest of all of the disciplines—even history, to some extent—by mathematics, are cases in point. But here the important point is that in the aping of the physical sciences, the social disciplines have become narrow specialties; as in the physical sciences, no one reads the classics in the field or indeed is familiar with the history of the discipline further back than this year's journal articles. No one writes systematic treatises anymore; systematic presentations are left for jejune textbooks, while the "real" scholars in the field spend their energy on technical minutiae for the professional journals.

We have seen that even the physical sciences have their problems from uncritical perpetuation of fundamental assumptions and paradigms; but in the social sciences and philosophy this aping of the methods of physical science has been disastrous. For while the social sciences were slow to change their fundamental assumptions in the past, they were eventually able to do so by pure reasoning and criticism of the basic paradigm. It took, for example, a long time for "marginal utility" economics to replace classical economics in the late nineteenth century, but it was finally done through such fundamental reasoning and questioning. But no systematic treatise—with one exception to be discussed below—has been written in economics, not a single one, since World War I. And if there are to be no systematic treatises, there can be no questioning of the fundamental assumptions; deprived of the laboratory testing that furnishes the ultimate checks on the theories of physical science and now also deprived of the systematic use of reason to challenge fundamental assumptions, it is almost impossible to see how contemporary philosophy and social science can ever change the fundamental paradigms in which they have been gripped for most of this century. Even if one were in total agreement with the fundamental drift of the social sciences in this century, the absence of fundamental questioning—the reduction of every discipline to narrow niggling in the journals—would be cause for grave doubts about the soundness of the social sciences.

But if one believes, as the present author does, that the fundamental paradigms of modern, twentieth-century philosophy and the social sciences have been grievously flawed and fallacious from the very beginning, including the aping of the physical sciences, then one is justified in a call for a radical and fundamental reconstruction of all these disciplines, and the opening up of the current specialized bureaucracies in the social sciences to a total critique of their assumptions and procedures.

Of all the social sciences, economics has suffered the most from this degenerative process. For economics is erroneously considered the most "scientific" of the disciplines. Philosophers still read Plato or Kant for insights into truth; political theorists still read Aristotle and Machiavelli for the same reason. But no economist reads Adam Smith or James Mill for the same purpose any longer. History of economic thought, once required in most graduate departments, is now a rapidly dying discipline, reserved for antiquarians alone. Graduate students are locked into the most recent journal articles, the reading of economists published before the 1960s is considered a dilettantish waste of time, and any challenging of fundamental assumptions behind current theories is severely discouraged. If there is any mention of older economists at all, it is only in a few perfunctory brush strokes to limn the precursors of the current Great Men in the field. The result is not only that economics is locked into a tragically wrong path, but also that the truths furnished by the great economists of the past have been collectively forgotten by the profession, lost in a form of Orwellian "memory hole."

Of all the tragedies wrought by this collective amnesia in economics, the greatest loss to the world is the eclipse of the "Austrian School." Founded in the 1870s and 1880s, and still barely alive, the Austrian School has had to suffer far more neglect than the other schools of economics for a variety of powerful reasons. First, of course, it was founded a century ago, which, in the current scientific age, is in itself suspicious. Second, the Austrian School has from the beginning been self-consciously philosophic rather than "scientistic"; far more concerned with methodology and epistemology than other modern economists, the Austrians arrived early at a principled opposition to the use of mathematics or of statistical "testing" in economic theory. By doing so, they set themselves in opposition to all the positivistic, natural-science-imitating trends of this century. It

meant, furthermore, that Austrians continued to write fundamental treatises while other economists were setting their sights on narrow, mathematically oriented articles. And third, by stressing the individual and his choices, both methodologically and politically, Austrians were setting themselves against the holism and statism of this century as well.

These three radical divergences from current trends were enough to propel the Austrians into undeserved oblivion. But there was another important factor, which at first might seem banal: the language barrier. It is notorious in the scholarly world that, "language tests" to the contrary notwithstanding, no American or English economists can really read a foreign language. Hence, the acceptance of foreign-based economics must depend on the vagaries of translation. Of the great founders of the Austrian School, Carl Menger's work of the 1870s and 1880s remained untranslated into English until the 1950s; Menger's student Eugen von Böhm-Bawerk fared much better, but even his completed work was not translated until the late 1950s. Böhm-Bawerk's great student, Ludwig von Mises, the founder and head of the "neo-Austrian" School, has fared almost as badly as Menger. His classic *Theory of Money and Credit*, published in 1912, which applied Austrian economics to the problems of money and banking, and which contained the seeds of a radically new (and still largely unknown) theory of business cycles, was highly influential on the Continent of Europe, but remained untranslated until 1934. By that time Mises's work was to be quickly buried in England and the United States by the fervor of the "Keynesian Revolution," which was at opposite poles from Mises's theory. Mises's book of 1928, *Geldwerstabilisierung und Konjunkturpolitik*, which predicted the Great Depression on the basis of his developed business cycle theory, remains untranslated to this day. Mises's monumental systematic treatise, *Nationalökonomie*, integrating economic theory on the grounds of a sound basic epistemology, was overlooked also from its being published in 1940, in the midst of war-torn Europe. Again its English translation as *Human Action* (1949) came at a time when economics had set its methodological and political face in a radically different direction, and therefore Mises's work, as in the case of other challenges to fundamental paradigms in science, was not refuted or criticized but simply ignored.

Thus, while Ludwig von Mises was acknowledged as one of Europe's most eminent economists in the 1920s and 30s, the language barrier shut off any recognition of Mises in the Anglo-American world until the mid-1930s; then, just as his business cycle theory was beginning to achieve renown as an explanation for the Great Depression, Mises's overdue recognition was lost in the hoopla of the Keynesian Revolution. A refugee deprived of his academic or social base in Europe, Mises emigrated to the United States at the mercy of his new-found environment. But while, in the climate of the day, the leftist and socialist refugees from Europe were cultivated, feted, and given prestigious academic posts, a different fate was meted out to a man who embodied a methodological and political individualism that was anathema to American academia. Indeed, the fact that a man of Mises's eminence was not offered a single regular academic post and that he was never able to teach in a prestigious graduate department in this country is one of the most shameful blots on the none too illustrious history of American higher education. The fact that Mises himself was able to preserve his great energy, his remarkable productivity, and his unfailing gentleness and good humor in the face of this shabby treatment is simply one more tribute to the qualities of this remarkable man whom we now honor on his ninetieth birthday.

Agreed then that Ludwig von Mises's writings are the embodiment of a courageous and eminent man hewing to his discipline and to his vision, unheeding of shabby maltreatment. Apart from this, what substantive truths do they have to offer an American in 1971? Do they present truths not found elsewhere and therefore do they offer intrinsic interest beyond the historical record of a fascinating personal struggle? The answer—which obviously cannot be documented in the compass of this article—is simply and startlingly this: that Ludwig von Mises offers to us nothing less than the complete and developed correct paradigm of a science that has gone tragically astray over the last half-century. Mises's work presents us with the correct and radically divergent alternative to the flaws, errors, and fallacies which a growing number of students are sensing in present-day economic orthodoxy. Many students feel that there is something very wrong with contemporary economics, and often their criticisms are trenchant, but they are ignorant of any theoretical alternative. And, as Thomas Kuhn has shown, a paradigm, however faulty, will

not be discarded until it can be replaced by a competing theory. Or, in the vernacular, "you can't beat something with nothing," and "nothing" is all that many present-day critics of economic science can offer. But the work of Ludwig von Mises furnishes that "something"; it furnishes an economics grounded not on the aping of physical science, but on the very nature of man and of individual choice. And it furnishes that economics in a systematic, integrated form that is admirably equipped to serve as a correct paradigmatic alternative to the veritable crisis situation—in theory and public policy—that modern economics has been bringing down upon us. It is not exaggeration to say that Ludwig von Mises is the Way Out of the methodological and political dilemmas that have been piling up in the modern world. But what is needed now is a host of "Austrians" who can spread the word of the existence of this neglected path.

Briefly, Mises's economic system—as set forth particularly in his *Human Action*—grounds economics squarely upon the axiom of action: on an analysis of the primordial truth that individual men exist and act, that is, make purposive choices among alternatives. Upon this simple and evident axiom of action, Ludwig von Mises deduces the entire systematic edifice of economic theory, an edifice that is as true as the basic axiom and the fundamental laws of logic. The entire theory is the working out of methodological individualism in economics, the nature and consequences of the choices and exchanges of individuals. Mises's uncompromising devotion to the free market, his opposition to every form of statism, stems from his analysis of the nature and consequences of individuals acting freely on the one hand, as against governmental coercive interference or planning on the other. For, basing himself on the action axiom, Mises is able to show the happy consequences of freedom and the free market in social efficiency, prosperity, and development, as against the disastrous consequences of government intervention in poverty, war, social chaos, and retrogression. This political consequence alone, of course, makes the methodology as well as the conclusions of Misesian economics anathema to modern social science.

As Mises puts it:

> Princes and democratic majorities are drunk with power They must reluctantly admit that they are subject to the laws of nature. But they reject the very notion of economic law. Are they not the supreme legislators? . . . In fact, economic history is a long record

of government policies that failed because they were designed with a bold disregard for the laws of economics.

It is impossible to understand the history of economic thought if one does not pay attention to the fact that economics as such is a challenge to the conceit of those in power. An economist can never be a favorite of autocrats and demagogues. With them he is always the mischief-maker. . . .

In the face of all this frenzied agitation, it is expedient to establish the fact that the starting point of all praxeological and economic reasoning, the category of human action, is proof against any criticisms and objections.... From the unshakable foundation of the category of human action praxeology and economists proceed step by step by means of discursive reasoning. Precisely defining assumptions and conditions, they construct a system of concepts and draw all the inferences implied by logically unassailable ratiocination.[5]

And again:

The laws of the universe about which physics, biology, and praxeology [essentially economics] provide knowledge are independent of the human will, they are primary ontological facts rigidly restricting man's power to act. . . .

Only the insane venture to disregard physical and biological laws. But it is quite common to disdain economic laws. Rulers do not like to admit that their power is restricted by any laws other than those of physics and biology. They never ascribe their failures and frustrations to the violation of economic law.[6]

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[5]Ludwig von Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1949), p. 67.

[6]Ibid., pp. 755–56. As Mises indicates, the revolt against economics as the harbinger of a free market economy is as old as the classical economists whom Mises acknowledges as his forebears. It is no accident, for example, that George Fitzhugh, the foremost Southern apologist for slavery and one of America's first sociologists, brusquely attacked classical economics as "the science of free society," while upholding socialism as "the science of slavery." See George Fitzhugh, *Cannibals All!*, C. Vann Woodward, ed. (Cambridge, Mass.: Harvard University Press, 1960), p. xviii; and Joseph Dorfman, *The Economic Mind in American Civilization* (New York: Viking Press, 1964), vol. 2, p. 929. On the statist and anti-individualist bias embedded deep in the foundations of sociology, see Leon Bramson, *The Political Context of Sociology* (Princeton, N.J.: Princeton University Press, 1961), esp. pp. 11–17.

A notable feature of Mises's analysis of "interventionism"—of government intervention in the economy—is that it is fundamentally what could now be called "ecological"; for it shows that an act of intervention generates unintended consequences and difficulties, which then present the government with an alternative: either more intervention to "solve" these problems, or repeal of the whole interventionist structure. In short, Mises shows that the market economy is a finely constructed, interrelated web; and coercive intervention at various points of the structure will create unforeseen troubles elsewhere. The logic of intervention, then, is cumulative; and so a mixed economy is unstable—always tending either toward full-scale socialism or back to a free-market economy. The American farm-price support program, as well as the New York City rent-control program, are almost textbook cases of the consequences and pitfalls of intervention. Indeed, the American economy has virtually reached the point where the crippling taxation, the continuing inflation, the grave inefficiencies and breakdowns in such areas as urban life, transportation, education, telephone and postal service, the restrictions and shattering strikes of labor unions, the accelerating growth of welfare dependency, all have brought about the full-scale crisis of interventionism that Mises has long foreseen. The instability of the interventionist welfare-state system is now making fully clear the fundamental choice that confronts us between socialism on the one hand and capitalism on the other.

Perhaps the most important single contribution of von Mises to the economics of intervention is also the one most grievously neglected in the present day: his analysis of money and business cycles. We are living in an age when even those economists supposedly most devoted to the free market are willing and eager to see the state monopolize and direct the issuance of money. Yet Mises has shown that:

1. there is never any social or economic benefit to be conferred by an increase in the supply of money;
2. the government's intervention into the monetary system is invariably inflationary;
3. therefore, government should be separated from the monetary system, just as the free market requires that government not intervene in any other sphere of the economy.

Here Mises emphasizes that there is only one way to ensure this freedom and separation: to have a money that is also a useful commodity, one whose production is like other commodities subject to the supply and demand forces of the market. In short, that commodity money—which in practice means the full gold standard—shall replace the fiat issue of paper money by the government and its controlled banking system.[7]

Mises's brilliant theory of the business cycle is the only such theory to be integrated with the economists' general analysis of the pricing system and of capital and interest. Mises shows that the business cycle phenomenon, the recurring alternations of boom and bust with which we have become all too familiar, cannot occur in a free and unhampered market. Neither is the business cycle a mysterious series of random events to be checked and counteracted by an ever-vigilant central government. On the contrary, the business cycle is generated by government: specifically, by bank credit expansion promoted and fueled by governmental expansion of bank reserves. The present-day "monetarists" have emphasized that this credit expansion process inflates the money supply and therefore the price level; but they have totally neglected the crucial Misesian insight that an even more damaging consequence is distortion of the whole system of prices and production. Specifically, expansion of bank money causes an artificial lowering of the rate of interest, and an artificial and uneconomic overinvestment in capital goods: machinery, plant, industrial raw materials, construction projects. As long as the inflationary expansion of money and bank credit continues, the unsoundness of this process is masked, and the economy can ride on the well-known euphoria of the boom; but when the bank credit expansion finally stops, and stop it must if we are to avoid a runaway inflation, then the day of reckoning will have arrived. For without the anodyne of continuing inflation of money, the distortions and misallocations of production, the overinvestment in uneconomic capital projects and the excessively high prices and wages in those capital goods industries become evident and obvious. It is then that the inevitable recession sets in, the recession being the reaction by which the market

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[7]Thus, see Ludwig von Mises, *The Theory of Money and Credit* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1971).

economy readjusts itself, liquidates unsound investments, and realigns prices and outputs of the economy so as to eliminate the unsound consequences of the boom. The recovery arrives when the readjustment has been completed.

It is clear that the policy prescriptions stemming from the Misesian theory of the business cycle are the diametric opposite of the "post-Keynesian" policies of modern orthodox economics. If there is an inflation, the Misesian prescription is, simply, for the government to stop inflating the money supply. When the inevitable recession occurs, in contrast to the modern view that the government should rush in to expand the money supply (the monetarists) or to engage in deficit spending (the Keynesians), the Austrians assert that the government should keep its hands off the economic system—should, in this case, allow the painful but necessary adjustment process of the recession to work itself out as quickly as possible. At best, generating another inflation to end the recession will simply set the stage for another, and deeper, recession, later on; at worst, the inflation will simply delay the adjustment process and thereby prolong the recession indefinitely, as happened tragically in the 1930s. Thus, while current orthodoxy maintains that the business cycle is caused by mysterious processes within the market economy and must be counteracted by an active government policy, the Mises theory shows that business cycles are generated by the inflationary policies of government and that, once underway, the best thing that government can do is to leave the economy alone. In short, the Austrian doctrine is the only consistent espousal of *laissez-faire*; for, in contrast to other "free market" schools in economics, Mises and the Austrians would apply *laissez-faire* to the "macro" as well as the "micro" areas of the economy.

If interventionism is invariably calamitous and self-defeating, what of the third alternative: socialism? Here Ludwig von Mises is acknowledged to have made his best-known contribution to economic science: his demonstration, over fifty years ago, that socialist central planning was irrational, since socialism could not engage in that "economic calculation" of prices indispensable to any modern, industrialized economy. Only a true market, based on private ownership of the means of production and on the exchange of such property titles, can establish such genuine market prices, prices which serve to allocate productive resources—land, labor, and capital—to

those areas which will most efficiently satisfy the demands of consumers. But Mises showed that even if the government were willing to forget consumer desires, it could not allocate efficiently for its own ends without a market economy to set prices and costs. Mises was hailed even by socialists for being the first to raise the whole problem of rational calculation of prices in a socialist economy; but socialists and other economists erroneously assumed that Oskar Lange and others had satisfactorily solved this calculation problem in their writings of the 1930s. Actually, Mises had anticipated the Lange "solutions" and had refuted them in his original article.[8]

It is highly ironic that, no sooner had the economics profession settled contentedly into the notion that Mises's charge had been refuted, when the Communist countries of Eastern Europe began to find, pragmatically and much against their will, that socialist planning was indeed unsatisfactory, especially as their economies were becoming industrialized. Beginning with Yugoslavia's breakaway from state planning in 1952, the countries of Eastern Europe have been heading with astonishing rapidity away from socialist planning and toward free markets, a price-system, profit-and-loss tests for enterprises, and so on. Yugoslavia has been particularly determined in its cumulative shift toward a free market and away even from state control of investments—the last government stronghold in a socialistic economy. It is unfortunate but not surprising that, neither in the East nor in the West, has Ludwig von Mises's name been brought up as the prophet of the collapse of central planning.[9]

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[8]Mises's classic article was translated as "Economic Calculation in the Socialist Commonwealth," in *Collectivist Economic Planning*, F.A. Hayek, ed. (London: George Routledge and Sons, 1935), pp. 87–130. Mises's and other articles by Lange and Hayek are reprinted in *Comparative Economic Systems*, Morris Bornstein, ed., rev. ed. (Homewood, Ill.: Richard D. Irwin, 1969). An excellent discussion and critique of the whole controversy may be found in Trygve J.B. Hoff, *Economic Calculation in the Socialist Society* (London: William Hodge, 1949).

[9]On Yugoslavia, see Rudolf Bicanic, "Economics of Socialism in a Developed Country," in *Comparative Economic Systems*, M. Bornstein, ed., pp. 222–35; on the other countries of Eastern Europe, see Michael Gamarnikow, *Economic Reforms in Eastern Europe* (Detroit, Mich.: Wayne State University Press, 1968).

If it is becoming increasingly evident that the socialist economies are collapsing in the East, and, on the other hand, that interventionism is falling apart in the West, then the outlook is becoming increasingly favorable for both East and West to turn before very long to the free market and the free society. For this courageous and devoted champion of liberty, there could be no more welcome prospect in his ninetieth year. But what should never be forgotten is that these events are a confirmation and a vindication of the stature of Ludwig von Mises, and of the importance of his contribution and his role. For Mises, almost singlehandedly, has offered us the correct paradigm for economic theory, for social science, and for the economy itself, and it is high time that this paradigm be embraced, in all of its parts.

There is no more fitting conclusion to a tribute to Ludwig von Mises than the moving last sentences of his greatest achievement, *Human Action*:

> The body of economic knowledge is an essential element in the structure of human civilization; it is the foundation upon which modern industrialism and all the moral, intellectual, technological, and therapeutical achievements of the last centuries have been built. It rests with men whether they will make the proper use of the rich treasure with which this knowledge provides them or whether they will leave it unused. But if they fail to take the best advantage of it and disregard its teachings and warnings, they will not annul economics; they will stamp out society and the human race.[10]

Thanks in no small measure to the life and work of Ludwig von Mises, we can realistically hope and expect that mankind will choose the path of life, liberty, and progress and will at last turn decisively away from death and despotism.

[10]Mises, *Human Action*, p. 881.

# 12

# Value Implications of Economic Theory

Economics, as a science, attempts and claims to be purely value-free; that is, separate from the personal, valuational, or political proclivities of the economist. And yet economics and economists are continually making political pronouncements; economics *per se* is shot through with value-loaded assumptions, usually implicit, which then emerge as political conclusions and recommendations. It is my contention that this procedure is illegitimate and unscientific, and that it is incumbent on economic theory to purge itself of all vestiges of the unsupported value judgment. As a science, economics can and should stand apart from such value judgments. But since all political policy recommendations necessarily involve value judgments, does this mean that the economist must never make any policy recommendations or indeed, never use any terminology that is value-loaded? Not necessarily.

There are only two possible kinds of philosophical status for value judgments. *Either* they are all necessarily purely subjective and personal whims on the part of the valuer, in which case for the economist to remain a scientist he must indeed refrain from all policy recommendations whatever. *Or* these judgments may well be part of a general ethical system which is rationally and objectively demonstrable; in that case, it is perfectly legitimate for the economist when he applies his scientific theory to public policy to use this ethical system to arrive at economic policy recommendations. Let us take an example from medicine. A "purely" scientific, value-free medical procedure enables a physician to say that Treatment X will cure disease Y.

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As an applied scientist, the physician can then take this knowledge and *combine* it with the ethical judgment that "cure of the disease is good" and indeed is the goal of his treatment, and then conclude with the "policy" conclusion that he should apply Treatment X. In this case both the patient and the physician are proceeding, implicitly or explicitly, on the basis of a deeply shared ethical system; their value judgments are neither personal nor arbitrary, but stem from a shared ethical system which pronounces health and life as great goods for man and death and disease as corresponding evils.[1]

The point is that in medicine all parties proceed from the basis of a deeply shared ethical system. In the case of economics, this is scarcely true; here there are many competing and clashing values and value-systems held in society. Hence, the applied economist is in a more difficult situation. If an economist does not have an ethical system, but only subjective and arbitrary values, then it is incumbent upon him as a scientist ruthlessly to keep them out of his work. In short, the economist who lacks an ethical system must refrain from any and all value-loaded or political conclusions. (This statement, of course, is itself a value judgment stemming from an ethical system which holds that science must confine itself strictly to the search for, and the exposition of, truth.) But suppose on the other hand that an economist *also* holds an ethical system. What then?

It must be emphasized that if ethics is a rational and demonstrable discipline, it is self-subsistent, that is, its principles are arrived at apart from economics or any other particular science except itself. As in the case of medicine, the applied economist would then have to take this ethical system and add it to his economic knowledge to arrive at policy conclusions and recommendations. But in that case it is incumbent upon the applied economist to state his ethical system fully and with supporting argument; whatever he does, he must not slip value judgments, *ad hoc*, unanalyzed, and unsupported, into the body of his economic theory or into his policy conclusions. And

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[1]In some cases, of course, Treatment X may lead to other effects that both patient and physician may consider "harmful"; again both share a judgment stemming from a shared ethic about the evils of injury to the human organism. Both parties will then have to judge the treatment by weighing these contrasting effects.

yet this is precisely what the bulk of economists have been doing. They, and economic theory along with them, habitually make a host of value judgments which are smuggled into their analyzes, and which then permit them to make policy recommendations, implicit or explicit, without presenting or defending a coherent ethical system. Because they cannot, like physicians, work from a universally shared ethical system, it is incumbent upon economists to present a coherent and supported ethical system or forever hold their valuational and political peace.

There is no room here to cover more than a few of the outstanding examples of the smuggling of unsupported value judgments into economic analysis. In the first place, there is the familiar case of the "Pareto Optimum." If A and B trade two goods or services, they each do so because they will be, or rather expect to be, better off as a result of the trade. Surely it is legitimate then to say that A and B are both better off, and "therefore" that "society is better off," since no one demonstrably loses by the exchange. It is implicit, and even explicit from the use of the value-loaded term "optimal," that this exchange is therefore a "good thing." I am sympathetic to the view that this exchange is a good thing, but I do not believe that this can be concluded merely from the fact of exchange, as the Pareto Optimum does. In the first place, there might well be one or more people in existence who dislike and envy A or B, and who therefore experience pain and psychic loss because the object of their envy has now improved his lot. We cannot therefore conclude from the mere fact of an exchange that "everyone" is better off, and we can therefore not simply leap to the valuational idea of social utility. In order to pronounce this voluntary exchange as "good," we need another term to our syllogism: we must make the ethical pronouncement that envy is evil, and should not be allowed to cloud our approval of the exchange. But in that case we are back to the need for a coherent ethical system. I believe, as an "ethicist," that envy is evil, but I see no willingness among economists to admit the need for, much less set forth, any sort of coherent ethical position.

This brings me to the position of the bulk of free market economists, such as the Chicago School, who favor the free market but claim to do so not on ethical grounds, but purely on the grounds of "efficiency." I maintain that it is impermissible to advocate the free market without bolstering one's economic analysis with an ethical

framework. Indeed, in some cases it is even *impossible* to set forth a coherent free-market approach without taking a frankly ethical position, and a position which goes beyond the almost universally-held utilitarian viewpoint of economists. Let us ponder our above-mentioned voluntary exchange between A and B. The free market economist advocates a world where such exchanges are legitimate and not interfered with. But any exchange implies an exchange of titles to private property. If I buy a newspaper for fifteen cents, what has happened is that I have ceded my ownership of the fifteen cents to the newsdealer, who in turn has granted his ownership of the newspaper to me. But this means that to *advocate* our right to make this exchange, means *also* to advocate the propriety, and hence the justice, of the existing property titles in the first place. To pronounce it "good" for myself and the newsdealer to have the right to make the exchange, means also to pronounce it "good" and just for each of us to own the fifteen cents and the newspaper to begin with. Yet economists are not willing to make this extension, for to do so would mean adopting a systematic concept of justice in property titles, which would involve the adoption of a system of political ethics. Economists have generally regarded such ethical systems as beyond their province; but if so, it is illegitimate for them to advocate a free market at all.

Let us illustrate: suppose that in our presumed exchange between A and B, A has sold to B a watch which he has stolen from a third party, C. Here it becomes clear that it is illegitimate to cheer this voluntary exchange from the sidelines. For since A had stolen the watch, it was not his legitimate property, and therefore he had no right to keep it or sell it; the watch was not in his legitimate title to do with as he wished. But if this is true in the case of the watch, then it would also be true in other less directly flagrant cases of unjust property titles.

Furthermore, not only is it illegitimate for the economist to *advocate* a free market without also adumbrating a theory of justice in property titles; he cannot even *define* a free market without doing so. For even to define and expound upon the free-market model, the economist is describing a system in which property titles are being exchanged, and therefore he must also define and expound upon how these titles are arrived at in the first place; he must have a theory of original property and of how property comes into being.

This problem of justice in property titles also exposes a fatal flaw in the concept of the "Unanimity Principle" as a supposedly value-free guide for the applied economist. Thus, Professor James Buchanan and others have declared that it is legitimate and presumably value-free for the economist to advocate a public policy, provided that everyone can agree on such a policy. Once again, and even more than in the case of the Pareto Optimum, this position is scarcely self-evident when subjected to analysis. For the implicit assumption of the Unanimity Principle is that all existing property titles are just. The Unanimity Principle would mean, for example, that it would be illegitimate to confiscate A's watch *even though* he had stolen it from C. But if we regard A's property title as illegitimate, then we must say that A's watch *should be* confiscated and returned to C. Once again, our ethical systems intrude ineluctably into the discussion.

The well-known Compensation Principle, adopted by most economists as a supposedly value-free route for making political recommendations, is in even worse straits than the pure Unanimity Principle. (*A fortiori*, the "weak" version of the Compensation Principle—that compensation does not *actually* have to be made but only be conceptually possible—seems to me to have no rational foundation whatever.) For the Compensation Principle assumes also that it is conceptually possible to measure losses and thereby to compensate the losers. But "utility" is a purely subjective and unmeasurable concept, and being purely psychic, it cannot be measured, either conceptually or in practice. If I buy the newspaper, all that can be known is that my utility from the newspaper is greater than from the fifteen cents, and *vice versa* for the newsdealer. There is no way of measuring these utility gains, for utility is not a quantity, but a rank order of subjective valuation.

Let us take, for example, the hypothetical proposition that the imposition of a tariff on zinc is "good" or socially useful because the gainers can (and even do) take their gains from the tariff, recompense the losers, and still have monetary gains left over. But suppose that I, as a convinced adherent of free trade and opponent of tariffs, declare that my psychic loss from the imposition of a zinc tariff is so great that no feasible monetary compensation could compensate me for that disutility. No one can say to me nay, and therefore the Compensation Principle falls to the ground. Conversely, the same could

be true for the idea that *repeal* of the tariff on zinc could be advocated in some sort of value-free manner on compensation grounds. Once again, I might be such a dedicated protectionist that I could not feasibly be compensated for my psychic loss stemming from repeal of the tariff. The Compensation Principle falls in either case.

The relation between the Compensation Principle (as well as the related Unanimity Principle) and theories of justice can be starkly demonstrated from the example of slavery. During the debates in the British Parliament in the early nineteenth century on abolition of slavery, the early adherents of the Compensation Principle were maintaining that the masters must be compensated for the loss of their investment in slaves. At that point, Benjamin Person, a member of the Manchester School, declared that "he had thought it was the slaves who should have been compensated."[2] Here is the stark example of the need, in advocating public policy, of an ethical system, of a concept of justice. Those of us who hold that slavery is unjust would always oppose the idea of compensating the masters, and indeed would think rather in terms of reparations: of the masters compensating the slaves for their years of oppression. But what is there here for the *wertfrei* economist to say?

A similar argument applies to the Coase-Demsetz analysis of property rights and external cost. Coase-Demsetz declare that "it doesn't matter" from the point of view of allocation of resources whether, for example, a railroad is given the property right to pour smoke onto the land of neighboring farmers, or the farmers are given the property right to require compensation for invasion of their land by the railroad. The implication is that the effect is "only" a matter of distribution of wealth. In the first place, of course, the decision "matters" a great deal to the railroad and the farmers. I contend that it is totally invalid to dismiss such "distribution effects" as somehow unworthy of consideration by the economist, even though it is clear that ethical considerations are directly relevant to any treatment of such distribution. But apart from this, the Coase-Demsetz analysis is not even correct for short-run allocational problems (setting aside its validity or invalidity for long-run allocation) if we realize that social costs are psychic to the individual and therefore cannot be measured

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[2]William D. Grampp, *The Manchester School of Economics* (Stanford, Calif.: Stanford University Press, 1960), p. 59.

in monetary terms. One or more of the farmers, for example, may love his land so deeply that no feasible monetary compensation for the smoke loss could be made by the railroad. As soon as we admit these psychic costs into the picture, the Coase-Demsetz analysis becomes invalid even for the short-run allocation of resources. This is apart from another consideration: that in law, an invasion of property can be stopped completely by court injunction and not merely be compensated after the fact.

This brings us to the entire analysis of neighborhood effects in the economic literature. It is simply assumed without adequate support, for example, that external economies *should* be internalized. But why? What is the ethical groundwork for this position? Let us take an example of an external economy which no economist has suggested we internalize—not out of logical consistency but simply from empirical convenience. Women, let us say, purchase and use cosmetics; this use has a great deal of external spillover effects in conferring psychic benefits among a large part of the population; and yet these males are "free riders"; they are not paying for the cosmetics. The neighborhood effect theorist, to be consistent, must claim that "too little" cosmetics are being used; that men are free riders on the female use of cosmetics and therefore should be taxed to subsidize females in their use. There are, of course, many problems with this doctrine, apart from those that we have already stated. The "internalizing" theorist must assume illegitimately that he can measure, even conceptually, how much men are being benefited, and gauge the precise amount of tax and subsidy. But apart from the conceptual impossibility of doing this, there are other grave problems involved in all attempts to apply such a principle for governmental action. One is that some men may dislike cosmetics intensely, and that *they* are therefore being penalized still further by the subsidy program. And furthermore, the very use of government implies a whole host of questionable political value judgments: for example, that government action *per se* involves neither psychic costs nor ethical injustice.

But there is a flaw even more directly germane to the concept of internalizing external economies. For by what ethical standard is the production and use of cosmetics "too low"? Too low for whom, and by what ethical standards? The very concept of "too low" is a value

judgment which is by no means self-evident and arrives here unsupported by any sort of ethical system.

Professor Demsetz goes on to advocate an allocation of property rights in accordance with whichever allocation involves lower total social transaction costs, such as costs of enforcing the given property right.[3] But once again, there are two grave flaws in this position. One, since social costs embody psychic costs or disutilities for each individual, it is impossible to measure and hence to add them up interpersonally. But apart from this, such a gauge for the allocation of property rights brusquely sets aside any consideration of the justice of property titles. But this *itself* is an ethical position unsupported by the economist. In the case of slavery, for example, it might well be found that the monetary cost of enforcing slave titles is lower than the monetary cost of each freed slave defending himself from re-enslavement. For those of us who claim that slavery is unjust, such considerations would be piddling as compared to the dictates of justice. But for an economist to try to decide such questions as the allocation of property rights by discarding considerations of justice must be totally unscientific and illegitimate.

There is only space here to touch very briefly on a few other examples of the illegitimate use of implicit value assumptions in economics. One example is the long-standing aim of the Chicago School—at least until Milton Friedman's recent essay on the "Optimum Quantity of Money"—to achieve a constant price level, either in the short or the long run. But little has been written to justify this goal. The value of the goal is scarcely self-evident, particularly when we consider the fact that a growing, unhampered economy will lead to secularly falling prices and costs, with the resulting higher living standards spread throughout the ranks of the consumers. And if falling prices would be a consequence of an increased demand for money, then again it is surely not self-evident that it is the business of government deliberately to thwart the desire of the public for a higher level of real cash balances—any more than it is the business of government to thwart the desires of consumers for any other goods or services.

[3]Thus, see Harold Demsetz, "When Does the Rule of Liability Matter?" *Journal of Legal Studies* 1, no. 1 (1971): 25–28; and Demsetz, "Some Aspects of Property Rights," *Journal of Law and Economics* (October 1966): 66.

Another example is the problem of rational pricing for governmental services. Thus, in recent years, much valuable work has been done advocating market-clearing prices for such services as streets, roads, and subways; for example, that pricing be graduated in accordance with peak hours and the degree of congestion on the roads. All this makes a great deal of sense, but one vital assumption is missing: that there is nothing wrong with the fact that an increased amount of revenue will thereby accrue to the coffers of government. The implicit value assumption is that there is nothing wrong economically or ethically with an increased amount of social resources being siphoned off to government. For those of us who do not take such a sanguine ethical view of government, this consideration must be an important factor in our policy conclusions.

In the area of government, indeed, there has been much discussion of the difficulties of national product accounting, but little has been said of the implicit—and scarcely self-evident—value assumption at the heart of the treatment of government. The blithe assumption that government expenditure on its own salaries can in any way measure government's contribution to the national product encapsulates what some of us would consider a highly naive view of the functions and operations of government—indeed a view that places one's ethical *imprimatur* on every one of the government's activities. In these days of military overkill, and of pyramid-building on a grand scale, there are not very many people who would still automatically accept Lord Keynes's famous dictum that building pyramids is just as productive an expenditure as anything else. In fact, anyone who believes that government expenditure contains at least 51 percent waste—surely not a very unreasonable assumption by anyone's reckoning—would construct national product accounts by *subtracting* government expenditures as a burden upon production and upon society, rather than adding it as a productive contribution.

Finally, there is the generally held view that an economist can provide technical advice to his client while remaining purely value-free. I submit, on the contrary, that servicing a client's ends thereby commits the economist to the ethical value of the end itself. Often it is held that by simply furnishing advice on the pursuit of goals or values held by the majority of the public, the economist remains uncommitted to values. But surely value-freedom means free of values, period; and the fact that the majority of the public might have such

values does not make commitment to them any less value-laden. To take a deliberately dramatic example, let us suppose that an economist is hired by the Nazis to advise the government on the most efficient way of setting up concentration camps. I submit that by doing so, the economist has, willy-nilly, adopted a pursuit of "better," that is, more efficient, concentration camps as a goal. And he would be doing so even if this goal were heartily endorsed by the great majority of the German public. To underscore this point, it should be clear that an economist whose value system led him to oppose concentration camps might well then give such advice to his clients as to make the concentration camps as *inefficient* as possible, that is, to sabotage their operations. In short, whatever advice he gives to his clients, the economist's value-commitment, for or against the clients' project, is inescapable. But if this is true for concentration camps, it is true also for the myriad of other and usually less significant projects that his clients have in mind.

I would like to cite a passage on this question from the last essay of the great Italian economist Luigi Einaudi. Einaudi wrote that the economic advisors to government "indispensable, extremely learned, extremely informed, the experts, the only people who know the jargon, have become . . . one of the seven plagues of Egypt, a disgrace to humanity." A "plague," Einaudi wrote, because of the typical economist's view that "I have performed my duty fully when I have decided whether the proposed means or other alternatives are consistent with the end prosecuted by the politician." Einaudi then commented: "No. The economist has failed in that case to perform the essential part of his task . . . The economist . . . has not the right to be neutral or to hide under an unreal distinction between means and ends. He must declare himself for that end to which he is closest; and must prove what he assumes."[4]

It is important to stress what this paper is *not* saying: I am *not* taking the position, now fashionable in many quarters, that there is no such thing as a value-free economics, that all economic analysis is inextricably shot through with value assumptions. On the contrary, I believe that the main body of economic analysis is scientific and value-free; what I *am* saying is that any time that economists impinge

[4]Luigi Einaudi, "Politicians and Economists," *Il Politico* (Pavia) (June 1962): 258, 262–63.

on political or policy conclusions, value-judgments have entered into their discussion. My conclusion, then, is that economists must *either* make their value judgments explicit and defend them with a coherent ethical system, *or* strictly refrain from entering, directly, or indirectly into the public policy realm.

# 13

# The Myth of Efficiency

I am delighted that Dr. Rizzo, in chapter 4 [of *Time, Uncertainty, and Disequilibrium*], is calling the highly touted concept of "efficiency" into grave question. I would like to carry his critique still further.

One of Rizzo's major points is that the concept of efficiency has no meaning apart from the pursuit of specified ends. But he concedes too much when he states, at least at the beginning of his paper, that "of course it [the common law] is efficient" relative to certain specified goals. For there are several layers of grave fallacy involved in the very concept of efficiency as applied to social institutions or policies: (1) the problem is not only in specifying ends but also in deciding *whose* ends are to be pursued; (2) individual ends are bound to conflict, and therefore any additive concept of social efficiency is meaningless; and (3) even each individual's actions cannot be assumed to be "efficient"; indeed, they undoubtedly will not be. Hence, efficiency is an erroneous concept even when applied to each individual's actions directed toward his ends; it is *a fortiori* a meaningless concept when it includes more than one individual, let alone an entire society.

Let us take a given individual. Since his own ends are clearly given and he acts to pursue them, surely at least *his* actions can be considered efficient. But no, they may not, for in order for him to act efficiently, he would have to possess perfect knowledge—perfect knowledge of the best technology, of future actions and reactions by

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other people, and of future natural events. But since no one can ever have perfect knowledge of the future, no one's action can be called "efficient." We live in a world of uncertainty. Efficiency is therefore a chimera.

Put another way, action is a learning process. As the individual acts to achieve his ends, he learns and becomes more proficient about how to pursue them. But in that case, of course, his actions cannot have been efficient from the start—or even from the end—of his actions, since perfect knowledge is never achieved, and there is always more to learn.

Moreover, the individual's ends are not *really* given, for there is no reason to assume that they are set in concrete for all time. As the individual learns more about the world, about nature and about other people, his values and goals are bound to change. The individual's ends will change as he learns from other people; they may also change out of sheer caprice. But if ends change in the course of an action, the concept of efficiency—which can only be defined as the best combination of means in pursuit of given ends—again becomes meaningless.

If the concept of efficiency is worthless even for each individual, it is *a fortiori* in far worse straits when the economist employs it in an additive way for all of society. Rizzo is being extremely gentle with the concept when he says that it amounts "to little more than maximizing gross national product" which "immediately breaks down once externalities are introduced into the system." The problem, however, is far deeper. For efficiency only makes sense in regard to people's ends, and individuals' ends differ, clash, and conflict. The central question of politics then becomes: *whose* ends shall rule?

The blindness of economic thought to the realities of the world is systematic and is a product of the utilitarian philosophy that has dominated economics for a century and a half. For utilitarianism holds that everyone's ends are *really* the same, and that therefore all social conflict is merely technical and pragmatic, and can be resolved once the appropriate means for the common ends are discovered and adopted. It is the myth of the common universal end that allows economists to believe that they can "scientifically" and in a supposedly value-free manner prescribe what political policies should be adopted. By taking this alleged common universal end as

an unquestioned given, the economist allows himself the delusion that he is not at all a moralist but only a strictly value-free and professional technician.

The alleged common end is a higher standard of living, or, as Rizzo puts it, a maximized gross national product. But suppose that, for one or more people, part of their desired "product" is something that other people will consider a decided detriment. Let us consider two examples, both of which would be difficult to subsume under the gentle rubric of "externalities." Suppose that some people pursue as a highly desired end the compulsory equality, or uniformity, of all persons, including each having the same living conditions and wearing the same shapeless blue garment. But then a highly desired goal for these egalitarians would be considered a grave detriment by those individuals who do not wish to be made equal to or uniform with everyone else. A second example of conflicting ends, of clashing meanings allotted to the concept of "product," would be one or more people who greatly desire either the enslavement or the slaughter of a disliked ethnic or other clearly defined social group. Clearly, the pursuit of product for the would-be oppressors or slaughterers would be considered a negative product, or detriment, by the potential oppressed. Perhaps we could jam this case into an externality problem by saying that the disliked social or ethnic group constitutes a "visual pollutant," a negative externality, for the other groups, and that these external "costs" can be (should be?) internalized by forcing the disliked group to pay the other groups enough to induce the latter to spare their lives. One wonders, however, how much the economist wishes to minimize social costs, and whether or not this proffered solution would really be "value-free."

In these cases of conflicting ends, furthermore, one group's "efficiency" becomes another group's detriment. The advocates of a program—whether of compulsory uniformity or of slaughtering a defined social group—would want their proposals carried out as efficiently as possible; whereas, on the other hand, the oppressed group would hope for as *in*efficient a pursuit of the hated goal as possible. Efficiency, as Rizzo points out, can only be meaningful relative to a given goal. But if ends clash, the opposing group will favor maximum inefficiency in pursuit of the disliked goal. Efficiency, therefore, can never serve as a utilitarian touchstone for law or for public policy.

Our cases of clashing ends bring us to the question of minimizing social costs. The first question to raise is: why *should* social costs be minimized? Or, why *should* externalities be internalized? The answers are scarcely self-evident, and yet the questions have never been satisfactorily addressed, let alone answered. And there is an important corollary question: even given the goal of minimizing costs, for the sake of argument, should this goal be held as an absolute or should it be subordinated, and to what degree, to other goals? And what reasons can be given for any answer?

In the first place, to say that social costs *should* be minimized, or that external costs *should* be internalized, is not a technical or a value-free position. The very intrusion of the word *should*, the very leap to a policy position, necessarily converts this into an ethical stand, which requires, at the very least, an ethical justification.

And second, even if, for the sake of argument, we consent to a goal of minimized social costs, the economist still must wrestle with the problem: how absolute should this commitment be? To say that minimized social costs must be absolute, or at least the highest-valued goal, is to fall into the same position that the cost-benefit economists scorn when it is taken by ethicists: namely, to consider equity or rights heedless of cost-benefit analysis. And what is their justification for such absolutism?

Third, even if we ignore these two problems, there is the grave fallacy in the very concept of "social cost," or of cost as applied to more than one person. For one thing, if ends clash, and one man's product is another man's detriment, costs cannot be added up across these individuals. But second, and more deeply, costs, as Austrians have pointed out for a century, are subjective to the individual, and therefore can neither be measured quantitatively nor, *a fortiori*, can they be added or compared among individuals. But if costs, like utilities, are subjective, nonadditive, and noncomparable, then of course any concept of social costs, including transaction costs, becomes meaningless. And third, even within each individual, costs are not objective or observable by any external observer. For an individual's cost is subjective and ephemeral; it appears only *ex ante*, at the moment before the individual makes a decision. The cost of any individual's choice is his subjective estimate of the value ranking of the highest value foregone from making his choice. For each individual tries, in every choice, to pursue his highest-ranking end; he forgoes

or sacrifices the other, lower-ranking, ends that he could have satisfied with the resources available. His cost is his second-highest ranking end, that is, the value of the highest ranking end that he has foregone to achieve a still more highly valued goal. The cost that he incurs in this decision, then, is only *ex ante*; as soon as his decision is made and the choice is exercised and his resource committed, the cost disappears. It becomes an historical cost, forever bygone. And since it is impossible for any external observer to explore, at a later date, or even at the same time, the internal mental processes of the actor, it is impossible for this observer to determine, even in principle, what the cost of any decision may have been.

Much of chapter 4 [in *Time, Uncertainty, and Disequilibrium*] is devoted to an excellent analysis demonstrating that objective social costs make no sense outside of general equilibrium, and that we can never be in such equilibrium, nor could we know if we were. Rizzo points out that since disequilibrium necessarily implies divergent and inconsistent expectations, we cannot simply say that these prices approximate equilibrium, since there is an important difference *in kind* between them and consistent equilibrium prices. Rizzo also points out that there is no benchmark to enable us to decide whether existing prices are close to equilibrium or not. I would simply underline his points here and make only two comments. To his point that tort law would not be needed in general equilibrium, I would add that torts themselves could not be committed in such a situation. For one feature of general equilibrium is certainty and perfect knowledge of the future; and presumably with such perfect knowledge no accidents could possibly occur. Even an intentional tort could not occur, for a perfectly foreseen tort could surely be avoided by the victim.

This comment relates to another point I would make about general equilibrium; not only has it never existed, and is not an operational concept, but also it could not conceivably exist. For we cannot really conceive of a world where every person has perfect foresight, and where no data ever change; moreover, general equilibrium is internally self-contradictory, for the reason one holds cash balances is the uncertainty of the future, and therefore the demand for money would fall to zero in a general equilibrium world of perfect certainty. Hence, a money economy, at least, could not be in general equilibrium.

I would also endorse Rizzo's critique of attempts to use objective probability theory as a way of reducing the real world of uncertainty to certainty equivalents. In the real world of human action, virtually all historical events are unique and heterogeneous, though often similar, to all other historical events. Since each event is unique and nonreproducible, it is impermissible to apply objective probability theory; expectations and forecasting become a matter of subjective estimates of future events, estimates that cannot be reduced to an objective or "scientific" formula. Calling two events by the same name does not make them homogeneous. Thus, two presidential elections are both called "presidential elections," but they are nevertheless highly varied, heterogeneous, and nonreproducible events, each occurring in different historical contexts. It is no accident that social scientists arguing for the use of the objective probability calculus almost invariably cite the case of the lottery; for a lottery is one of the few human situations where the outcomes are indeed homogeneous and reproducible, and, furthermore, where the events are random with no one possessing any influence upon its successors.

Not only is "efficiency" a myth, then, but so too is any concept of social or additive cost, or even an objectively determinable cost for each individual. But if cost is individual, ephemeral, and purely subjective, then it follows that no policy conclusions, including conclusions about law, can be derived from or even make use of such a concept. There can be no valid or meaningful cost-benefit analysis of political or legal decisions or institutions.

Let us now turn more specifically to Rizzo's discussion of the law, and its relation to efficiency and social costs. His critique of the efficiency-economists could be put more sharply. Let us take, for example, Rizzo's discussion of the Good Samaritan problem. As he poses the problem, he supposes that B could save A "at minimal cost to himself," and he concludes that, from the point of view of the efficiency theorists, B should be liable for injuries to A if B doesn't save A. But there are more problems with the efficiency approach. For one thing, there is the characteristic confusion of monetary and psychic costs. For, since B's costs in this case are purely psychic, how can anyone but B, say a court, know what B's costs would entail? Suppose indeed that B is a good swimmer and could rescue A easily, but that it turns out that A is an old enemy of his, so that the psychic costs of his rescuing A are very high. The point is that any

assessment of B's costs can only be made in terms of B's own values, and that no outside observer can know what these are.[1] Furthermore, when the efficiency theorists put the case that, in Rizzo's words, "clearly . . . A would have been willing to pay B more than enough to compensate his costs in order to be rescued," this conclusion is not really clear at all. For how do we know, or how do the courts know, if A would have had the money to pay B, and how would B know it—especially if we realize that no one except B can know what his psychic costs may be?

Furthermore, the question of causation could be put far more sharply. Rizzo's quotation from Mises on nonaction also being a form of "action" is praxeologically correct, but is irrelevant to the law. For the law is trying to discover who, if anyone, in a given situation has aggressed against the person or property of another—in short, who has been a tortfeasor against the property of another and is therefore liable for penalty. A nonaction may be an "action" in a praxeological sense, but it sets no positive chain of consequences into motion, and therefore cannot be an act of aggression. Hence, the wisdom of the common law's stress on the crucial distinction between misfeasance and nonfeasance, between a wrongful aggression against someone's rights, and leaving that person alone.[2] *Vincent* v. *Lake Erie Transport* was a superb decision, for there the court was careful to investigate the causal agent at work—in this case, the boat, which clearly slammed against the dock. In some ways, tort law can be summed up as: "No liability without fault, no fault without liability." The vital importance of Richard Epstein's strict liability doctrine is that it

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[1]Marc A. Franklin, *Injuries and Remedies* (Mineola, N.Y.: Foundation Press, 1971), p. 401.

[2]There is no distinction more deeply rooted in the common law and more fundamental than that between misfeasance and nonfeasance, between active misconduct working positive injury to others and passive inaction, a failure to take positive steps to benefit others, or to protect them from harm not created by any wrongful act of the defendant.

Francis H. Bohlen, "The Moral Duty to Aid Others as a Basis of Tort Liability," *University of Pennsylvania Law Review* 56, no. 4 (April 1908): 219–21; cited in Williamson M. Evers, "The Law of Omissions and Neglect of Children," *Journal of Libertarian Studies* (Winter, 1978).

returns the common law to its original strict emphasis on causation, fault, and liability, shorn of modern accretions of negligence and pseudo-"efficiency" considerations.

I conclude that we cannot decide on public policy, tort law, rights, or liabilities on the basis of efficiencies or minimizing of costs. But if not costs or efficiency, then what? The answer is that only *ethical principles* can serve as criteria for our decisions. Efficiency can never serve as the basis for ethics; on the contrary, ethics must be the guide and touchstone for any consideration of efficiency. Ethics is the primary. In the field of law and public policy, as Rizzo wittily indicates, the primary ethical consideration is the concept that "dare not speak its name"—the concept of justice.

One group of people will inevitably balk at our conclusion; I speak, of course, of the economists. For in this area economists have been long engaged in what George Stigler, in another context, has called "intellectual imperialism." Economists will have to get used to the idea that not all of life can be encompassed by our own discipline. A painful lesson no doubt, but compensated by the knowledge that it may be good for our souls to realize our own limits—and, just perhaps, to learn about ethics and about justice.

# 14

# Breaking Out of the Walrasian Box: Schumpeter and Hansen

Since World War II, mainstream neoclassical economics has followed the general equilibrium paradigm of Swiss economist Léon Walras (1834–1910).[1] Economic analysis now consists of the exegesis and elaboration of the Walrasian concept of general equilibrium, in which the economy pursues an endless and unchanging round of activity—what the Walrasian Joseph Schumpeter aptly referred to as "the circular flow." Since the equilibrium economy is by definition a changeless and unending round of robotic behavior, everyone on the market has perfect knowledge of the present and the future, and the pervasive uncertainty of the real world drops totally out of the picture. Since there is no more uncertainty, profits and losses disappear, and every business firm finds that its selling price exactly equals its cost of production.

It is surely no accident that the rise to dominance of Walrasian economics has coincided with the virtual mathematization of the social sciences. Mathematics enjoys the prestige of being truly "scientific," but it is difficult to mathematize the messy and fuzzy

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Originally appeared in the *Review of Austrian Economics* 1, no. 2 (1987): 97–108. Rothbard learned the basic insights of this article many years ago from lectures of Professor Arthur F. Burns at Columbia University.

[1]Before World War II, the dominant paradigm, at least in Anglo-American economics, was the neo-Ricardian partial equilibrium theory of Alfred Marshall. In that era, Walras and his followers, the earliest being the Italian Vilfredo Pareto, were referred to as "the Lausanne School." With the Walrasian conquest of the mainstream, what was once a mere school has now been transformed into "microeconomics."

uncertainties and inevitable errors of real world entrepreneurship and human actions. Once one expunges such actions and uncertainties, however, it is easy to employ algebra and the tangencies of geometry in analyzing this unrealistic but readily mathematical equilibrium state.

Most mainstream economic theorists are content to spend their time elaborating on the general equilibrium state, and simply to assume that this state is an accurate presentation of real world activity. But some economists have not been content with contemplating general equilibrium; they have been eager to apply this theory to the real world of dynamic change. For change clearly exists, and for some Walrasians it has not sufficed to simply translate general equilibrium analysis to the real world and to let the chips fall where they may.

As someone who has proclaimed that Léon Walras was the greatest economist who ever lived, Joseph A. Schumpeter (1883–1950) faced this very problem. As a Walrasian, Schumpeter believed that general equilibrium is an overriding reality; and yet, since change, entrepreneurship, profits, and losses clearly exist in the real world, Schumpeter set himself the problem of integrating a theoretical explanation of such change into the Walrasian system. It was a formidable problem indeed, since Schumpeter, unlike the Austrians, could not dismiss general equilibrium as a long-run tendency that is never reached in the real world. For Schumpeter, general equilibrium had to be the overriding reality: the realistic starting point as well as the end point of his attempt to explain economic change.[2]

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[2]In maintaining that Schumpeter was more influenced by the Austrians than by Walras, Mohammed Khan overlooks the fact that Schumpeter's first book, and the only one still untranslated into English, *Das Wesen und der Hauptinhalt der Theoretischen Nationalökonomie* (The essence and principal contents of economic theory; Leipzig, 1908), written while he was still a student of Böhm-Bawerk, was an aggressively Walrasian work. Not only is *Das Wesen* a nonmathematical apologia for the mathematical method, but it is also a study in Walrasian general equilibrium that depicts economic events as the result of mechanistic quantitative interactions of physical entities, rather than as consequences of purposeful human action—the Austrian approach. Thus, Fritz Machlup writes that:

> Schumpeter's emphasis on the character of economics as a quantitative science, as an equilibrium system whose elements are

To set forth a theory of economic change from a Walrasian perspective, Schumpeter had to begin with the economy in a real state of general equilibrium. He then had to explain change, but that change always had to *return* to a state of equilibrium, for without such a return, Walrasian equilibrium would only be real at *one single point* of past time and would not be a recurring reality. But Walrasian equilibrium is a world of unending statics; specifically, it depicts the consequences of a fixed and unchanging set of individual tastes, techniques, and resources in the economy. Schumpeter began, then, with the economy in a Walrasian box; the only way for any change to occur is through a change in one or more of these static givens.

Furthermore, Schumpeter created even more problems for himself. In the Walrasian model, profits and losses were zero, but a rate of interest continued to be earned by capitalists, in accordance with the alleged marginal productivity of capital. An interest charge became incorporated into costs. But Schumpeter was too much of a student of Böhm-Bawerk to accept a crude productivity explanation of interest. The Austrian approach was to explain interest by a social rate of time preference, of the market's preference for present goods over future goods. But Schumpeter rejected the concept of time-preference as well, and so he concluded that in a state of general equilibrium, the rate of interest as well as profits and losses are all zero.

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> "quantities of goods," led him to regard it as unnecessary, and, hence, as methodologically mistaken for economics to deal with "economic conduct" and with "the motives of human conduct." (Fritz Machlup, "Schumpeter's Economic Methodology," *Review of Economics and Statistics* 33 [May 1951]: 146–47)

Cf. Mohammed Shabbir Khan, *Schumpeter's Theory of Capitalist Development* (Aligarh, India: Muslim University of India, 1957).

On *Das Wesen*, see Erich Schneider, *Joseph Schumpeter: Life and Work of a Great Social Scientist* (Lincoln: University of Nebraska Bureau of Business Research, 1975), pp. 5–8. On Schumpeter as Walrasian, also see Schneider, "Schumpeter's Early German Work, 1906–17," *Review of Economics and Statistics* (May 1951): 1–4; and Arthur W. Marget, "The Monetary Aspects of the Schumpeterian System," ibid., pp. 112ff. On Schumpeter as not being an "Austrian," also see "Haberler on Schumpeter," in Henry W. Spiegel, ed., *The Development of Economic Thought* (New York: John Wiley and Sons, 1952), pp. 742–43.

Schumpeter acknowledged that time-preference, and hence interest, exist on consumption loans, but he was interested in the production structure. Here he stressed, as against the crude productivity theory of interest, the Austrian concept of imputation, in which the values of products are imputed back to productive factors, leaving, in equilibrium, no net return. Also, in the Austrian manner, Schumpeter showed that capital goods can be broken down ultimately into the two original factors of production, land and labor.[3] But what Schumpeter overlooked, or rather rejected, is the crucial Böhm-Bawerkian concept of time and time-preference in the process of production. Capital goods are not *only* embodied land and labor; they are embodied land, labor, and *time*, while interest becomes a payment for "time." In a productive loan, the creditor of course exchanges a "present good" (money that can be used now) for a "future good" (money that will only be available in the future). And the primordial fact of time-preference dictates that every one will prefer to have wants satisfied

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[3]Thus, Schumpeter wrote that

> in the normal circular flow the whole value product must be imputed to the original productive factors, that is to the services of labor and land; hence the whole receipts from production must be divided between workers and landowners and there can be no permanent net income other than wages and rent. Competition on the one hand and imputation on the other must annihilate any surplus of receipts over outlays, any excess of the value of the product over the value of the services of labor and land embodied in it. The value of the original means of production must attach itself with the faithfulness of a shadow to the value of the product, and could not allow the slightest permanent gap between the two to exist. . . . To be sure, produced means of production have the capacity of serving in the production of goods. . . . And these goods also have a higher value than those which could be produced with the produced means of production. But this higher value must also lead to a higher value of the services of labor and land employed. No element of surplus value can remain permanently attached to these intermediate means of production. (Joseph A. Schumpeter, *The Theory of Economic Development: An Inquiry Into Profits, Capital, Credit, Interest and the Business Cycle* [New York: Oxford University Press, 1961], pp. 160, 162)

now than at some point in the future, so that a present good will always be worth more than the *present prospect* of the equivalent future good. Hence, at any given time, future goods are discounted on the market by the social rate of time-preference.

It is clear how this process works in a loan, in an exchange between creditor and debtor. But Böhm-Bawerk's analysis of time-preference and interest went far deeper, and far beyond the loan market for he showed that time-preference and hence interest return exist apart from or even in the absence of any lending at all. For the capitalist who purchases or hires land and labor factors and employs them in production is buying these factors with money (present good) in the expectation that they will yield a future return of output, of either capital goods or consumer goods. In short, these original factors, land and labor, are future goods to the capitalist. Or, put another way, land and labor produce goods that will only be sold and hence yield a monetary return at some point *in the future*; yet they are paid wages or rents by the capitalist now, in the present.

Therefore, in the Böhm-Bawerkian or Austrian insight, factors of production, hence workers or landowners, do *not* earn, as in neoclassical analysis, their marginal value product in equilibrium. They earn their marginal value product discounted by the rate of time-preference or rate of interest. And the capitalist, for his service of supplying factors with present goods and waiting for future returns, is paid the discount.[4] Hence, time-preference and interest income exist in the state of equilibrium, and not simply as a charge on loans but as a return earned by every investing capitalist.

Schumpeter can deny time-preference because he can somehow deny the role of time in production altogether. For Schumpeter, production apparently takes no time in equilibrium, because production and consumption are "synchronized."[5] Time is erased from the

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[4]See the attack on this Austrian view from a Knightian neoclassical perspective in Earl Rolph, "The Discounted Marginal Productivity Doctrine," in *Readings in the Theory of Income Distribution,* W. Fellner and B. Haley, eds. (Philadelphia: Blakiston, 1946), pp. 278–93. For a rebuttal, see Murray N. Rothbard, *Man, Economy, and State* (Los Angeles: Nash Publishing, 1970), vol. 1, pp. 431–33; included in this volume as chapter 15.

[5]On this alleged synchronization, see Khan, *Schumpeter's Theory*, pp. 51, 53. The concept of synchronization of production is a most un-Austrian

picture, even to the extent of assuming away accumulated stocks of capital goods, and therefore of any age structure of distribution of such goods.[6] Since production is magically "synchronized," there is then no necessity for land and labor to receive any advances from capitalists. As Schumpeter writes:

> There is no necessity [for workers or landowners] to apply for any "advances" of present consumption goods. . . . The individual need not look beyond the current period. . . . The mechanism of the economic process sees to it that he also provides for the future at the same time. . . . Hence every question of the accumulation of such stocks [of consumer goods to pay laborers] disappears.

From this bizarre set of assumptions, "it follows," notes Schumpeter, "that everywhere, even in a trading economy, produced means of production are nothing but transitory items. Nowhere do we find a stock of them fulfilling any functions." In denying, further, that there is any "accumulated stock of consumer goods" ready to pay laborers and landowners, Schumpeter is also denying the patent fact that wages and rents are always paid out of the accumulated savings of capitalists, savings which could have been spent on consumer goods but which laborers and landowners will instead spend with their current incomes.

How can Schumpeter come to this conclusion? One reason is that when workers and landowners exchange their services for present money, he denies that these involve "advances" of consumer goods, because "It is simply a matter of exchange, and not of credit

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one that Schumpeter took from John Bates Clark, which in turn led to the famous battle in the 1930s between the Clark-Knight concept of capital and the Austrian views of Hayek, Machlup, and Boulding. See ibid., p. 6*n*. Also see F.A. Hayek, "The Mythology of Capital," in Fellner and Haley, eds., *Readings*, pp. 355–83.

[6]In Khan's words, for Schumpeter "capital cannot have any age structure and perishes in the very process of its function of having command over the means of production" (Khan, *Schumpeter's Theory*, p. 48). Schumpeter achieves this feat by sundering capital completely from its embodiment in capital goods, and limiting the concept to only a money fund used to purchase those goods. For Schumpeter, then, capital (like interest) becomes a purely monetary phenomenon, not rooted in real goods or real transactions. See Schumpeter, *Economic Development*, pp. 116–17.

transactions. The element of time plays no part." What Schumpeter overlooks here is the profound Böhm-Bawerkian insight that the time market is not merely the *credit* market. For when workers and landowners earn money now for products that will only reap a return to capitalists in the future, they *are* receiving advances on production paid for out of capitalist saving, advances for which they in effect pay the capitalists a discount in the form of an interest return.[7]

In most conceptions of final equilibrium, net savings are zero, but interest is high enough to induce gross saving by capitalists to just replace capital equipment. But in Schumpeter's equilibriums interest is zero, and this means that *gross* saving is zero as well. There appear to be neither an incentive for capitalists to maintain their capital equipment in Schumpeterian equilibrium nor the means for them to do so. The Schumpeterian equilibrium is therefore internally inconsistent and cannot be maintained.[8]

Lionel Robbins puts the case in his usual pellucid prose:

> If there were no yield to the use of capital . . . there would be no reason to refrain from consuming it. If produced means of production are not productive of a net product, why devote resources to maintaining them when these resources might be devoted to providing present enjoyment? One would not have one's cake rather than eat it, if there were no gain to be derived from having it. It is, in short, *an* interest rate, which, other things being given, keeps the stationary state—the rate at which it does not pay to turn income into capital or capital into income. If interest were to disappear the stationary state would cease to be stationary. Schumpeter can argue that no accumulation will be made once stationary equilibrium has been attained. But he is not entitled to argue

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[7]See Schumpeter, *Economic Development*, pp. 43–44.

[8]Clemence and Doody attempt to refute this charge, but do so by assuming a zero rate of time-preference. Capitalists would then be interested in maximizing their utility returns over time without regard for when they would be reaped. Hence, capital goods would be maintained indefinitely. But for those who believe that everyone has a positive rate of time-preference, and hence positively discounts future returns, a zero rate of return would quickly cause the depletion of capital and certainly the collapse of stationary equilibrium. Richard V. Clemence and Francis S. Doody, *The Schumpeterian System* (Cambridge, Mass.: Addison-Wesley, 1950), pp. 28–30.

> that there will be no *de*cumulation unless he admits the existence of interest.[9] (emphasis added)

To return to Schumpeter's main problem, if the economy begins in a Walrasian general equilibrium modified by a zero rate of interest, how can any economic change, and specifically how can economic development, take place? In the Austrian-Böhm-Bawerkian view, economic development takes place through greater investment in more roundabout processes of production, and that investment is the result of greater net savings brought about by a general fall in rates of time-preference. Upon such a fall, people are more willing to abstain from consumption and to save a greater proportion of their incomes, and thereby invest in more capital and longer processes of production. In the Walrasian schema, change can only occur through alterations in tastes, techniques, or resources. A change in time-preference would qualify as a very important aspect of a change in consumer "tastes" or values.

But for Schumpeter, *there is no* time-preference, and no savings in equilibrium. Consumer tastes are therefore irrelevant to increasing investment, and besides there are *no savings* or interest income out of which such investment can take place. A change in tastes or time-preferences cannot be an engine for economic change, and neither can investment in change emerge out of savings, profit, or interest.

As for consumer values or tastes apart from time-preference, Schumpeter was convinced that consumers were passive creatures and he could not envision them as active agents for economic change.[10] And even if consumer tastes change actively, how can a

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[9]Emphasis added. In the excellent critique of Schumpeter's zero-interest equilibrium by Lionel Robbins, "On a Certain Ambiguity in the Conception of Stationary Equilibrium," *Economic Journal* 40 (June 1930): 211–14. Also see Gottfried Haberler, "Schumpeter's Theory of Interest," *Review of Economics and Statistics* (May 1951): 122ff.

[10]Thus, Schumpeter wrote: "It is not the large mass of consumers which induces production. On the contrary, the crowd *is mastered and led by the key personalities in production*" (italics are Schumpeter's) in "Die neuere Wirtschaftstheorie in den Vereinigten Staaten" ("Recent economic theory in the United States") *Schmollers Jahrbuch* (1910), cited in Schneider, *Joseph A. Schumpeter*, p. 13.

mere shift of demand from one product to another bring about economic development?

*Resources* for Schumpeter are in no better shape as engines of economic development than are tastes. In the first place, the supplies of land and labor never change very rapidly over time, and furthermore they cannot account for the necessary investment that spurs and embodies economic growth.

With tastes and resources disposed of, there is only one logically possible instrument of change or development left in Schumpeter's equilibrium system: technique. "Innovation" (a change in embodied technical knowledge or production functions) is for Schumpeter the only logically possible avenue of economic development. To admire Schumpeter, as many economists have done, for his alleged realistic insight into economic history in seeing technological innovation as the source of development and the business cycle, is to miss the point entirely. For this conclusion is not an empirical insight on Schumpeter's part; it is logically the only way that he can escape from the Walrasian (or neo-Walrasian) box of his own making; it is the only way for any economic change to take place in his system.

But if innovation is the only way out of the Schumpeterian box, how is this innovation to be financed? For there are no savings, no profits, and no interest returns in Schumpeterian equilibrium. Schumpeter is stuck: for there is no way within his own system for innovation to be financed, and therefore for the economy to get out of his own particularly restrictive variant of the Walrasian box. Hence, Schumpeter has to invent a *deus ex machina*, an exogenous variable from outside his system that will lift the economy out of the box and serve as the only possible engine of economic change. And that *deus ex machina* is inflationary bank credit. Banks must be postulated that expand the money supply through fractional reserve credit, and furthermore, that lend that new money exclusively to innovators—to new entrepreneurs who are willing and able to invest in new techniques, new processes, new industries. But they cannot do so because, by definition, there are no savings available for them to invest or borrow.

Hence, the conclusion that innovation is the instrument of economic change and development, and that the innovations are financed by inflationary bank credit, is *not* a perceptive empirical generalization discovered by Joseph Schumpeter. It is not an empirical

generalization at all; indeed it has *no* genuine referent to reality. Suggestive though his conclusion may seem, it is solely the logical result of Schumpeter's fallacious assumptions and his closed system, and the only logical way of breaking out of his Walrasian box.

One sees, too, why for Schumpeter the entrepreneur is always a disturber of the peace, a disruptive force *away* from equilibrium, whereas in the Austrian tradition of Mises and Kirzner, the entrepreneur harmoniously adjusts the economy in the direction of equilibrium. For in the Austrian view the entrepreneur is the main bearer of uncertainty in the real world, and successful entrepreneurs reap profits by bringing resources, costs, and prices further in the direction of equilibrium. But Schumpeter starts, not in the real world, but in the never-never land of general equilibrium which he insists is the fundamental reality. But in the equilibrium world of stasis and certainty there are no entrepreneurs and no profit. The *only* role for entrepreneurship, by logical deduction, is to innovate, to disrupt a preexisting equilibrium. The entrepreneur cannot adjust, because everything has already been adjusted. In a world of certainty, there is no room for the entrepreneur; only inflationary bank credit and innovation enable him to exist. His only prescribed role, therefore, is to be disruptive and innovative.

The entrepreneur, then, pays interest to the banks, interest for Schumpeter being a strictly monetary phenomenon. But where does the entrepreneur-innovator get the money to pay interest? Out of profits, profits that he will reap when the fruits of his innovation reach the market, and the new processes or products reap revenue from the consumers. Profits, therefore, are *only* the consequence of successful innovation, and interest is only a payment to inflationary banks out of profit.

Inflationary bank credit means, of course, a rise in prices, and also a redirection of resources toward the investment in innovation. Prices rise, followed by increases in the prices of factors, such as wages and land rents. Schumpeter has managed, though not very convincingly, to break out of the Walrasian box. But he has not finished his problem. For it is not enough for him to break out of his box; he must also get back in. As a dedicated Walrasian, he must return the economy to *another* general equilibrium state, for after all, by definition a real equilibrium is a state to which variables tend to return once they are replaced. How does the return take place?

For the economy to return to equilibrium, profits and interest must be evanescent. And innovation of course must also come to an end. How can this take place? For one thing, innovations must be discontinuous; they must only appear in discrete clusters. For if innovation were *continuous*, the economy would never return to the equilibrium state. Given this assumption of discontinuous clusters, Schumpeter found a way: When the innovations are "completed" and the new processes or new products enter the market, they outcompete the old processes and products, thereby reaping the profits out of which interest is paid. But these profits are made at the expense of severe losses for the old, now inefficient, firms or industries, which are driven to the wall. After a while, the innovations are completed, and the inexorable imputation process destroys all profits and therefore all interest, while the sudden losses to the old firms are also ended. The economy returns to the unchanging circular flow, and stays there until another cluster of innovations appears, whereupon the cycle starts all over again.

"Cycle" is here the operative term, for in working out the logical process of breakout and return, Schumpeter has at the same time seemingly developed a unique theory of the business cycle. Phase I, the breakout, looks very much like the typical boom phase of the business cycle: inflationary bank credit, rise in prices and wages, general euphoria, and redirection of resources to more investment. Then, the events succeeding the "completion" of the innovation look very much like the typical recession or depression: sudden severe losses for the old firms, retrenchment. And finally, the disappearance of both innovation and euphoria, and eventually of losses and disruption—in short, a return to a placid period which can be made to seem like the state of stationary equilibrium.

But Schumpeter's doctrine only *seems* like a challenging business cycle theory worthy of profound investigation. For it is not really a cycle theory at all. It is simply the only logical way that Schumpeter can break out and then return to the Walrasian box. As such, it is certainly an ingenious formulation, but it has no genuine connection with reality at all.

Even within his own theory, indeed, there are grave flaws. In the Walrasian world of perfect certainty (an assumption which is not relaxed with the coming of the innovator), how is it that the old firms wait until the "completion" of the innovation to find suddenly

that they are suffering severe losses? In a world of perfect knowledge and expectations, the old firms would know of their fate from the very beginning, and early take steps to adjust to it. In a world of perfect expectations, therefore, there would be no losses, and therefore no recession or depression phase. There would be no cycle as economists know it.

Finally, Schumpeter's constrained model can only work if innovations come in clusters, and the empirical evidence for such clusters is virtually nil.[11] In the real world, innovations occur all the time. Therefore, there is no reason to postulate any return to an equilibrium, even if it had ever existed in the past.

In conclusion, Schumpeter's theory of development and of business cycles has impressed many economists with his suggestive and seemingly meaningful discussions of innovation, bank credit, and the entrepreneur. He has seemed to offer far more than static Walrasian equilibrium analysis and to provide an economic dynamic, a theoretical explanation of cycles and of economic growth. In fact, however, Schumpeter's seemingly impressive system has no relation to the real world at all. He has not provided an economic dynamic; he has only found an ingenious but fallacious way of trying to break out of the static Walrasian box. His theory is a mere exercise in equilibrium logic leading nowhere.

It is undoubtedly at least a partial realization of this unhappy fact that prompted Schumpeter to expand his business cycle theory from his open-cycle model of the *Theory of Economic Development* of 1912 to his three-cycle schema in his two-volume *Business Cycles* nearly three decades later.[12] More specifically, Schumpeter saw that one of the problems in applying his model to reality was that if the length of the boom period is determined by the length of time required to "complete" the innovation and bring it to market, then how could his model apply to real life, where simultaneous innovations occur, each of which requires a different time for its completion? His later three-cycle theory is a desperate attempt to encompass such real-life

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[11]See Simon S. Kuznets, "Schumpeter's Business Cycles," *American Economic Review* (June 1940).

[12]Joseph A. Schumpeter, *Business Cycles: A Theoretical, Historical, and Statistical Analysis of the Capitalist Process*, 2 vols. (New York: McGraw-Hill, 1939).

problems. Specifically, Schumpeter has now postulated that the economy, instead of unitarily breaking out and returning to equilibrium, consists of three separate hermetically sealed, strictly periodic cycles—the "*Kitchin,*" the "*Juglar*," and the "*Kondratieff*"—each with the same innovation-inflation-depression characteristics. This conjuring up of allegedly separate underlying cycles, each cut off from the other, but all adding to each other to yield the observable results of the real world, can only be considered a desperate lapse into mysticism in order to shore up his original model.

In the first place, there are far more than three innovations going on at one time in the economy, and there is no reason to assume strict periodicity of each set of disparate changes. Indeed, there is no such clustering of innovations as would be required by the theory. Second, in the market economy, all prices and activities interact; there therefore can never be any hermetically sealed cycles. The multicycle scheme is an unnecessary and heedless multiplication of entities in flagrant violation of Occam's Razor. In an attempt to save the theory, it asserts propositions that cannot be falsifiable, since another cycle can always be conjured up to explain away anomalies.[13] In an attempt to salvage his original model, Schumpeter only succeeded in adding new and greater fallacies to the old.

In the years before and during World War II, the most popular dynamic theory of economic change was the gloomy doctrine of "secular stagnation" (or "economic maturity") advanced by Professor Alvin H. Hansen.[14] The explanation of the Great Depression of the 1930s, for Hansen, was that the United States had become mired in permanent stagnation, from which it could not be lifted by free market capitalism. A year or two after the publication of Keynes's *General Theory*, Hansen had leaped on the New Economics to become the leading American Keynesian; but secular stagnation, while giving

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[13]This does not mean that all propositions must be falsifiable; they can be self-evident or deduced from self-evident axioms. But no one can claim that the alleged Kitchin, Juglar, and Kondratieff cycles are in any sense self-evident.

[14]See Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York: W.W. Norton, 1941). For a clear summary statement of his position, see Hansen, "Economic Progress and Declining Population Growth," in *Readings in Business Cycle Theory,* Gottfried Haberler, ed. (Philadelphia: Blakiston, 1944), pp. 366–84.

Keynesianism a left-flavor, was unrelated to Keynesian theory. For Keynes, the key to prosperity or depression was private investment: flourishing private investment means prosperity; weak and fitful investment leads to depression. But Keynes was an agnostic on the investment question, whereas Hansen supplied his own gnosis. Private investment in the United States was doomed to permanent frailty, Hansen opined, because (1) the frontier was now closed; (2) population growth was declining rapidly; and (3) there would be hardly any further inventions, and what few there were would be of the capital-saving rather than labor-saving variety, so that total investment could not increase.

George Terborgh, in his well-known refutation of the stagnation thesis, *The Bogey of Economic Maturity*, concentrated on a statistical critique.[15] If the frontier had been "closed" since the turn of the century, why then had there been a boom for virtually three decades until the 1930s? Population growth too, had been declining for many decades. It was easy, also, to demolish the rather odd and audacious prediction that few or no further inventions, at least of the labor-saving variety, would ever more be discovered. Predictions of the cessation of invention, which have occurred from time to time through history, are easy targets for ridicule.

But Terborgh never penetrated to the fundamentals of the Hansen thesis. In an age beset by the constant clamor of population doomsayers and zero-population-growth enthusiasts, it is difficult to conjure up an intellectual climate when it seemed to make sense to worry about the *slowing* of population growth. But why, indeed, should Hansen have considered population growth as *ipso facto* a positive factor for the spurring of investment? And why would a slowing down of such growth be an impetus to decay? Schumpeter, in his own critique of the Hansen thesis, sensibly pointed out that population growth could easily lead to a fall in real income per capita.[16]

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[15]George Terborgh, *The Bogey of Economic Maturity* (Chicago: Machinery and Allied Products Institute, 1945).

[16]Schumpeter, *Business Cycles*, p. 74.

Ironically, however, Schumpeter did not recognize that Hansen, too, in his own way, was trying to break out of the Walrasian box. Hansen began implicitly (not explicitly like Schumpeter) with the circular flow and general equilibrium, and then considered the various possible factors that might change—or, more specifically, might increase. And these were the familiar Walrasian triad: land, labor, and technique. As Terborgh noted, Hansen had a static view of "investment opportunities." He treated them as if they were a limited physical entity, like a sponge. They were a fixed amount, and when that maximum amount was reached, investment opportunities were "saturated" and disappeared. The implicit Hansen assumption is that these opportunities could be generated only by increases in land, labor, and improved techniques (which Hansen limited to inventions rather than Schumpeterian innovations). And so the closing of the frontier meant the drying up of "land-investment opportunities", as one might call them, the slowing of population growth, the end of "labor-investment opportunities," leading to a situation where innovation could not carry the remaining burden.

And so Hansen's curious view of the economic effects of diminishing population growth, as gloomily empirical as it might seem, was not really an empirical generalization at all. Indeed, it said nothing about dynamic change or about the real world at all. The allegedly favorable effect of high population growth was merely the logical spinning out of Hansen's own unsuccessful variant of trying to escape from the Walrasian box.

# 15

# Professor Rolph on the Discounted Marginal Productivity Theory

Of current schools of economic thought, the most fashionable have been the econometric, the Keynesian, the institutionalist, and the neo-classic. "Neo-classic" refers to the pattern set by the major economists of the late nineteenth century. The dominant neoclassical strain at present is to be found in the system of Professor Frank Knight, of which the most characteristic feature is an attack on the whole concept of time preference. Denying time preference, and basing interest return solely on an alleged "productivity" of capital, the Knightians attack the doctrine of the *discounted* MVP and instead advocate a pure MVP theory. The clearest exposition of this approach is to be found in an article by a follower of Knight's, Professor Earl Rolph.[1]

Rolph defines "product" as any *immediate* results of "present valuable activities." These include work on goods that will be consumed only in the future. Thus, "workmen and equipment beginning the construction of a building may have only a few stakes in the ground to show for their work the first day, but this and not the completed structure is their immediate product. Thus, the doctrine that a factor receives the value of its marginal product refers to this immediate product. The simultaneity of production and product does not

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Originally a discussion in *Man, Economy, and State* (1962; Auburn, Ala.: Ludwig von Mises Institute, 1993), vol. 1, app. B, pp. 431–33.

[1]Earl Rolph, "The Discounted Marginal Productivity Doctrine" in *Readings in the Theory of Income Distribution*, W. Fellner and B.F. Haley, eds. (Philadelphia: Blakiston, 1946), pp. 278–93.

require any simplifying assumptions. It is a direct appeal to the obvious. Every activity has its immediate results."

Obviously, no one denies that people work on goods and move capital a little further along. But is the immediate result of this a *product* in any meaningful sense? It should be clear that the product is the end product—the good sold to the consumer. The whole purpose of the production system is to lead to final consumption. All the intermediate purchases are based on the expectation of final purchase by the consumer and would not take place otherwise. Every activity may have its immediate "results," but they are not results that would command any monetary income from anyone if the owners of the factors themselves were joint owners of all they produced until the final consumption stage. In that case, it would be obvious that they do not get paid immediately; hence, their product is not immediate. The only reason that they *are* paid immediately (and even here there is not strict immediacy) on the market is that capitalists advance present goods in exchange for those *future* goods for which they expect a premium, or interest return. Thus, the owners of the factors are paid the *discounted* value of their marginal product.

The Knight-Rolph approach, in addition, is a retreat to a real-cost theory of value. It assumes that present efforts will somehow always bring present results. But when? In "present valuable activities." But how do these activities *become* valuable? Only if their *future product* is sold, as expected, to consumers. Suppose, however, that people work for years on a certain good and are paid by capitalists, and then the final product is not bought by consumers. The capitalists absorb monetary losses. Where was the immediate payment according to marginal product? The payment was only an investment in future goods by capitalists.

Rolph then turns to another allegedly heinous error of the discount approach, namely, the "doctrine of *noncoordination of factors*." This means that some factors, in their payment, receive the *discounted* value of their product and some do not. Rolph, however, is laboring under a misapprehension; there is no assumption of noncoordination in any sound discounting theory. As we have stated above, *all* factors—land, and capital goods—receive their discounted marginal value product. The difference in regard to the owners of capital goods is that, in the ultimate analysis, they do not

receive any *independent* payment, since capital goods are resolved into the factors that produced them, ultimately land and labor factors, and to interest for the time involved in the advance of payment by the capitalists.[2] Rolph believes that noncoordination is involved because owners of land and labor factors "receive a discounted share," and capital "receives an undiscounted share." But this is a faulty way of stating the conclusion. Owners of land and labor factors receive a discounted share, but owners of capital (money capital) receive *the discount*.

The remainder of Rolph's article is largely devoted to an attempt to prove that no time lag is involved in payments to owners of factors. Rolph assumes the existence of "production centers" within every firm, which, broken down into virtually instantaneous steps, produce and then implicitly receive payment instantaneously. This tortured and unreal construction misses the entire point. Even if there were atomized "production centers," the point is that some person or persons will have to make advances of present money along the route, in whatever order, until the final product is sold to the consumers. Let Rolph picture a production system, atomized or integrated as the case may be, with no one making the advances of present goods (money capital) that he denies exist. And as the laborers and landowners work on the intermediate products for years without pay, until the finished product is ready for the consumer, let Rolph

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[2]Rolph ascribes this error to Knut Wicksell, but such a confusion is not attributable to Wicksell, who engages in a brilliant discussion of capital and the production structure and the role of time in production. Wicksell demonstrates correctly that labor and land are the only ultimate factors, and that therefore the marginal productivity of capital goods is reducible to the marginal productivity of labor and land factors, so that money capital earns the interest (or discount) differential.

Wicksell's discussion of these and related issues is of basic importance. He recognized, for example, that capital goods are fully and basically coordinate with land and labor factors *only from the point of view of the individual firm*, but not when we consider the total market in all of its interrelations. Current economic theorizing is, to its detriment, even more preoccupied than writers of his day with the study of an isolated firm instead of the interrelated market. Wicksell, *Lectures on Political Economy* (London: Routledge and Kegan Paul, 1934), vol. 1, pp. 148–54, 185–95.

exhort them not to worry, since they have been implicitly paid simultaneously as they worked. For this is the logical implication of the Knight-Rolph position.[3]

[3]Rolph ends his article, consistently, with a dismissal of any time-preference influences on interest, which he explains in Knightian vein by the "cost" of producing new capital goods.

# 16

# Professor Kirzner on Entrepreneurship

Since I admittedly know more about Austrian economic theory than about Richard Cantillon, I would like to focus my comments on the Austrian aspects of Professor Hébert's paper, in particular his discussion of entrepreneurship. Hébert is correct in his discussion of the differences between Mises's and Kirzner's concept of the entrepreneur and in his critique of the Kirzner approach.

Mises conceives of the entrepreneur as the uncertainty-bearer, who receives profits to the degree that he can successfully forecast the future, and suffers losses to the extent that his forecasting goes awry. One evident case of rewards in proportion to the success of forecasting is the stock or commodity market. The stock or commodity speculator, furthermore, clearly suffers losses to the extent that his forecasting is significantly less accurate than that of his fellow speculators. But Mises points out that the market as a whole is in the same situation as the stock or commodity market. The entrepreneur who buys raw material and hires labor, and who thereby incurs costs in order to produce a future product, is expecting that he will be able to sell the product to customers for a revenue greater than the costs. Just as the stock speculator purchases stock in the hope and the expectation that it will rise in price, so the employer incurs costs in the expectation that he will be able to sell the product at a greater price.

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To Kirzner, on the other hand, entrepreneurship becomes reduced to the quality of *alertness*; and uncertainty seems to have little to do with the matter. In his lectures, Kirzner likes to stress the analogy that the entrepreneur is a person who, upon seeing a $10 bill in front of his nose, is alert to the existence of the money and leaps to grab it. The alert man will grab the $10 note rapidly; the less alert will take longer to see his opportunity and to take advantage of it. One problem, as Hébert mentions, is that it is difficult to account for actual *losses*; for the worst that can happen to the non-alert sluggard is that he misses his opportunity for gaining $10. But how then does it ever come about that he actually *loses* ten or more dollars? Moreover, by stressing alertness, Kirzner is emphasizing a quality of perception, of perceiving an opportunity that virtually exists, as a real *thing* out there. In reality, however, any profit opportunity is uncertain, and rather than be a real existing entity, it must always be subject to uncertainty. It is never as simple as mere alertness.

Take the case of perhaps the best fictional portrayal of the entrepreneurial function, Somerset Maugham's short story, *The Verger*. In this story, the illiterate verger of a church in London is fired for not being able to read or write. Walking down the street looking for a cigarette for consolation, he observes that he cannot find a tobacconist in the neighborhood, and so he decides to invest his severance pay in setting up a tobacconist shop. This comes close to the Kirzner model of "perceived opportunity," of being alert to a gap in the services provided by the market. But even here, matters were not that simple. The verger, after all, had to forecast costs and revenues, and he could well have suffered losses if his forecasting had erred greatly. The need for a tobacconist could have withered from a change of smoking habits, from a new store entering the neighborhood at the same time, or whatever.

Even Kirzner's best case, the arbitrageur, is subject to uncertainty, a point which Hébert overlooks. The arbitrageur can perceive that a product sells for one price at one place and at a higher price somewhere else, and therefore buy in the first place to sell in the second. But he'd better be cautious. The transactions are not instantaneous, and something might occur in the interim to change the seemingly certain profits into losses. It is, after all, possible that the other entrepreneurs, far from purblind to the profit opportunity lying await for arbitrage, know something which our would-be arbitrageur

does not. At any rate, he might be better advised to look before he leaps. Surely, *some* arbitrageurs in the history of the world have suffered losses.

As Hébert points out, Mises applies the concept of entrepreneur to all cases of uncertainty-bearing, and since laborers face uncertainty in deciding where to move or what occupation to go into, laborers are also entrepreneurs. But the most important case of entrepreneurship, the driving force in shaping the actual structure and patterns of production in the market economy, are the capitalist-entrepreneurs, the ones who commit and risk their capital in deciding when, what, and how much to produce. The capitalists, too, are far more subject to actual monetary losses than are the laborers.

Kirzner's entrepreneur is a curious formulation. He need not, apparently, risk anything. He is a free-floating wraith, disembodied from real objects. He does not, and need not, possess any assets. All he need have to earn profits is a faculty of alertness to profit opportunities. Since he need not risk any capital assets to meet the chancy fate of uncertainty, he *cannot* suffer any losses. But if the Kirznerian entrepreneur owns no assets, then how in the world does he earn profits? Profits, after all, are simply the other side of the coin of an increase in the value of one's capital; losses are the reflection of a loss in capital assets. The speculator who expects a stock to rise uses money to purchase that stock; a rise or fall in the price of stock will raise or lower the value of the stock assets. If the price rises, the profits are one and the same thing as the increase in capital assets. The process is more complex but similar in the purchase or hiring of factors of production, the creating of a product and then its sale on the market. In what sense can an entrepreneur ever make profits if he owns no capital to make profits on?

For example, I might have a brilliant idea on how to make a profit on the market. I might be keenly alert to a profit opportunity virtually lying at my feet. I may have a sure tip on the stock market. But if I haven't got any money to invest, the profits, perceived opportunity or not, will simply not be made. Entrepreneurial ideas without money are mere parlor games until the money is obtained and committed to the projects.

One Kirznerian reply to such criticisms is that the entrepreneur need not own any assets, need not be a capitalist, if he can induce other people with money to invest in his idea.

But this reply is unsatisfactory. Let us consider two possible such cases. In one example, I, with a brilliant entrepreneurial idea, sell that idea to someone with money; we invest in that project, with him putting up all the money and letting me be a junior partner because I contributed the idea. He keeps, say, 80 percent of the shares, and gives me the other 20 percent. But the Kirznerian Concept is now contradicted. In the first place, the moneyed man, risking his own assets in the firm, has thereby *become* an entrepreneur. The employer who spends his capital and hopes for a profitable return *is* an entrepreneur, an uncertainty-bearer, and he is also to the same extent a capitalist, since that is the extent of assets that he is risking. But there is more to the problem than this. For I might have begun as a free-floating wraith, as a man with an idea and no assets. But because of my contract with the moneyed investor, I have now *become* a capitalist, since I now own assets to the amount of 20 percent of the firm. In other words, there are here two fundamental and fatal flaws in Kirzner's notion of the alert idea man as the entrepreneur: one, that the capitalist is *also* an entrepreneur, and two, that the pure idea man has, willy nilly, become a capitalist.

The second possible case of the entrepreneur financing his project at first blush looks more favorable for Kirzner's doctrine. The pure idea man induces a capitalist to *lend* him all the money he needs to invest in his idea. The entrepreneur takes the loaned funds and sets up his business, investing in the new idea, and hoping for profits. But, once again, the Kirzner concept is contradicted. For the idea man has still become a capitalist-owner; for he now owns all the assets of the new company, even though they may be mortgaged to the hilt in loans from his backer.

The former idea man has once again, willy nilly, become an asset-owner, a capitalist. He owns the equipment and the raw material, he owns the product before sale, and he owns the money acquired from sale. He will suffer losses if the revenues do not meet expectations. It is true that he will have to share any profits with the lender by paying him interest. But the lender, though his interest return is fixed, is still partly an entrepreneur. For while his return is fixed, it is by no means certain, and if the idea fails and the firm goes bankrupt, the capitalist's money has been lost. So that he, too, still shares the entrepreneurial function with the idea man.

It might be said that, in this case at least, the idea man can lose no money because all the money was loaned to him by the capitalist. But, as in the first case where he received assets as a gift from his partner, the entrepreneur, by borrowing money, soon *became* a capitalist and asset owner. The man who borrows $1 million and then buys $1 million worth of assets is now someone risking that million, and he loses his share of the assets if he suffers insolvency. Furthermore, his interest payment is now a net loss to him. Aside from the interest due, it is true that he will not be monetarily worse than he was at the beginning, when he had the idea. But he will be monetarily poorer than he was while he owned the new plant. An employer-entrepreneur must be a capitalist; *at what time* he became a capitalist and asset owner is irrelevant to the theory.

If I may engage in a bit of sociology of knowledge, I think I can explain why Kirzner has deviated so sharply from the main Misesian line. In the first place, there is a certain uncharacteristic lack of clarity in Mises's discussion of entrepreneurship. While Mises basically links the capitalist and entrepreneur together in uncertainty-bearing, there are passages in his *Human Action* which treat the entrepreneur as an entirely separate entity, and not just as the forecasting aspect of the activities of the capitalist or laborer. In other words, there is a certain amount of textual justification in Mises for the Kirzner turn—justification which did not exist in Böhm-Bawerk, where the entrepreneur is clearly the capitalist and there is no possibility of such separation. On the other hand, Böhm-Bawerk did not develop the theory of profits, losses, and uncertainty to any extent, which had to wait for Mises, who grounded himself on Frank Knight as well as the other Austrians.

But, second and I think more important, Kirzner developed his theory of entrepreneurial alertness I believe in reaction to the opposite deviation from main-line Misesianism introduced into the Austrian arena by Ludwig M. Lachmann. Becoming a disciple of G.L.S Shackle, Lachmann, and following him other younger Austrians, maintains not only that uncertainty is pervasive on the market, but also that we cannot even say that the market contains a tendency toward equilibrium, a tendency fueled by the profit-and-loss signals of the market. To Lachmann, expectations and therefore actions on the market are random, rather than responsive to market signals. It is one thing to say, with Mises and his followers, and in contrast to

the neoclassical economists, that equilibrium does not and can never exist on the market. It is quite another thing to say that the market does not even harbor equilibrating tendencies.

The upshot is really the scrapping of economic theory altogether, and the Lachmannian economist becomes a mere institutionalist and historian, recording past choices and trends. There is no question that Mises would have called such a doctrine *anti*economics. I believe that it was in horrified reaction to this Lachmannian nihilism that Professor Kirzner sought a way to downplay uncertainty and to make his entrepreneur a more tangible and objective entity earning tangible profits on the market. In the dialectic of the history of thought, it is a common occurrence for one deviation from the main line of theory to give rise to a deviation in the opposite direction. Since I believe the Mises-Hayek mainline position to be the correct one on this issue, I can only hope that these deviations will in effect cancel each other out and that Austrian thought will return to its own mainstream position.

Next, Professor Hébert mentions Schumpeter's theory of entrepreneurship, and contrasts it to the Misesian position. But while it is true that Schumpeter was trained in Böhm-Bawerk's seminar in Vienna at the same time as Mises, he early shifted to a Walrasian position. Being a Walrasian, Schumpeter had to believe that general equilibrium is a living reality, an existing state of affairs, at least part of the time. But if the world is in general equilibrium, how do business cycles or growth and development emerge?

Schumpeter's *Theory of Economic Development* was a fascinating, though ill-conceived, attempt to derive a theory of the business cycle and economic growth from a Walrasian general equilibrium starting-point. According to Walras, tastes, technology, and resources were given in general equilibrium. If we begin with the economy in that equilibrium state, therefore, any change from that state must occur in at least one of these variables. To Schumpeter, as to other neoclassical economists, tastes could not be the changing element. Tastes he regarded as basically fixed; certainly they could not be the driving force of economic change. Total supply of resources didn't change very frequently either. So Schumpeter was left with innovation in technology as the only possible motor force for any change, be it business cycles or economic development. But then Schumpeter was confronted with a problem: how would these innovations be financed?

Not out of new savings, since tastes were given, and since by definition net savings are zero in equilibrium. Not out of profits, since by definition profits are zero in equilibrium. One way out might have been finance out of interest returns, since according to Austrian theory, savings, the result of positive time preference, are positive even in equilibrium. But Schumpeter had rejected the concept of time preference, so he was left with interest and profits both being zero in equilibrium. The result was that Schumpeter had trapped himself in a Walrasian box: the only conceivable way by which new investment, which had to be in innovations, could be financed was by the creation of new money. This meant that only inflationary bank credit could finance economic development.

In short, because Schumpeter believed in the real existence of Walrasian general equilibrium, and since he boxed himself into the position that only inflationary bank credit could finance innovations, some important consequences necessarily followed. Since general equilibrium is by definition a world of perfect knowledge and certainty, and since that world of endlessly unchanging rounds of activity has no room for entrepreneurship, it followed automatically that the only entrepreneurial function could be disruption of equilibrium. Entrepreneurs could not make any adjustments, since in the fixed and certain world of general equilibrium, there is nothing to adjust.

Second, it followed that entrepreneurial profits could only redound to the innovators, and that interest is the return on inflationary bank loans. Economic development, and the inflationary boom, a boom sparked by bank credit to innovations, had begun. But if the economy begins in Walrasian equilibrium, it had to return there, otherwise equilibrium is only relevant to one originating point of the economic process. Equilibrium cannot be a real entity unless a strong tendency exists to return to that state, once dislodged. So to maintain his Walrasianism in dealing with economic change, Schumpeter had to come up with the business cycle; the depression would have to be the mechanism by which the economy returned to the general equilibrium state. Schumpeter found the mechanism of that return in the alleged moment in which the new products or new equipment are finally produced and poured onto the market; the advent of the new products, Schumpeter theorized, outcompeted the older firms and drove them into bankruptcy. The losses imposed on the older firms constituted the depression phase of the cycle.

It was an ingenious schema, but with many grave flaws. Apart from the fact that there is no evidence that booms are confined to innovations or recessions to older processes (which forced Schumpeter to confuse matters still more with a multi-cycle schema two decades later), one wonders why in a Walrasian world of perfect certainty—or, indeed, in the real world of reasonably astute entrepreneurs—the older firms had to wait for the shock of the influx of new products. Why couldn't they foresee the moment much earlier and take precautionary measures?

But the major problem is fundamental and methodological. Schumpeter's business cycle theory and his theory of growth are, for all their suggestiveness, not positive theories of the real world at all; they are simply ways by which slavish adherence to Walrasian categories boxed Schumpeter in and forced him into his conclusions. In a sense, this was theory by default.[1]

The Schumpeter case highlights the true nature of Austrian economics and Austrian methodology. Austrian economics has generally been dismissed as extreme *a priorism*, cut off from the empirical data of the real world. The true situation is exactly the opposite. Austrian theory ruthlessly confines itself to an analysis of real life in the real world. It avoids abstract and unreal "models" and theoretical boxes. It shuns false assumptions and premises. It rests its deductive theoretical structures squarely on empirically grounded general axioms. Methodologically, it is far closer to classical economics than is the current Walrasian orthodoxy.

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[1]For a development of this theme, see "Breaking Out of the Walrasian Box: The Cases of Schumpeter and Hansen," *Review of Austrian Economics* 1 (1987): 97–108; included in this volume as chapter 14.

# 17

# Toward a Reconstruction of Utility and Welfare Economics

Individual valuation is the keystone of economic theory. For, fundamentally, economics does not deal with things or material objects. Economics analyzes the logical attributes and consequences of the existence of individual valuations. "Things" enter into the picture, of course, since there can be no valuation without things to be valued. But the essence and the driving force of human action, and therefore of the human market economy, are the valuations of individuals. Action is the result of choice among alternatives, and choice reflects values, that is, individual preferences among these alternatives.

Individual valuations are the direct subject matter of the theories of utility and of welfare. Utility theory analyzes the laws of the values and choices of an individual; welfare theory discusses the relationship between the values of many individuals, and the consequent possibilities of a scientific conclusion on the "social" desirability of various alternatives.

Both theories have lately been foundering in stormy seas. Utility theory is galloping off in many different directions at once; welfare theory, after reaching the heights of popularity among economic theorists, threatens to sink, sterile and abandoned, into oblivion.

The thesis of this paper is that both related branches of economic theory can be salvaged and reconstructed, using as a guiding principle of both fields the concept of "demonstrated preference."

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## Demonstrated Preference

### *A Statement of the Concept*

Human action is the use of means to arrive at preferred ends. Such action contrasts to the observed behavior of stones and planets, for it implies purpose on the part of the actor. Action implies choice among alternatives. Man has means, or resources, which he uses to arrive at various ends; these resources may be time, money, labor energy, land, capital goods, and so on. He uses these resources to attain his most preferred ends. From his action, we can deduce that he has acted so as to satisfy his most highly valued desires or preferences.

The concept of *demonstrated preference* is simply this: that actual choice reveals, or demonstrates, a man's preferences; that is, that his preferences are deducible from what he has chosen in action. Thus, if a man chooses to spend an hour at a concert rather than a movie, we deduce that the former was preferred, or ranked higher on his value scale. Similarly, if a man spends five dollars on a shirt we deduce that he preferred purchasing the shirt to any other uses he could have found for the money. This concept of preference, rooted in real choices, forms the keystone of the logical structure of economic analysis, and particularly of utility and welfare analysis.

While a similar concept played a role in the writings of the early utility economists, it had never received a name, and it therefore remained largely undeveloped and unrecognized as a distinct concept. It was generally discarded in the 1930s, before it had even achieved recognition. This view of preference as derived from choice was present in varying degree in the writings of the early Austrian economists, as well as in the works of Jevons, Fisher, and Fetter. Fetter was the only one who clearly employed the concept in his analysis. The clearest and most thorough formulation of the concept has been the works of Professor Mises.[1]

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[1]See Alan R. Sweezy, "The Interpretation of Subjective Value Theory in the Writings of the Austrian Economists," *Review of Economic Studies* (June 1934): 176–85, for an historical survey. Sweezy devotes a good part of the article to a criticism of Mises as the leading exponent of the demonstrated preference approach. For Mises's views, see *Human Action* (New

### *Positivism and the Charge of Tautology*

Before developing some of the applications of the demonstrated preference principle to utility and welfare theory, we must consider the methodological objections that have been levelled against it. Professor Alan Sweezy, for example, seizes on a sentence of Irving Fisher's which very succinctly expressed the concept of demonstrated preference: "Each individual acts as he desires." Sweezy is typical of the majority of present-day economists in not being able to understand how such a statement can be made with absolute validity. To Sweezy, insofar as it is not an empirically testable proposition in psychology, such a sentence must simply reduce to the meaningless tautology: "each individual acts as he acts."

This criticism is rooted in a fundamental epistemological error that pervades modern thought: the inability of modern methodologists to understand how economic science can yield substantive truths by means of logical deduction (that is, the method of "praxeology"). For they have adopted the epistemology of positivism (now dubbed "logical empiricism" or "scientific empiricism" by its practitioners), which uncritically applies the procedures appropriate in physics to the sciences of human action.[2]

In physics, simple facts can be isolated in the laboratory. These isolated facts are known directly, but the laws to explain these facts are not. The laws may only be hypothecated. Their validity can only be determined by logically deducing consequents from them which can be verified by appeal to the laboratory facts. Even if the laws explain the facts, however, and their inferences are consistent with them, the laws of physics can never be *absolutely* established. For some other law may prove more elegant or capable of explaining a wider range of facts. In physics, therefore, postulated explanations have to be hypothecated in such a way that they or their consequents can be empirically tested. Even then, the laws are only tentatively rather than absolutely valid.

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Haven, Conn.: Yale University Press, 1949), pp. 94–96, 102–03; *Theory of Money and Credit* (1912, 3rd ed; New Haven, Conn.: Yale University Press, 1951), pp. 46ff. Also see Frank A. Fetter, *Economic Principles* (New York: The Century Co., 1915), pp. 14–21.

[2]See the methodological treatises of Kaufman, Hutchison, Souter, Stonier, Myrdal, Morgenstern, *and so on*.

In human action, however, the situation is reversed. There is here no laboratory where "facts" can be isolated and broken down into their simple elements. Instead, there are only historical "facts" which are complex phenomena, resultants of many causal factors. These phenomena must be explained, but they cannot be isolated or used to verify or falsify any law. On the other hand, economics, or praxeology, has full and complete knowledge of its original and basic axioms. These are the axioms *implicit in the very existence of human action*, and they are absolutely valid so long as human beings exist. But if the axioms of praxeology are absolutely valid for human existence, then so are the consequents which can logically be deduced from them. Hence, economics, in contrast to physics, can derive absolutely valid substantive truths about the real world by deductive logic. The axioms of physics are only hypothecated and hence subject to revision; the axioms of economics are already known and hence absolutely true.[3] The irritation and bewilderment of positivists over the "dogmatic" pronouncements of praxeology stem, therefore, from their universal application of methods proper only to the physical sciences.[4]

The suggestion has been made that praxeology is not really scientific, because its logical procedures are verbal ("literary") rather than mathematical and symbolic.[5] But mathematical logic is uniquely appropriate to physics, where the various logical steps along the way are not in themselves meaningful; for the axioms and therefore the

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[3]On the methodology of praxeology and physics, see Mises, *Human Action*, and F.A. Hayek, *The Counter Revolution of Science* (Glencoe, Ill.: The Free Press, 1952), pt 1.

[4]It is even dubious that positivists accurately interpret the proper methodology of physics itself. On the widespread positivist misuse of the Heisenberg Uncertainty Principle in physics as well as in other disciplines, cf. Albert H. Hobbs, *Social Problems and Scientism* (Harrisburg, Penn.: The Stackpole Co., 1953), pp. 220–32.

[5]For a typical suggestion, cf. George J. Schuller, "Rejoinder," *American Economic Review* (March 1951): 188. For realization that mathematical logic is essentially subsidiary to basic verbal logic, cf. the remarks of André Lalande and René Poirier, on "Logique" and "Logistique," in André Lalande, ed., *Vocabulaire téchnique et critique de la philosophie*, 6th ed. (Paris: Presses Universitaires de France, 1951), pp. 574, 579.

deductions of physics are in themselves meaningless, and only take on meaning "operationally," insofar as they can explain and predict given facts. In praxeology, on the contrary, the axioms themselves are known as true and are therefore meaningful. As a result, each step-by-step deduction is meaningful and true. Meanings are far better expressed verbally than in meaningless formal symbols. Moreover, simply to translate economic analysis from words into symbols, and then to retranslate them so as to explain the conclusions, makes little sense, and violates the great scientific principle of Occam's Razor that there should be no unnecessary multiplication of entities.

The crucial concept of the positivists, and the one that forms the basis for their attack on demonstrated preference, is that of "operational meaning." Indeed, their favorite critical epithet is that such and such a formulation or law is "operationally meaningless."[6] The test of "operationally meaningful" is derived strictly from the procedures of physics as outlined above. An explanatory law must be framed so that it can be tested and found empirically false. Any law which claims to be absolutely true and not empirically capable of being falsified is therefore "dogmatic" and operationally meaningless—hence, the positivist's view that if a statement or law is not capable of being falsified empirically, it must simply be a tautologous definition. And consequently, Sweezy's attempted reduction of Fisher's sentence to a meaningless identity.[7]

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[6]Paul Samuelson has added the weight of his authority to Sweezy's criticism of Mises and demonstrated preference, and has couched his endorsement in terms of "operational meaning." Samuelson explicitly rejects the idea of a *true* utility theory in favor of one that is merely hypothetical. See Paul A. Samuelson, "The Empirical Implications of Utility Analysis," *Econometrica* (1938): 344ff.; and Samuelson, *Foundations of Economic Analysis* (Cambridge, Mass.: Harvard University Press, 1947), pp. 91–92.

The concept of operational meaning was originated by the physicist Percy W. Bridgman explicitly to explain the methodology of physics. Cf. Bridgman, *The Logic of Modern Physics* (New York: Macmillan, 1927). Many founders of modern positivism, such as Mach and Boltzmann, were also physicists.

[7]The heros of positivism, Rudolf Carnap and Ludwig Wittgenstein, disparaged deductive inference as merely drawing out "tautologies" from the axioms. Yet all reasoning is deductive, and this process is peculiarly vital to

Sweezy objects that Fisher's "each man acts as he desires" is circular reasoning, because action implies desire, and yet desires are not arrived at independently, but are only discoverable through the action itself. Yet this is not circular. For desires exist by virtue of the concept of human action and of the existence of action. It is precisely the characteristic of human action that it is motivated by desires and ends, in contrast to the unmotivated bodies studied by physics. Hence, we can say validly that action is motivated by desires and yet confine ourselves to deducing the *specific* desires from the real actions.

### *Professor Samuelson and "Revealed Preference"*

"Revealed preference"—preference revealed through choice—would have been an apt term for our concept. It has, however, been preempted by Samuelson for a seemingly similar but actually quite different concept of his own. The critical difference is this: Samuelson assumes the existence of an underlying preference scale that forms the basis of a man's actions and that remains constant in the course of his actions over time. Samuelson then uses complex mathematical procedures in an attempt to "map" the individuals preference scale on the basis of his numerous actions.

The prime error here is the assumption that the preference scale remains constant over time. There is no reason whatever for making any such assumption. All we can say is that an action, at a specific point of time, reveals part of a man's preference scale *at that time*. There is no warrant for assuming that it remains constant from one point of time to another.[8]

The "revealed preference" theorists do not recognize that they are assuming constancy; they believe that their assumption is simply that of *consistent* behavior, which they identify with "rationality." They will admit that people are not always "rational," but uphold

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arriving at truth. For a critique of Carnap and Wittgenstein, and a demonstration that inference is not merely identity to "tautology," cf. Lalande, "Tautoglie," in *Vocabulaire*, pp. 1103–04.

[8]Samuelson's analysis suffers from other errors as well, such as the use of invalid "index number" procedures. On the theoretical fallacies of index numbers, cf. Mises, *Theory of Money and Credit*, pp. 187–94.

their theory as being a good first approximation or even as having normative value. However, as Mises has pointed out, *constancy* and *consistency* are two entirely different things. Consistency means that a person maintains a transitive order of rank on his preference scale (if A is preferred to B and B is preferred to C, then A is preferred to C). But the revealed preference procedure does not rest on this assumption so much as on an assumption of *constancy*—that an individual maintains the same value scale over time. While a violation of the former might be called irrational, there is certainly nothing irrational about someone's value scales changing through time. Hence, no valid theory can be built on a constancy assumption.[9]

One of the most absurd procedures based on a constancy assumption has been the attempt to arrive at a consumer's preference scale not through observed real action, but through quizzing him by questionnaires. *In vacuo*, a few consumers are questioned at length on which abstract bundle of commodities they would prefer to another abstract bundle, and so on. Not only does this suffer from the constancy error, no assurance can be attached to the mere questioning of people when they are not confronted with the choices in actual practice. Not only will a person's valuation differ when talking about them from when he is actually choosing, but there is also no guarantee that he is telling the truth.[10]

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[9]See Mises, *Human Action*, pp. 102–03. Mises demonstrates that Wicksteed and Robbins committed a similar error.

[10]It is to Samuelson's credit that he rejects the questionnaire approach. Professors Kennedy and Keckskemeti, for different reasons, defend the questionnaire method. Kennedy simply says, rather illogically, that *in vacuo* procedures are being used anyway, when the theorist states that *more* of a good is preferred to *less*. But this is not *in vacuo*; it is a conclusion based on the praxeological knowledge that since a *good* is any object of action, more must be preferred to less while it remains a good. Kennedy is wrong, therefore, when he asserts that this is a circular argument, for the fact that action exists is not "circular."

Keckskemeti actually asserts that the questionnaire method is preferable to observing behavior in discovering preferences. The basis of his arguments is a spurious dichotomy between utility and ethical valuations. Ethical valuations may be considered either as identical with, or a subset of, utility judgments, but they can not be separated.

The bankruptcy of the revealed-preference approach has never been better portrayed than by a prominent follower, Professor Kennedy. Says Kennedy: "In what respectable science would the assumption of consistency (that is, constancy) be accepted for one moment?"[11] But he asserts it must be retained anyway, else utility theory could not serve any useful purpose. The abandonment of truth for the sake of a spurious usefulness is a hallmark of the positivist-pragmatist tradition. Except for certain auxiliary constructions, it should be clear that the false cannot be useful in constructing a true theory. This is particularly the case in economics, which is explicitly built on *true* axioms.[12]

### *Psychologizing and Behaviorism: Twin Pitfalls*

The revealed-preference doctrine is one example of what we may call the fallacy of "psychologizing," the treatment of preference scales as if they existed as separate entities apart from real action. Psychologizing is a common error in utility analysis. It is based on the assumption that utility analysis is a kind of "psychology," and that, therefore, economics must enter into psychological analysis in laying the foundations of its theoretical structure.

Praxeology, the basis of economic theory, differs from psychology, however. Psychology analyzes the *how* and the *why* of people forming values. It treats the concrete content of ends and values. Economics, on the other hand, rests simply on the assumption of the *existence* of ends, and then deduces its valid theory from such a

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Cf. Charles Kennedy, "The Common Sense of Indifference Curves," *Oxford Economic Papers* (January 1950): 123–31; Kenneth J. Arrow, "Review of Paul Keckskemeti's *Meaning, Communication, and Value*," *Econometrica* (January 1955): 103.

[11]Kennedy, "The Common Sense of Indifference Curves." Kennedy's article furnishes the best brief explanation of the revealed-preference approach.

[12]This error again stems from physics, where such assumptions as absence of friction are useful as first approximations—to *known* facts from *unknown* explanatory laws! For a refreshing skepticism on the value of false axioms, cf. Martin Bronfenbrenner, "Contemporary Economics Resurveyed," *Journal of Political Economy* (April 1953).

general assumption.[13] It therefore has nothing to do with the content of ends or with the internal operations of the mind of the acting man.[14]

If psychologizing is to be avoided, so is the opposite error of *behaviorism*. The behaviorist wishes to expunge "subjectivism," that is, motivated action, completely from economics, since he believes that any trace of subjectivism is unscientific. His ideal is the method of physics in treating observed movements of unmotivated, inorganic matter. In adopting this method, he throws away the subjective knowledge of action upon which economic science is founded; indeed, he is making any scientific investigation of human beings impossible. The behaviorist approach in economics began with Cassel, and its most prominent modern practitioner is Professor Little. Little rejects the demonstrated preference theory because it assumes the existence of preference. He glories in the fact that, in his analysis, the maximizing individual "at last disappears" which means, of course, that economics disappears as well.[15]

The errors of psychologizing and of behaviorism have in common a desire by their practitioners to endow their concepts and procedures with "operational meaning," either in the areas of observed behavior or in mental operations. Vilfredo Pareto, perhaps the founder of an explicitly positivist approach in economics, championed both errors. Discarding a demonstrated preference approach as "tautologous," Pareto, on the one hand, sought to eliminate subjective preferences from economics and, on the other, to investigate and

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[13]The axiom of the existence of ends may be considered a proposition in philosophical psychology. In that sense, praxeology is grounded in psychology, but its development then completely diverges from psychology proper. On the question of purpose, praxeology takes its stand squarely with the Leibnizian tradition of philosophical psychology as opposed to the Lockean tradition upheld by positivists, behavorists, and associationists. For an illuminating discussion of this issue, cf. Gordon W. Allport, *Becoming* (New Haven, Conn.: Yale University Press, 1955), pp. 6–17.

[14]Thus, the law of diminishing marginal utility does not at all rest on some postulated psychological law of satiety of wants, but on the praxeological truth that the first units of a good will be allocated to the most valuable uses, the next units to the next-most valuable uses, and so on.

[15]I.M.D. Little, "A Reformulation of the Theory of Consumers' Behavior," *Oxford Economic Papers* (January 1949): 90–99.

measure preference scales apart from real action. Pareto was, in more ways than one, the spiritual ancestor of most current utility theorists.[16,17]

### *A Note on Professor Armstrong's Criticism*

Professor Armstrong has delivered a criticism of the revealed-preference approach which he would undoubtedly apply to demonstrated preference as well. He asserts that when more than one commodity is being ranked, individual preference scales cannot be unitary, and we cannot postulate the ranking of the commodities on one scale.[18] On the contrary, it is precisely the characteristic of a deduced preference scale that it is unitary. Only if a man ranks two alternatives as more and less valuable on one scale can he choose between them. Any of his means will be allocated to his more preferred use. Real choice therefore always demonstrates relevant preferences ranked on a unitary scale.

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[16]Vilfredo Pareto, "On the Economic Phenomenon," *International Economic Papers* 3 (1953): 188–94. For an excellent rebuttal, cf. Benedetto Croce, "On the Economic Principle, Parts I and II," ibid., pp. 175–76, 201. The famous Croce-Pareto debate is an illuminating example of early debate between praxeologic and positivist views in economics.

[17]Vivian C. Walsh is an interesting current example of the combinations of both types of error. On the one hand, he is an extreme behaviorist, who refuses to recognize that any preferences are relevant to, or can be demonstrated by, action. On the other hand, he also takes the extreme psychologizing view that psychological states *per se* can be directly observed. For this, he falls back on "common sense." But this position fails because Walsh's psychological "observations" are *ideal types* and not analytic categories. Thus, Walsh says that: "saying that someone is a smoker is different from saying that he is smoking now," upholding the former type of statement for economics. But such statements are historical ideal types, relevant to history and psychology, but not to economic analysis. Cf. Vivian C. Walsh, "On Descriptions of Consumers' Behavior," *Economica* (August 1954): 244–52. On ideal types and relation to praxeology, cf. Mises, *Human Action*, pp. 59–64.

[18]Wallace E. Armstrong, "A Note on the Theory of Consumer's Behavior," *Oxford Economic Papers* (January 1950): 199ff. On this point, cf. Little's rebuttal, in I.M.D. Little, "The Theory of Consumer's Behavior—A Comment," ibid., pp. 132–35.

## UTILITY THEORY

Utility theory, over the last generation, has been split into two warring camps: (1) those who cling to the old concept of cardinal, measurable utility, and (2) those who have thrown over the cardinal concept, but have dispensed with the utility concept as well and have substituted an analysis based on indifference curves.

In its pristine form, the cardinalist approach has been abandoned by all but a rearguard. On demonstrated preference grounds, cardinality must be eliminated. Psychological magnitudes cannot be measured since there is no objectively extensive unit—a necessary requisite of measurement. Further, actual choice obviously cannot demonstrate any form of *measurable* utility; it can only demonstrate one alternative being preferred to another.[19]

### *Ordinal Marginal Utility and Total Utility*

The ordinalist rebels, led by Hicks and Allen in the early 1930s, felt it necessary to overthrow the very concept of marginal utility along with measurability. In doing so, they threw out the Utility baby together with the Cardinal bathwater. They reasoned that marginal utility itself implies measurability. Why? Their notion rested on the implicit neoclassical assumption that the marginal in marginal utility is equivalent to the marginal of the differential calculus. Since, in mathematics, a total "something" is the integral of "marginal somethings," economists early on assumed that "total utility" was the mathematical integral of a series of "marginal utilities."[20] Perhaps, too, they realized that this assumption was essential to a mathematical representation of utility. As a result, they assumed, for example, that the "marginal utility" of a good with a supply of six units is equal to the "total utility" of six units minus the "total utility" of five units. If utilities can be subjected to the arithmetical operation of subtraction, and can be differentiated and integrated, then obviously the

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[19]Mises's priority in establishing this conclusion is acknowledged by Professor Robbins; cf. Lionel Robbins, "Robertson on Utility and Scope," *Economica* (May 1953): 99–111; Mises, *Theory of Money and Credit*, pp. 38–47 and passim. Mises's role in forging an ordinal marginal utility theory has suffered almost total neglect.

[20]The error began perhaps with Jevons. Cf. W. Stanley Jevons, *Theory of Political Economy* (London: Macmillan, 1888), pp. 49ff.

concept of marginal utility must imply cardinally measurable utilities.[21]

The mathematical representation of the calculus rests on the assumption of *continuity*, that is, infinitely small steps. In human action, however, there can be no infinitely small steps. Human action and the facts on which it is based must be in observable and discrete steps and not infinitely small ones. Representation of utility in the manner of the calculus is therefore illegitimate.[22]

There is, however, no reason why marginal utility must be conceived in calculus terms. In human action, "marginal" refers not to an infinitely small unit, but to the *relevant* unit. Any unit relevant to a particular action is marginal. For example, if we are dealing in a specific situation with single eggs, then each egg is the unit; if we are dealing in terms of six-egg cartons, then each six-egg carton is the unit. In either case, we can speak of a marginal utility. In the former case, we deal with the "marginal utility of an egg" with various supplies of eggs; in the latter, with the "marginal utility of cartons" whatever the supply of cartons of eggs. Both utilities are marginal. In no sense is one utility a "total" of the other.

To clarify the relationship between marginal utility and what has been misnamed "total utility" but actually refers to a marginal utility of a larger-sized unit, let us hypothetically construct a typical value scale for eggs:

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[21]That this reasoning lay at the base of the ordinalists' rejection of marginal utility may be seen in John R. Hicks, *Value and Capital*, 2nd ed. (Oxford: Oxford University Press, 1946), p. 19. That many ordinalists regret the loss of marginal utility may be seen in the statement by Arrow that: "The older discussion of diminishing marginal utility as aiming for the satisfaction of more intense wants first makes more sense" than the current "indifference-curve" analysis, but that, unfortunately it is "bound up with the untenable notion of measurable utility." Quoted in D.H. Robertson, "Utility and All What?" *Economic Journal* (December 1954): 667.

[22]Hicks concedes the falsity of the continuity assumption but blindly pins his faith on the hope that all will be well when individual actions are aggregated. Hicks, *Value and Capital*, p. 11.

Ranks in Value

5 eggs
4 eggs
3 eggs
2 eggs
1 egg
2nd egg
3rd egg
4th egg
5th egg

This is a man's ordinal value, or preference, scale for eggs. The higher the ranking, the higher the value. At the center is one egg, the first egg in his possession. By the Law of Diminishing Marginal Utility (ordinal), the second, third, fourth eggs, and so on, rank below the first egg on his value scale, and in that order. Now, since eggs are goods and therefore objects of desire, it follows that a man will value two eggs more than he will one, three more than he will two, and so on. Instead of calling this "total utility," we will say that *the marginal utility of a unit of a good is always higher than the marginal utility of a unit of smaller size*. A bundle of 5 eggs will be ranked higher than a bundle of 4 eggs, and so on. It should be clear that the only arithmetic or mathematical relationship between these marginal utilities is a simple ordinal one. On the one hand, given a certain sized unit, the marginal utility of that unit declines as the supply of units increases. This is the familiar Law of Diminishing Marginal Utility. On the other hand, the marginal utility of a larger-sized unit is greater than the marginal utility of a smaller-sized unit. This is the law just underlined. And there is no mathematical relationship between, say, the marginal utility of 4 eggs and the marginal utility of the 4th egg except that the former is greater than the latter.

We must conclude then that *there is no such thing as total utility*; all utilities are marginal. In those cases where the supply of a good totals only one unit, then the "total utility" of that whole supply is simply the marginal utility of a unit the size of which equals the

whole supply. The key concept is the *variable size* of the marginal unit, depending on the situation.[23]

A typical error on the concept of marginal utility is a recent statement by Professor Kennedy that "the word 'marginal' presupposes increments of utility" and hence measurability. But the word "marginal" presupposes *not* increments of utility, *but the utility of increments of goods*, and this need have nothing to do with measurability.[24]

### *Professor Robbins's Problem*

Professor Lionel Robbins, in the course of a recent defense of ordinalism, raised a problem which he left unanswered. Accepted doctrine, he declared, states that if *difference* between utility rankings can be judged by the individual, as well as the rankings themselves, then the utility scale can in some way be *measured*. Yet, Robbins says, he can judge differences. For example, among three paintings, he can say that he prefers a Rembrandt to a Holbein far less than he prefers a Holbein to a Munnings. How, then, can ordinalism be saved?[25] Is

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[23]The analysis of total utility was first put forward by Mises, in *Theory of Money and Credit*, pp. 38–47. It was continued by Harro F. Bernardelli, especially in his "The End of the Marginal Utility Theory?" *Economica* (May 1938): 206. Bernardelli's treatment, however, is marred by laborious attempts to find some form of legitimate mathematical representation. On the failure of the mathematical economists to understand this treatment of marginal and total, see the criticism of Bernardelli by Paul A. Samuelson, "The End of Marginal Utility: A Note on Dr. Bernardelli's Article," *Economica* (February 1939): 86–87; Kelvin Lancaster, "A Refutation of Mr. Bernardelli," *Economica* (August 1953): 259–62. For rebuttals see Bernardelli, "A Reply to Mr. Samuelson's Note," *Economica* (February 1939): 88–89; and "Comment on Mr. Lancaster's Refutation," *Economica* (August 1954): 240–42.

[24]See Charles Kennedy, "Concerning Utility," *Economica* (February 1954): 13. Kennedy's article, incidentally, is an attempt to rehabilitate a type of cardinalism by making distinctions between "quantity" and "magnitude," and using the Bertrand Russell concept of "relational addition." Surely, this sort of approach falls with one slash of Occam's Razor—the great scientific principle that entities not be multiplied unnecessarily. For a criticism, cf. D.H. Robertson, "Utility and All What?" pp. 668–69.

[25]Robbins, "Robertson on Utility and Scope," p. 104.

he not conceding measurability? Yet Robbins's dilemma had already been answered twenty years earlier in a famous article by Oskar Lange.[26] Lange pointed out that in terms of what we would call demonstrated preference, only pure rankings are revealed by acts of choice. "Differences" in rank are not so revealed, and are therefore mere psychologizing, which, however interesting, are irrelevant to economics. To this, we need only add that differences of rank can be revealed through real choice, whenever the goods *can* be obtained by money. We need only realize that *money* units (which are characteristically highly divisible) can be lumped in the same value-scale as commodities. For example, suppose someone is willing to pay $10,000 for a Rembrandt, $8,000 for a Holbein and only $20 for a Munnings. Then, his value-scale will have the following descending order: Rembrandt, $10,000; Holbein, $9,000, $8,000, $7,000, $6,000; . . . Munnings, $20. We may observe these ranks and no question of the measurability of utilities need arise.

That money and units of various goods can be ranked on one value scale is the consequence of Mises's money-regression theorem, which makes possible the application of marginal utility analysis to money.[27] It is characteristic of Professor Samuelson's approach that he scoffs at the whole problem of circularity which money-regression had solved. He falls back on Léon Walras, who developed the idea of "general equilibrium in which all magnitudes are simultaneously

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[26]Oskar Lange, "The Determinateness of the Utility Function," *Review of Economic Studies* (June 1934): 224ff. Unfortunately, Lange balked at the implications of his own analysis and adopted an assumption of cardinality, solely because of his anxious desire to reach certain cherished "welfare" conclusions.

[27]See Mises, *Theory of Money and Credit*, pp. 97–123. Mises replied to critics in *Human Action*, pp. 405ff. The only further criticism has been that of Gilbert, who asserts that the theorem does not explain how a paper money can be introduced after the monetary system has broken down. Presumably he refers to such cases as the German *Rentenmark*. The answer, of course, is that such paper was not introduced *de novo*; gold and foreign exchange existed previously, and the *Rentenmark* could exchange in terms of these previously existing moneys. Cf. J.C. Gilbert, "The Demand for Money: The Development of an Economic Concept," *Journal of Political Economy* (April 1953): 149.

determined by efficacious interdependent relations," which he contrasts to the "fears of literary writers" about circular reasoning.[28] This is one example of the pernicious influence of the mathematical method in economics. The idea of mutual determination is appropriate in physics, which tries to explain the unmotivated motions of physical matter. But in praxeology, the *cause* is known: individual purpose. In economics, therefore, the proper method is to proceed from the causing action to its consequent effects.

### *The Fallacy of Indifference*

The Hicksian Revolutionaries replaced the cardinal utility concept with the concept of indifference classes, and for the last twenty years, the economic journals have been rife with a maze of two- and three-dimensional indifference curves, tangencies, "budget lines," and so on. The consequence of an adoption of the demonstrated preference approach is that the entire indifference-class concept, along with the complicated superstructure erected upon it, must fall to the ground.

Indifference can never be demonstrated by action. Quite the contrary. Every action necessarily signifies a *choice*, and every choice signifies a definite preference. Action specifically implies the *contrary* of indifference. The indifference concept is a particularly unfortunate example of the psychologizing error. Indifference classes are assumed to exist somewhere underlying and apart from action. This assumption is particularly exhibited in those discussions that try to "map" indifference curves empirically by the use of elaborate questionnaires.

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[28]Samuelson, *Foundations of Economic Analysis*, pp. 117–18. For similar attacks on earlier Austrian economists, cf. Frank H. Knight, "Introduction" in Carl Menger, *Principles of Economics* (Glencoe, Ill.: The Free Press, 1950), p. 23; George J. Stigler, *Production and Distribution Theories* (New York: Macmillan, 1946), p. 181. Stigler criticizes Böhm-Bawerk for spurning "mutual determination" for "the older concept of cause and effect" and explains this by saying that Böhm-Bawerk was untrained in mathematics. For Menger's attack on the mutual determination concept, cf. Terence W. Hutchison, *A Review of Economic Doctrines, 1870–1929* (Oxford: Clarendon Press, 1953), p. 147.

If a person is really indifferent between two alternatives, then he cannot and will not choose between them.[29] Indifference is therefore never relevant for action and cannot be demonstrated in action. If a man, for example, is indifferent between the use of 5.1 ounces and 5.2 ounces of butter because of the minuteness of the unit, then there will be no occasion for him to act on these alternatives. He will use butter in larger-sized units, where varying amounts are *not* indifferent to him.

The concept of "indifference" may be important for psychology, but not for economics. In psychology, we are interested in finding out intensities of value, possible indifference, and so on. In economics, however, we are only interested in values revealed through choices. It is immaterial to economics whether a man chooses alternative A to alternative B because he strongly prefers A or because he tossed a coin. The *fact of ranking* is what matters for economics, *not* the reasons for the individuals arriving at that rank.

In recent years, the indifference concept has been subjected to severe criticism. Professor Armstrong pointed out that under Hicks's curious formulation of "indifference," it is possible for an individual to be "indifferent" between two alternatives and yet choose one over the other.[30] Little has some good criticisms of the indifference concept, but his analysis is vitiated by his eagerness to use faulty theorems in order to arrive at welfare conclusions, and by his radically behaviorist methodology.[31] A very interesting attack on the indifference concept from the point of view of psychology has been levelled by Professor Macfie.[32]

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[29]The "indifference theorists" also err in assuming infinitely small steps, essential for their geometric representation but erroneous for an analysis of human action.

[30]Wallace E. Armstrong, "The Determinateness of Utility Function," *Economic Journal* (1939): 453–67. Armstrong's point that indifference is not a transitive relation (as Hicks assumed), only applies to different-sized units of *one* commodity. Also cf. Armstrong, "A Note on the Theory of Consumers' Behavior."

[31]Little, "Reformulation" and "Theory." It is another defect of Samuelson's revealed preference approach that he attempts to "reveal" indifference-curves as well.

[32]Alec L. Macfie, "Choice in Psychology and as Economic Assumption," *Economic Journal* (June 1953): 352–67.

The indifference theorists have two basic defenses of the role of indifference in real action. One is to cite the famous fable of *Buridan's Ass*. This is the "perfectly rational" ass who demonstrates indifference by standing, hungry, equidistant from two equally attractive bales of hay.[33] Since the two bales are equally attractive in every way, the ass can choose neither one and starves therefore. This example is supposed to indicate how indifference can be revealed in action. It is, of course, difficult to conceive of an ass, or a person, who could be *less* rational. Actually, he is not confronted with *two* choices but with *three*, the third being to starve where he is. Even on the indifference theorists' own grounds, this third choice will be ranked lower than the other two on the individuals value-scale. He will *not* choose starvation.

If both bundles of hay are equally attractive, then the ass or man, who must choose one or the other, will allow pure chance, such as the flip of a coin, to decide on either one. But then indifference is still not revealed by this choice, for the flip of a coin has enabled him to establish a preference![34]

The other attempt to demonstrate indifference classes rests on the consistency—constancy fallacy, which we have analyzed above. Thus, Kennedy and Walsh claim that a man can reveal indifference if, when asked to repeat his choices between A and B *over time*, he chooses each alternative 50 percent of the time.[35]

If the concept of the individual indifference curve is completely fallacious, it is quite obvious that Baumol's concept of the "community indifference curve," which he purports to build up from individual curves, deserves the shortest possible shrift.[36]

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[33]Thus, cf. Joseph A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), pp. 94*n* and 1064.

[34]Also see Croce's warning about using animal illustrations in analyses of human action. Croce, "Economic Principle I," p. 175.

[35]Kennedy, "The Common Sense of Indifference Curves" and "On Descriptions of Consumer's Behavior."

[36]William J. Baumol, *Welfare Economics and the Theory of the State* (1952; Cambridge, Mass.: Harvard University Press, 1965), pp. 47ff.

### *The Neo-Cardinalists: The von Neumann-Morgenstern Approach*

In recent years, the world of economics has been taken by storm by a neo-cardinalist, quasi-measurement theory of utility. This approach, which has the psychological advantage of being garbed in a mathematical form more advanced than economics had yet known, was founded by von Neumann and Morgenstern in their celebrated work.[37] Their theory had the further advantage of being grounded on the most recent and fashionable (though incorrect) developments in the philosophy of measurement and the philosophy of probability. The von Neumann-Morgenstern thesis was adopted by the leading mathematical economists and has gone almost unchallenged to this day. The chief consolation of the ordinalists has been the assurance by the neo-cardinalists that their doctrine applies only to utility under conditions of uncertainty, and therefore does not shake the ordinalist doctrine too drastically.[38] But this consolation is really quite limited, considering that some uncertainty enters into every action.

The von Neumann-Morgenstern theory is briefly as follows: an individual can compare not only certain events, but also combinations of events with definite numerical probabilities for each event. Then, according to the authors, if an individual prefers alternative A to B, and B to C, he is able to decide whether he prefers B or a 50:50 probability combination of C and A. If he prefers B, then his preference of B over C is deduced as being greater than his preference of A over B. In a similar fashion, various combinations of probabilities

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[37]John von Neumann and Oskar Morgenstern, *Theory of Games and Economic Behavior*, 2nd ed. (Princeton, N.J.: Princeton University Press, 1947), pp. 8, 15–32, 617–32.

[38]Thus see the excellent expository article by Armen A. Alchian, "The Meaning of Utility Measurement," *American Economic Review* (May 1953): 384–97. The leading adherents of the Neumann-Morgenstern approach are Marschak, Friedman, Savage, and Samuelson.

Claims of the theory, even at its best, to measure utility in any way have been nicely exploded by Ellsberg, who also demolishes Marschak's attempt to make the theory normative. Ellsberg's critique suffers considerably, however, from being based on the "operational meaning" concept. D. Ellsberg, "Classic and Current Notions of Measurable Utility," *Economic Journal* (September 1954): 528–56.

are selected. A quasi-measurable numerical utility is assigned to his utility scale in accordance with the indifference of utilities of B as compared with various probability combinations of A or C. The result is a numerical scale given when arbitrary numbers are assigned to the utilities of two of the events.

The errors of this theory are numerous and grave:

(1) None of the axioms can be validated on demonstrated preference grounds, since admittedly all of the axioms can be violated by the individual actors.

(2) The theory leans heavily on a constancy assumption so that utilities can be revealed by action over time.

(3) The theory relies heavily on the invalid concept of *indifference* of utilities in establishing the numerical scale.

(4) The theory rests fundamentally on the fallacious application of a theory of numerical probability to an area where it cannot apply. Richard von Mises has shown conclusively that numerical probability can be assigned only to situations where there is a class of entities, such that nothing is known about the members except they are members of this class, and where successive trials reveal an asymptotic tendency toward a stable proportion, or frequency of occurrence, of a certain event in that class. There can be no numerical probability applied to specific individual events.[39]

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[39]Richard von Mises, *Probability, Statistics, and Truth* (New York: Macmillan, 1957). Also Ludwig von Mises, *Human Action*, pp. 106–17. The currently fashionable probability theories of Rudolf Carnap and Hans Reichenbach have failed to shake the validity of Richard von Mises's approach. Mises refutes them in the third German edition of his work, unfortunately unavailable in English. See Richard von Mises, *Wahrscheinlichkeit, Statistik, und Wahrheit,* 3rd ed. (Vienna: J. Springer, 1951). The only plausible critique of Richard von Mises has been that of W. Kneale, who pointed out that the numerical assignment of probability depends on an *infinite* sequence, whereas in no human action can there be an infinite sequence. This, however, *weakens* the application of numerical probability even to cases such as lotteries, rather than enabling it to expand into other areas. See also Little, "A Reformulation of the Theory of Consumers' Behavior."

Yet, in human action, precisely the opposite is true. Here, there are no classes of homogeneous members. Each event is a unique event and is different from other unique events. These unique events are not repeatable. Therefore, there is no sense in applying numerical probability theory to such events.[40] It is no coincidence that, invariably, the application of the neo-cardinalists has always been to lotteries and gambling. It is precisely and *only* in lotteries that probability theory can be applied. The theorists beg the entire question of its applicability to general human action by confining their discussion to lottery cases. For the purchaser of a lottery ticket knows only that the individual lottery ticket is a member of a certain-sized class of tickets. The entrepreneur, in making his decisions, is on the contrary confronted with unique cases about which he has some knowledge and which have only limited parallelism to other cases.

(5) The neo-cardinalists admit that their theory is not even applicable to gambling if the individual has either a like or a dislike for gambling itself. Since the fact that a man gambles demonstrates that he likes to gamble, it is clear that the von Neumann-Morgenstern utility doctrine fails even in this tailor-made case.[41]

(6) A curious new conception of measurement. The new philosophy of measurement discards concepts of "cardinal" and "ordinal" in favor of such labored constructions as measurable up to a multiplicative constant (cardinal); "measurable up to a

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[40]Frank Knight's basic distinction between the narrow cases of actuarial "risk" and the more widespread, non-actuarial "uncertainty." Frank H. Knight, *Risk, Uncertainty, and Profit*, 2nd ed. (London: London School of Economics, 1940). G.L.S. Shackle has also leveled excellent criticism at the probability approach to economics, especially that of Marschak. His own "surprise" theory, however, is open to similar objections; C.F. Carter, "Expectations in Economics," *Economic Journal* (March 1950): 92–105; and G.L.S. Shackle, *Expectations in Economics* (Cambridge, Mass.: Cambridge University Press, 1949), pp. 109–23.

[41]It is curious how economists have been tempted to discuss gambling by first assuming that the participant doesn't like to gamble. It is on this assumption that Alfred Marshall based his famous "proof" that gambling (because of each individual's diminishing utility of money) is "irrational."

> monotonic transform" (ordinal); "measurable up to a linear transform" (the new quasi-measurement, of which the von Neumann-Morgenstern proposed utility index is an example). This terminology, apart from its undue complexity (under the influence of mathematics), implies that everything, including ordinality, is somehow measurable. The man who proposes a new definition for an important word must prove his case; the new definition of measurement has hardly done so. Measurement, on any sensible definition, implies the possibility of a unique assignment of numbers which can be meaningfully subjected to all the operations of arithmetic. To accomplish this, it is necessary to define a fixed unit. In order to define such a unit, the property to be measured must be extensive in space, so that the unit can be objectively agreed upon by all. Therefore, subjective states, being *intensive* rather than objectively extensive, cannot be measured and subjected to arithmetical operations. And utility refers to intensive states. Measurement becomes even more implausible when we realize that utility is a praxeologic, rather than a directly psychologic, concept.

A favorite rebuttal is that subjective states *have* been measured; thus, the old, unscientific subjective feeling of heat has given way to the objective science of thermometry.[42] But this rebuttal is erroneous; thermometry does *not* measure the intensive subjective feelings themselves. It assumes an approximate correlation between the intensive property and an objective extensive event—such as the physical expansion of gas or mercury. And thermometry can certainly lay no claim to precise measurement of subjective states: we all know that some people, for various reasons, feel warmer or colder at different times even if the external temperature remains the same.[43] Certainly no correlation whatever can be found for demonstrated preference scales in relation to physical lengths. For preferences have no *direct* physical basis, as do feelings of heat.

No arithmetical operations whatever can be performed on ordinal numbers; therefore, to use the term measurable in any way for

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[42]Thus, cf. von Neumann and Morgenstern, *Theory of Games and Economic Behavior*, pp. 16–17.

[43]Morris R. Cohen, *A Preface to Logic* (New York: H. Holt, 1944), p. 151.

ordinal numbers is hopelessly to confuse the meaning of the term. Perhaps the best remedy for possible confusion is to avoid using *any* numbers for ordinal rank; the rank concept can just as well be expressed in letters (A, B, C . . .), using a convention that A, for example, expresses higher rank.

As to the new type of quasi-measurability, no one has yet proved it capable of existence. The burden of proof rests on the proponents. If an object is extensive, then it is at least theoretically capable of being measured, for an objective fixed unit can, in principle, be defined. If it is intensive, then no such fixed unit can apply, and any assignment of number would have to be ordinal. There is no room for an intermediate case. The favorite example of quasi-measurability that is always offered is, again, temperature. In thermometry, centigrade and Fahrenheit scales are supposed to be convertible into each other *not* at a multiplicative constant (cardinality) but by multiplying and then adding a constant (a "linear transform"). More careful analysis, however, reveals that both scales are simply derivations from one scale based on an absolute zero point. All we need to demonstrate the cardinality of temperature is to transform both centigrade and Fahrenheit scales into scales where "absolute zero" *is* zero, and then each will be convertible into the other by a multiplicative constant. Furthermore, the actual measurement in temperature is a measurement of length (say, of the mercury column) so that temperature is really a derived measure based on the cardinally measurable magnitude of length.[44]

Jacob Marschak, one of the leading members of the von Neumann-Morgenstern School, has conceded that the temperature case

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[44]On measurement, see Norman Campbell, *What is Science?* (New York: Dover, 1952), pp. 109–34; and Campbell, *An Account of the Principles of Measurement and Calculation* (London: Longmans, Green, 1928). Although the above view of measurement is not currently fashionable, it is backed by the weighty authority of Mr. Campbell. A description of the controversy between Campbell and S. Stevens on the issue of measurement of intensive magnitudes was included in the unpublished draft of Carl G. Hempel's *Concept Formation*, but was unfortunately omitted from Hempel's published *Fundamentals of Concept Formation in Empirical Science* (Chicago: University of Chicago, 1952). Campbell's critique can be found in A. Ferguson, et al. *Interim Report* (British Association for the Advancement of Science Final Report, 1940), pp. 331–49.

is inappropriate for the establishment of quasi-measurability, because it is derived from the fundamental, cardinal, measurement of distance. Yet, astonishingly, he offers *altitude* in its place. But if "temperature readings are nothing but distance," what else is altitude, which is solely and purely distance and length?[45]

## WELFARE ECONOMICS: A CRITIQUE

### *Economics and Ethics*

It is now generally accepted among economists, at least *pro forma*, that economics *per se* cannot establish ethical judgments. It is not sufficiently recognized that to accept this need not imply acceptance of the Max Weber position that ethics can never be scientifically or rationally established. Whether we accept the Max Weber position, or we adhere to the older view of Plato and Aristotle that a rational ethics is possible, it should be clear that *economics* by itself cannot establish an ethical position. If an ethical science is possible, it must be built up out of data supplied by truths established by all of the other sciences.

Medicine can establish the fact that a certain drug can cure a certain disease, while leaving to other disciplines the problem whether the disease *should* be cured. Similarly, economics can establish that Policy A leads to the advancement of life, prosperity, and peace, while Policy B leads to death, poverty, and war. Both medicine and economics can establish these consequences scientifically, and without introducing ethical judgments into the analysis. It might be protested that doctors would not inquire into possible cures for a disease if they did not want a cure, or economists would not investigate causes of prosperity if they did not want the result. There are two answers to this point: (1) that this is undoubtedly true in almost all cases, but not *necessarily* so—some doctors or economists may care only about the discovery of truth, and (2) this only establishes the psychologic motivation of the scientists; it does not establish that the discipline itself arrives at values. On the contrary, it bolsters the thesis that ethics is arrived at apart from the specific sciences of medicine or economics.

[45]Jacob Marschak, "Rational Behavior, Uncertain Prospects, and Measureability," *Econometrica* (April 1950): 131.

Thus, whether we hold the view that ethics is a matter of non-rational emotions or taste, or whether we believe in a rational ethic, we must agree that economic science *per se* cannot establish ethical statements. As political policy judgment is a branch of ethics, the same conclusion applies to politics. If prosperity vs. poverty, for example, are political alternatives, economic science cannot decide between them; it simply presents the truth about the consequences of each alternative political decision. As citizens, we take these truths into account when we make our politico-ethical decisions.

### *The Problem of the New Welfare Economics: The Unanimity Rule*

The problem of "welfare economics" has always been to find some way to circumvent this restriction on economics, and to make ethical, and particularly *political*, statements directly. Since economics discusses individuals' aiming to maximize their utility or happiness or welfare, the problem may be translated into the following terms: When can economics say that "society is better off" as a result of a certain change? Or alternatively, when can we say that "social utility" has been increased or "maximized"?

Neoclassical economists, led by Professor Pigou, found a simple answer. Economics can establish that a man's marginal utility of money diminishes as his money-income increases. Therefore, they concluded, the marginal utility of a dollar is less to a rich man than to a poor man. *Other things being equal*, social utility is maximized by a progressive income tax which takes from the rich and gives to the poor. This was the favorite demonstration of the "old welfare economics," grounded on Benthamite utilitarian ethics, and brought to fruition by Edgeworth and Pigou.

Economists continued blithely along this path until they were brought up short by Professor Robbins. Robbins showed that this demonstration rested on interpersonal comparisons of utility, and since utility is not a cardinal magnitude, such comparisons involve ethical judgments.[46] What Robbins actually accomplished was to

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[46]Lionel Robbins, "Interpersonal Comparisons of Utility," *Economic Journal* (December 1938): 635–41; and Robbins, *An Essay on the Nature and Significance of Economic Science*, 2nd ed. (London: Macmillan, 1935), pp. 138–41.

reintroduce Pareto's Unanimity Rule into economics and establish it as the iron gate where welfare economics must test its credentials.[47] This Rule runs as follows: We can only say that "social welfare" (or better, "social utility") has *increased* due to a change, if no individual is worse off because of the change (and at least one is better off). If one individual is worse off, the fact that interpersonal utilities cannot be added or subtracted prevents economics from saying anything about social utility. Any statement about social utility would, in the absence of unanimity, imply an ethical interpersonal comparison between the gainers and the losers from a change. If X number of individuals gain, and Y number lose, from a change, any weighing to sum up in a "social" conclusion would necessarily imply an ethical judgment on the relative importance of the two groups.[48]

The Pareto-Robbins Unanimity Rule conquered economics and liquidated the old Pigovian welfare economics almost completely. Since then, an enormous literature known as the "new welfare economics" has flourished, devoting itself to a series of attempts to square the circle: to assert certain political judgments as scientific economics, while still retaining the unanimity rule.

### *Professor Robbins's Escape Route*

Robbins's own formulation of the Unanimity Rule far undervalues the scope of its restrictive power over the assertions of economists. Robbins stated that only *one* ethical assertion would be necessary for economists to make interpersonal comparisons: namely, that every man has an "equal capacity for satisfaction" in similar circumstances. To be sure, Robbins grants that this ethical assumption cannot be established by economics; but he implies that since all good democrats are bound to make this egalitarian assumption, we can all pretty well act *as if* interpersonal comparisons of utility can be made and go on to make ethical judgments.

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[47]Vilfredo Pareto, *Manuel d'Économie Politique*, 2nd ed. (Paris: Marcel Giard, 1927), p. 617.

[48]Kemp tries to alter the Unanimity Rule to read that social utility is only increased if everyone is better off, non being worse off or indifferent. But, as we have seen, indifference cannot be demonstrated in action, and therefore this alteration is invalid. Murray C. Kemp, "Welfare Economics: A Stocktaking," *Economic Record* (November 1954): 245.

In the first place, it is difficult, upon analysis, to make sense of the phrase "equal capacity for satisfaction." Robbins, as we have seen, admits that we cannot scientifically compare utilities or satisfactions between individuals. But since there is no unit of satisfaction by which we can make comparisons, there is no meaning to any assumption that different men's satisfactions will be "equal" to any circumstances. "Equal" in what way, and in what units? We are not at liberty to make any ethical assumption we please, because even an ethical assumption must be framed meaningfully, and its terms must be definable in a meaningful manner. Since there is no meaning to the term "equality" without some sort of definable unit, and since there is no unit of satisfaction or utility, it follows that there can be no ethical assumption of "equal capacity for satisfaction," and that this cannot provide a shortcut to permit the economists to make conclusions about public policy.

The Robbins position, moreover, embodies a highly oversimplified view of ethics and its relation to politico-economic affairs. The problem of interpersonal comparisons of utility *is only one* of the very many ethical problems which must at least be discussed before any policy conclusions can rationally be framed. Suppose, for example, that two social changes take place, each of which causes 99 percent of the people to gain in utility and 1 percent to lose. Surely no assumption about the interpersonal comparison of utility can suffice to establish an ethical judgment, divorced from the *content* of the change itself. If, for example, one change was the enslavement of the 1 percent by the 99 percent, and the other was the removal of a governmental subsidy to the 1 percent, there is apt to be a great deal of difference in our ethical pronouncements on the two cases, even if the assumed "social utility" in the two cases is approximately the same.

### *The Compensation Principle*

A particularly notable attempt to make policy conclusions within the framework of the Unanimity Rule was the Kaldor-Hicks "compensation principle," which stated that "social utility" may scientifically be said to increase, if the winners *may* be able to compensate the losers and still remain winners.[49] There are many fatal errors in

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[49]On the compensation principle, see Nicholas Kaldor, "Welfare Propositions in Economics," *Economic Journal* (September 1939): 549; John R.

this approach. In the first place, since the compensation principle is supposed to help economists form policy judgments, it is evident that we must be able to compare, at least in principle, *actual* social states. We are therefore always concerned with *actual*, and not *potential*, winners and losers from any change. Whether or not the winners *may* compensate the losers is therefore irrelevant; the important question is whether the compensation *does*, in fact take place. Only if the compensation is actually carried out so that not a single person remains a loser, can we still assert a gain in social utility. But *can* this compensation ever be carried out? In order to do so, everybody's utility scale would have to be investigated by the compensators. But from the very nature of utility scales this is an impossibility. Who knows what has happened to anyone's utility scale? The compensation principle is necessarily divorced from demonstrated preference, and once this occurs, it is impossible to find out what has happened to anyone's utility. The reason for the divorce is that the act of compensation is, necessarily, a unilateral gift *to* a person rather than an act *of* that person, and therefore it is impossible to estimate how much his utility has increased as compared to its decrease in some other situation. Only if a person is actually confronted with a *choice* between two alternatives can we say that he prefers one to the other.

Certainly, the compensators could not rely on questionnaires in a situation where everyone need only *say* that he has lost utility in order to receive compensation. And suppose someone proclaims that his sensibilities are so hurt by a certain change that no monetary reward could ever compensate him? The existence of one such person would annul any compensation attempt. But these problems necessarily occur when we leave the realm of demonstrated preference.

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Hicks, "The Foundations of Welfare Economics," *Economic Journal* (December 1939): 706. For a criticism, see William J. Baumol, "Community Indifference," *Review of Economic Studies* (1946–1947): 44–48; Baumol, *Welfare Economics and the Theory of the State*, pp. 12ff.; Kemp, "Welfare Economics: A Stocktaking," pp. 246–50. For a summary of the discussion, see D.H. Robertson, *Utility and All That* (London: Allen and Unwin, 1952): pp. 29–35. The weakness in Robbins's accession to the Unanimity Rule is demonstrated by his endorsement of the compensating principle. Robbins, "Robertson on Utility and Scope."

### *The Social Welfare Function*

Under the impact of criticisms far less thoroughgoing than the above, the compensation principle has been abandoned by most economists. There have been recent attempts to substitute another device—the "Social Welfare Function." But after a flurry of activity, this concept, originated by Professors Bergson and Samuelson, quickly struck rocky waters, and virtually sank under the impact of various criticisms. It came to be regarded as an empty and therefore meaningless concept. Even its founders have given up the struggle and concede that economists must import ethical judgments from outside economics in order to make policy conclusions.[50] Professor Rothenberg has made a desperate attempt to salvage the social welfare function by radically changing its nature, that is, by identifying it with an existing "social decision-making process." To uphold this shift, Rothenberg must make the false assumption that "society" exists apart from individuals and makes "its" own valuation. Furthermore, as Bergson has pointed out, this procedure abolishes welfare economics, since the function of the economist would be to observe empirically the social decision-making process at work and to pronounce its decisions as gains in "social utility."

### *The Economist as Adviser*

Failing the establishment of policy conclusions through the compensation principle or the social welfare function, there is another very popular route to enable the economist to participate in policy formation while still remaining an ethically neutral scientist. This view holds that someone else may set the ends, while the economist is justified in telling that person (and in being hired by that person) the correct means for attaining these desired ends. Since the economist takes *someone else's* hierarchy of ends as given and only points out the means to attain them, he is alleged to remain ethically neutral

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[50]See Abram Bergson, "On the Concept of Social Welfare," *Quarterly Journal of Economics* (May 1954): 249; Paul A. Samuelson, "Welfare Economics; Comment," in *A Survey of Contemporary Economics*, B.F. Haley, ed. (Homewood, Ill.: R.D. Irwin, 1952), vol. 2, p. 37. Also Jerome Rothenberg, "Conditions for a Social Welfare Function," *Journal of Political Economy* (October 1953): 397; Sidney Schoeffler, "Note on Modern Welfare Economics," *American Economic Review* (December 1952): 881; I.M.D. Little, "Social Choice and Individual Values," *Journal of Political Economy* (October 1952): 422–32.

and strictly scientific. This viewpoint, however, is a misleading and fallacious one. Let us take an example suggested by a passage in Professor Philbrook's seminal article; a monetary economist advising the Federal Reserve System.[51] Can this economist simply take the ends set by the heads of this System and advise on the most efficient means to attain them? *Not unless the economist affirms these ends as being positively good*, that is, not unless he makes an ethical judgment. For suppose that the economist is convinced that the entire Federal Reserve System is pernicious. In that case, his best course may well be to advise that policy which would make the System highly *inefficient* in the pursuit of its ends. The economist employed by the System cannot, therefore, give any advice whatever without abandoning ethical neutrality. If he advises the System on the best way to achieve its ends, it must be logically inferred that he supports these ends. His advice involves no less an ethical judgment on his part if he chooses to "tacitly accept the decisions of the community as expressed through the political machinery."[52]

### *The End of Welfare Economics?*

After twenty years of florid growth, welfare economics is once more confined to an even tighter Unanimity Rule. Its attempts to say anything about political affairs within the confines of this rule have been in vain.

The death of the New Welfare Economics has begun to be reluctantly recognized by all of its supporters, and each has taken turns in pronouncing its demise.[53] If the strictures advanced in this paper are conceded, the burial rites will be accelerated, and the corpse

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[51]Clarence Philbrook, "'Realism' in Policy Espousal," *American Economic Review* (December 1953): 846–59. The entire article is of fundamental importance in the study of economics and its relation to public policy.

[52]E.J. Mishan, "The Principle of Compensation Reconsidered," *Journal of Political Economy* (August 1952): 312. See especially the excellent note of I.M.D. Little, "The Scientist and the State," *Review of Economic Studies* (1949–50): 75–76.

[53]Thus, see the rather mournful discussion in the American Economic Association's second volume of the *Survey of Contemporary Economics*; Kenneth E. Boulding, "Welfare Economics," pp. 1–34; Melvin W. Reder, "Comment," pp. 34–36; and Samuelson, *The Empirical Implications of Utility Analysis*. Also see the articles by Schoeffler, Bergson, and Kemp cited above.

decently interred. Many New Welfare Economists understandably continue to grope for some way of salvaging something out of the wreckage. Thus, Reder suggests that economics make specific, piecemeal policy recommendations anyway. But surely this is only a despairing refusal to take the fundamental problems into account. Rothenberg tries to inaugurate a constancy assumption based on psychologizing about underlying basic personalities.[54] Aside from the fact that "basic" changes can take place at any time, economics deals with *marginal* changes, and a change is no less a change for being marginal. In fact, whether changes are marginal or basic is a problem for psychology, not praxeology. Bergson tries the mystical route of denying demonstrated preference, and claiming it to be possible that peoples values "really differed" from what they chose in action. He does this by adopting the "consistency"-constancy fallacy.

Does the Unanimity Rule then spell the end of *all* possible welfare economics, as well as the "old" and the "new" versions? Superficially, it would seem so. For if all changes must injure nobody, that is, if no people must feel worse off as a result of a change, what changes could pass muster as socially useful within the Unanimity Rule? As Reder laments: "Consideration of the welfare implications of envy, for example, make it impossible even to say that welfare will be increased by everyone having more of every commodity."[55]

## Welfare Economics: A Reconstruction

### *Demonstrated Preference and the Free Market*

It is the contention of this paper that the wake for all welfare economics is premature, and that welfare economics can be reconstructed with the aid of the concept of demonstrated preference. This reconstruction, however, will have no resemblance to either of the "old" or "new" edifices that preceded it. In fact, if Reder's thesis is correct, our proposed resurrection of the patient may be considered by many as more unfortunate than his demise.[56]

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[54]Jerome Rothenberg, "Welfare Comparisons and changes in Tastes," *American Economic Review* (December 1953): 888–90.

[55]Reder, "Comment," p. 35.

[56]"To a considerable extent, welfare (and related) theorizing of the 1930s and 1940s was an attempt to show the variety and importance of the circumstances under which *laissez-faire* was inappropriate." Ibid.

Demonstrated preference, as we remember, eliminates hypothetical imaginings about individual value scales. Welfare economics has until now always considered values as hypothetical valuations of hypothetical "social states." But demonstrated preference only treats values as revealed through chosen action.

Let us now consider exchanges on the free market. Such an exchange is voluntarily undertaken by both parties. Therefore, the very fact that an exchange takes place demonstrates that both parties benefit (or more strictly, *expect* to benefit) from the exchange. The fact that both parties chose the exchange demonstrates that they both benefit. The free market is the name for the array of all the voluntary exchanges that take place in the world. Since every exchange demonstrates a unanimity of benefit for both parties concerned, we must conclude that *the free market benefits all its participants*. In other words, welfare economics can make the statement that the free market increases social utility, while still keeping to the framework of the Unanimity Rule.[57]

But what about Reder's bogey: the envious man who hates the benefits of others? To the extent that he himself has participated in the market, to that extent he reveals that he likes and benefits from the market. And we are not interested in his opinions about the exchanges made by *others*, since his preferences are not demonstrated through action and are therefore irrelevant. How do we *know* that this hypothetical envious one loses in utility because of the exchanges of others? Consulting his verbal opinions does not suffice, for his proclaimed envy might be a joke or a literary game or a deliberate lie.

We are led inexorably, then, to the conclusion that the processes of the free market always lead to a gain in social utility. And we can say this with absolute validity as economists, without engaging in ethical judgments.

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[57]Haavelmo criticizes the thesis that the free market maximizes social utility on the grounds that this "assumes" that the individuals "somehow get together" to make an optimal decision. But the free market is precisely the method by which the "get together" takes place! See Trygve Haavelmo, "The Notion of Involuntary Economic Decision," *Econometrica* (January 1950): 8.

### *The Free Market and the "Problem of Distribution"*

Economics, in general, and welfare economics, in particular, have been plagued with the problem of distribution. It has been maintained, for example, that assertions of increased social utility on the free market are all very well, but only within the confines of assuming a given distribution of income.[58] Since changes in the distribution of income seemingly injure one person and benefit another, no statements, it is alleged, can be made about social utility with respect to changes in distribution. And income distribution is always changing.

On the free market, however, there *is* no such thing as a separate "distribution." A man's monetary assets have been acquired precisely because his or his ancestors' services have been purchased by others on the free market. There is no distributional process apart from the production and exchange processes of the market; hence the very concept of "distribution" becomes meaningless on the free market. Since "distribution" is simply the result of the free exchange process, and since this process benefits all participants in the market and increases social utility, it follows directly that the distributional results of the free market also increase social utility.

The strictures of the critics do apply, however, to cases of State action. When the State takes from Peter and gives to Paul it is effecting a separate *distribution* process. Here, there does exist a process *separate* from production and exchange, and hence the concept becomes meaningful. Moreover, such State action obviously *and demonstrably* benefits one group and injures another, thus violating the Unanimity Rule.

### *The Role of the State*

Until quite recently, welfare economics has never analyzed the role of the State. Indeed, economics in general has never devoted much attention to this fundamental problem. Specific problems, such as public finance, or price controls, have been investigated, but the State itself has been a shadowy figure in the economic literature. Usually, it has vaguely been considered as representing "society" or "the public in some way." "Society," however, is not a real entity; it is

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[58]It would be more correct to say given distribution of money *assets*.

only a convenient short-hand term for an array of all existing individuals.[59] The largely unexplored area of the State and State actions, however, can be analyzed with the powerful tools of Demonstrated Preference and the Unanimity Rule.

The State is distinguished from all other institutions in society in two ways: (1) it and it alone can interfere by the use of violence with actual or potential market exchanges of other people; and (2) it and it alone obtains its revenues by a compulsory levy, backed by violence. No other individual or group can legally act in these ways.[60] Now what happens when the State, or a criminal, uses violence to interfere with exchanges on the market? Suppose that the government prohibits A and B from making an exchange they are willing to make. It is clear that the utilities of both A and B have been lowered, for they are prevented by threat of violence from making an exchange that they otherwise would have made. On the other hand, there has been a gain in utility (or at least an anticipated gain) for the government officials imposing this restriction, otherwise they would not have done so. As economists, we can therefore say nothing about social utility in this case, since some individuals have demonstrably gained and some demonstrably lost in utility from the governmental action.

The same conclusion follows in those cases where the government forces C and D to make an exchange which they otherwise would not have made. Once again, the utilities of the government officials gain. And *at least one* of the two participants (C or D) lose in utility, because at least one would not have wanted to make the exchange in the absence of governmental coercion. Again, economics can say nothing about social utility in this case.[61]

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[59]On this fallacy of methodological collectivism, and the broader fallacy of conceptual realism, see the excellent discussion in Hayek, *Counter Revolution of Science*, pp. 53ff.

[60]*Criminals* also act in these ways, but they cannot do so legally. For the purpose of praxeologic rather than legal analysis, the same conclusions apply to both groups.

[61]We cannot discuss here the praxeological analysis of general economics which shows that, in the long run, for many acts of coercive interference, the coercer himself loses in utility.

We conclude therefore that *no government interference with exchanges can ever increase social utility*. But we can say more than that. It is the essence of government that it alone obtains its revenue by the compulsory levy of taxation. All of its subsequent acts and expenditures, whatever their nature, rest on this taxing power. We have just seen that whenever government forces anyone to make an exchange which he would not have made, this person loses in utility as a result of the coercion. But taxation is just such a coerced exchange. If everyone would have paid just as much to the government under a system of voluntary payment, then there would be no need for the compulsion of taxes. Given the fact that coercion is used for taxes, therefore, and since all government actions rest on its taxing power, we deduce that: *no act of government whatever can increase social utility*.

Economics, therefore, without engaging in any ethical judgment whatever, and following the scientific principles of the Unanimity Rule and Demonstrated Preference, concludes: (1) that the free market always increases social utility; and (2) that no act of government can ever increase social utility. These two propositions are the pillars of the reconstructed welfare economics.

Exchanges between persons can take place either voluntarily or under the coercion of violence. There is no third way. If, therefore, free market exchanges always increase social utility, while no coerced exchange or interference can increase social utility, we may conclude that the maintenance of *a free and voluntary market "maximizes" social utility* (provided we do not interpret "maximize" in a cardinal sense).

Generally, even the most rigorously *Wertfrei* economists have been willing to allow themselves one ethical judgment: they feel free to recommend any change or process that increases social utility under the Unanimity Rule. Any economist who pursues this method would have to (a) uphold the free market as always beneficial, and (b) refrain from advocating any governmental action. In other words, he would have to become an advocate of "*ultra*" *laissez-faire*.

### *Laissez-faire Reconsidered*

It has been quite common to scoff at the French "optimist" *laissez-faire* school of the nineteenth century. Usually, their welfare economic analysis has been dismissed as naive prejudice. Actually, however, their writings reveal that their *laissez-faire* conclusions were

*post-judices*—were judgments *based* on their analysis, rather than preconceptions of their analysis.[62] It was the discovery of the general social benefit from free exchange that led to the rhapsodies over the free exchange process in the works of such men as Frédéric Bastiat, Edmond About, Gustave de Molinari, and the American, Arthur Latham Perry. Their analyses of State action were far more rudimentary (except in the case of Molinari), but their analyses generally needed only the ethical presumption in favor of social utility to lead them to a pure *laissez-faire* position.[63] Their treatment of exchange may be seen in this passage from the completely neglected Edmond About:

> Now what is admirable in exchange is that it benefits the two contracting parties. . . . Each of the two, by giving what he has for that which he has not, makes a good bargain. . . . This occurs at every free and straightforward exchange. . . . In fact, whether you sell, whether you buy, you perform an act of preference. No one constrains you to give over any of your things for the things of another.[64]

The analysis of free exchange underlying the *laissez-faire* position has suffered general neglect in economics. When it is considered, it is usually dismissed as "simple." Thus, Hutchison calls the idea of exchange as mutual benefit "simple"; Samuelson calls it

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[62]Lionel Robbins's *The Theory of Economic Policy in English Classical Political Economy* (London: Macmillan, 1952) is devoted to the thesis that the English classical economists were really "scientific" because they did not uphold *laissez-faire*, while the French optimists were dogmatic and "metaphysical" because they did. To uphold this, Robbins abandons his praxeological approach of twenty years before, and adopts positivism: "The final test whether a statement is metaphysical (sic) or scientific is . . . whether it argues dogmatically a priori or by way of appeal to experience." Naturally, Robbins cites examples from the physical sciences to bolster this fallacious dichotomy. Ibid., pp. 23–24.

[63]Bastiat's writings are well known, but his "welfare" analysis was generally inferior to that of About or Molinari. For a brilliant analysis of State action, see Gustave de Molinari, *The Society of Tomorrow* (New York: G.P. Putnam and Sons, 1904), pp. 65–96.

[64]Edmond About, *Handbook of Social Economy* (London: Straham, 1872), p. 104. Also, ibid., pp. 101–12; and Arthur Latham Perry, *Political Economy*, 21st ed. (New York: Charles Scribners' Sons, 1892), p. 180.

"unsophisticated." Simple is perhaps it, but simplicity *per se* is hardly a liability in science. The important consideration is whether the doctrine is correct; if it is correct, then Occam's Razor tells us that the simpler it is, the better.[65]

The rejection of the simple seems to have its root in the positivist methodology. In physics (the model of positivism), the task of science is to go beyond common-sense observation, building a complex structure of explanation of the common-sense facts. Praxeology, however, begins with the common-sense truths as its *axioms*. The laws of physics need complicated empirical testing; the axioms of praxeology are known as obvious to all upon reflection. As a result, positivists are uncomfortable in the presence of universal truth. Instead of rejoicing in the ability to ground knowledge on universally accepted truth, the positivist rejects it as simple, vague, or "naïve."[66]

Samuelson's only attempt to refute the l*aissez-fare* position was to refer briefly to the allegedly classic refutation by Wicksell.[67] Wicksell, however, also dismissed the approach of the "French harmony economists" without argument, and went on to criticize at length the far weaker formulation of Léon Walras. Walras tried to prove "maximum utility" from free trade in the sense of an interpersonally cardinal utility and thus left himself wide open to refutation.

Furthermore, it should be stressed that the theorem of maximum social utility applies not to any type of "perfect" or "pure" competition, or even to "competition" as against "monopoly." It applies simply to any voluntary exchange. It might be objected that a voluntary cartel's action in raising prices makes many consumers worse off, and therefore that assertion of the benefits of voluntary exchange would have to exclude cartels. It is not possible, however, for an observer scientifically to compare the social utilities of results on the free market

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[65]Terence W. Hutchison, *A Review of Economic Doctrines, 1870–1929*, p. 282; Samuelson, *Foundations of Economic Analysis*, p. 204.

[66]For an example of this attitude, see the critique of Hayek's *Counter Revolution of Science* by May Brodbeck, in "On the Philosophy of the Social Sciences," *Philosophy of Science* (April 1954). Brodbeck complains that the praxeologic axioms are not "surprising"; if she pursued the analysis, however, she might find the conclusions surprising enough.

[67]Knut Wicksell, *Lectures on Political Economy* (London: Routledge and Kegan Paul, 1934), vol. 1, pp. 72ff.

from one period of time to the next. As we have seen above, we cannot determine a man's value-scales over a period of time. How much more impossible for all individuals! Since we cannot discover people's utilities over time, we must conclude that whatever the institutional conditions of exchange, however large or small the number of participants on the market, the free market at any time will maximize social utility. For all the exchanges are exchanges effected voluntarily by all parties. Then, suppose some producers voluntarily form a cartel in an industry. This cartel makes its exchanges in Period 2. Social utility is again maximized, for again no one's exchanges are being altered by coercion. If, in Period 2, the government should intervene to prohibit the cartel, it could not increase social utility since the prohibition demonstrably injures the producers.[68]

### *The State as a Voluntary Institution: A Critique*

In the development of economic thought, far more attention has been paid to analysis of free exchange than to State action. Generally, as we have indicated, the State has simply been assumed to be a voluntary institution. The most common assumption is that the State is voluntary because all government must rest on majority consent. If we adhere to the Unanimity Rule, however, it is obvious that a majority is not unanimity, and that therefore economics cannot consider the State as voluntary on this ground. The same comment applies to the majority voting procedures of democracy. The man who votes for the losing candidate, and even more the man who abstains from voting, can hardly be said voluntarily to approve of the action of the government.[69]

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[68]It is also possible to argue, on *general* economic, rather than welfare-economic, grounds, that a voluntary cartel action, *if profitable*, will benefit consumers. In that case, consumers as well as producers would be injured by governmental outlawry of the cartel. As we have indicated above, *welfare* economics demonstrates that no governmental action can increase social utility. *General* economics demonstrates that, in many instances of government actions, even those who immediately benefit lose in the long run.

[69]Schumpeter is properly scornful when he says: "The theory which construes taxes on the analogy of club dues or of purchase of services of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind." Joseph A. Schumpeter, *Capitalism, Socialism, and*

In the last few years, a few economists have begun to realize that the nature of the State needs careful analysis. In particular, they have realized that welfare economics must prove the State to be in some sense voluntary before it can advocate any State action whatever. The most ambitious attempt to designate the State as a "voluntary" institution is the work of Professor Baumol.[70] Baumol's "external economy" thesis may be put succinctly as follows: certain wants are by their nature "collective" rather than "individual." In these cases, every individual will rank the following alternatives on his value scale: In (A) he would most prefer that *everyone but himself* be coerced to pay for the satisfaction of the group want (for example, military protection, public parks, dams, and so on). But since this is not practicable, he must choose between alternatives B and C. In (B) *no one* is forced to pay for the service, in which case the service will probably not be provided since each man will tend to shirk his share; in (C) *everyone*, including the particular individual himself, is forced to pay for the service. Baumol concludes that people will pick C; hence the State's activities in providing these services are "really voluntary." Everyone cheerfully chooses that he be coerced.

This subtle argument can be considered on many levels. In the first place, it is absurd to hold that "voluntary coercion" can be a demonstrated preference. If the decision were truly voluntary, no tax coercion would be necessary—people would voluntarily and publicly agree to pay their share of contributions to the common project. Since they are all supposed to prefer getting the project to not paying for it and not getting it, they are then really *willing* to pay the tax-price to obtain the project. Therefore, the tax coercion apparatus is not necessary, and all people would bravely, if a bit reluctantly, pay what they are "supposed" to without any coercive tax system.

Second, Baumol's thesis undoubtedly is true for the *majority*, since the majority, passively or eagerly, must support a government if it is to survive any length of time. But even if the majority are willing to coerce themselves in order to coerce others (and perhaps tip

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*Democracy* (New York: Harper and Brothers, 1942), p. 198. For a realistic analysis see Molinari, *The Society of Tomorrow*, pp. 87–95.

[70]See William J. Baumol, "Economic Theory and the Political Scientist," *World Politics* (January 1954): 275–77; and Baumol, *Welfare Economics and the Theory of the State*.

the balance of coercion *against* the others), this proves nothing for welfare economics, which must rest its conclusions on *unanimity*, not majority, rule. Will Baumol contend that *everyone* has this value ordering? Isn't there *one* person in the society who prefers freedom for all to coercion over all? If one such person exists, Baumol can no longer call the State a voluntary institution. On what grounds, *a priori* or empirical, can anyone contend that no such individual exists?[71]

But Baumol's thesis deserves more detailed consideration. For even though he cannot establish the existence of voluntary coercion, if it is really true that certain services simply cannot be obtained on the free market, then this would reveal a serious weakness in the free-market "mechanism." Do cases exist where only coercion can yield desired services? At first glance, Baumol's "external economy" grounds for an affirmative answer seem plausible. Such services as military protection, dams, highways, and so on, are important. People desire that they be supplied. Yet wouldn't each person tend to slacken his payment, hoping that the others would pay? But to employ this as a rationale for State provision of such services is a question-begging example of circular reasoning. For this peculiar condition holds only and precisely because the State, not the market, provides these services! The fact that the State provides a service means that, unlike the market, its *provision of the service is completely separated from its collection of payment*. Since the service is generally provided free and more or less indiscriminately to the citizens, it naturally follows that every individual—assured of the service—will try to shirk his taxes. For, unlike the market, his individual tax payment brings him nothing directly. And this condition cannot be a justification for State action; for it is only the *consequence* of the existence of the State action itself.

But perhaps the State must satisfy some wants because these wants are "collective" rather than "individual"? This is Baumol's second line of attack. In the first place, Molinari has shown that the existence of collective wants does not necessarily imply State action. But, furthermore, the very concept of "collective" wants is a dubious

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[71]Galbraith, in effect, does make such an assumption, but obviously without adequate basis. See John K. Galbraith, *Economics and the Art of Controversy* (New Brunswick, N.J.: Rutgers University Press, 1955), pp. 77–78.

one. For this concept must imply the existence of some existent collective entity who does the wanting! Baumol struggles against conceding this, but he struggles in vain. The necessity for assuming such an entity is made clear in Haavelmo's discussion of "collective action," cited favorably by Baumol. Thus, Haavelmo grants that deciding on collective action "requires a way of thinking and a power to act which are outside the functional sphere of any individual group as such."[72]

Baumol attempts to deny the necessity for assuming a collective entity by stating that some services can be financed only jointly, and will serve many people jointly. Therefore, he argues that individuals on the market cannot provide these services. This is a curious position indeed. For all large-scale businesses are "jointly" financed with huge aggregations of capital, and they also serve many consumers, often jointly. No one maintains that private enterprise cannot supply steel or automobiles or insurance because they are "jointly" financed. As for joint consumption, in one sense no consumption can be joint, for only individuals exist and can satisfy their wants, and therefore everyone must consume separately. In another sense, almost all consumption is "joint." Baumol, for example, asserts that parks are an example of "collective wants" jointly consumed, since many individuals must consume them. Therefore, the government must supply this service. But going to a theater is even more joint, for all must go at the same time. Must all theaters therefore be nationalized and run by the government? Furthermore, in a broad view, all modern consumption depends on mass production methods for a wide market. There are no grounds by which Baumol can separate certain services and dub them "examples of interdependence" or "external economies." What individuals could buy steel or automobiles or frozen foods, or almost anything else, if enough other individuals did not exist to demand them and make their mass-production methods worthwhile? Baumollian interdependencies are all around us, and there is no rational way to isolate a few services and call them "collective."

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[72]Haavelmo, "The Notion of Involuntary Economic Decision." Yves Simon, cited favorably by Rothenberg, is even more explicit, postulating a "public reason" and a "public will" as contrasted to individual reasonings and wills. See Yves Simon, *Philosophy of Democratic Government* (Chicago: University of Chicago, 1951); Rothenberg, "Conditions," pp. 402–03.

A common argument related to, though more plausible than, Baumol's thesis is that certain services are so vital to the very existence of the market that they must be supplied collectively outside the market. These services (protection, transportation, and so on) are so basic, it is alleged, that they permeate market affairs and are a prior necessary condition for its existence. But this argument proves far too much. It was the fallacy of the classical economists that they considered goods in terms of large *classes*, rather than in terms of *marginal units*. All actions on the market are marginal, and this is precisely the reason that valuation and imputation of value-productivity to factors can be effected. If we start dealing with whole classes rather than marginal units, we can discover all sorts of activities which are necessary prerequisites of, and vital to, all market activity; land, room, food, clothing, shelter, power, and so on—and even paper! Must all of these be supplied by the State and the State only?

Stripped of its many fallacies, the whole "collective wants" thesis boils down to this: certain people on the market will receive benefits from the action of others without paying for them.[73] This is the long and short of the criticism of the market, and this is the only relevant "external economy" problem.[74] A and B decide to pay for the building of a dam for their uses; C benefits though he did not pay. A and B educate themselves at their expense and C benefits by being able to deal with educated people, and so on. This is the problem of the Free Rider. Yet it is difficult to understand what the hullabaloo is all about. Am I to be specially taxed because I enjoy the sight of my neighbor's garden without paying for it? A's and B's purchase of a good reveals that *they* are willing to pay for it; if it indirectly benefits C as well, no one is the loser. If C feels that he would be deprived of the benefit if only A and B paid, then he is free to contribute too. In any case, all the individuals consult their own preferences in the matter.

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[73]See the critique of a similar position of Spencer's by "S.R.," "Spencer As His Own Critic," *Liberty* (June 1904).

[74]The famous "external diseconomy" problems (noise, smoke nuisance, fishing, and so on) are really in an entirely different category, as Mises has shown. These "problems" are due to insufficient defense of private property against invasion. Rather than a defect of the free market, therefore, they are the results of invasions, of property, invasions which are ruled out of the free market by definition. See Mises, *Human Action*, pp. 650–56.

In fact, we are *all* free riders on the investment, and the technological development, of our ancestors. Must we wear sackcloth and ashes, or submit ourselves to State dictation, because of this happy fact?

Baumol and others who agree with him are highly inconsistent. On the one hand, action cannot be left up to voluntary individual choice because the wicked free rider might shirk and obtain benefits without payment. On the other hand, individuals are often denounced because people will not *do enough* to benefit free riders. Thus, Baumol criticizes investors for not violating their own time-preferences and investing more generously. Surely, the sensible course is neither to penalize the free rider nor to grant him special privilege. This would also be the only solution consistent with the unanimity rule and demonstrated preference.[75]

Insofar as the "collective want" thesis is not the problem of the Free Rider, it is simply an ethical attack on individual valuations, and a desire by the economist (stepping into the role of an ethicist) to substitute his valuations for those of other individuals in deciding the *latter's* actions. This becomes clear in the assertion by Suranyi-Unger: "he (an individual) may be led by a niggardly or thoughtless or frivolous evaluation of utility and disutility and by a corresponding low degree or complete absence of group responsibility."[76]

Tibor Scitovsky, while engaging in an analysis similar to Baumol's, also advances another objection to the free market based on what he calls "pecuniary external economies."[77] Briefly, this conception suffers

[75]In a good, though limited, criticism of Baumol, Reder points out that Baumol completely neglects voluntary social organizations formed by individuals, for he assumes the State to be the only social organization. This error may stem partly from Baumol's peculiar definition of "individualistic" as meaning a situation where no one considers the effects of his actions on anyone else. See Melvin W. Reder, "Review of Baumol's *Welfare Economics and the Theory of the State*," *Journal of Political Economy* (December 1953): 539.

[76]Theo Suranyi-Unger, "Individual and Collective Wants," *Journal of Political Economy* (February 1948): 1–22. Suranyi-Unger also employs such meaningless concepts as the "aggregate utility" of the "collectivized want satisfaction."

[77]Tibor Scitovsky, "Two Concepts of External Economies," *Journal of Political Economy* (April 1954): 144–51.

from the common error confusing the general (and unattainable!) equilibrium of the evenly rotating economy with an ethical ideal and therefore belaboring such ever-present phenomena as the existence of profits as departures from such an ideal.

Finally, we must mention the very recent attempts of Professor Buchanan to designate the State as a voluntary institution.[78] Buchanan's thesis is based on the curious dialectic that majority rule in a democracy is really unanimity because majorities can and do always shift! The resulting pulling and hauling of the political process, because obviously not irreversible, are therefore supposed to yield a social unanimity. The doctrine that endless political conflict and stalemate really amount to a mysterious social unanimity must be set down as a lapse into a type of Hegelian mysticism.[79]

## Conclusion

In his brilliant survey of contemporary economics, Professor Bronfenbrenner described the present state of economic science in the gloomiest possible terms.[80] "Wilderness" and "hash" were typical epithets, and Bronfenbrenner ended his article in despair by quoting the famous poem *Ozymandias*. Applied to currently fashionable theory, his attitude is justified. The 1930s was a period of eager activity and seemingly pathbreaking advances in economic thought. Yet one by one, reaction and attenuation have set in, and in the mid-1950s the high hopes of twenty years ago are either dying or fighting desperate rearguard action. None of the formerly new approaches any longer inspires fresh theoretical contributions. Bronfenbrenner

[78]See James M. Buchanan, "Social Choice, Democracy, and Free Markets," *Journal of Political Economy* (April 1954): 114–23; and Buchanan, "Individual Choice in Voting and the Market," *Journal of Political Economy* (August 1954): 334–43. In many other respects, Buchanan's articles are quite good.

[79]How flimsy this "unanimity" is, even for Buchanan, is illustrated by the following very sensible passage: "a dollar vote is never overruled; the individual is never placed in the position of being a member of dissenting minority"—as he is in the voting process (Buchanan, "Individual Choice in Voting and the Market," p. 339). Buchanan's approach leads him so far as to make a positive virtue out of inconsistency and indecision in political choices.

[80]Bronfenbrenner, "Contemporary Economics Resurveyed."

specifically mentions in this connection the imperfect competition and the Keynesian theories, and justly so. He could also have mentioned utility and welfare theory. For the mid-1930s saw the development of the Hicks-Allen indifference curve analysis and the New Welfare Economics. Both of these theoretical revolutions have been enormously popular in the upper reaches of economic theory; and both are now crumbling.

The contention of this paper is that while the formerly revolutionary and later orthodox theories of utility and welfare deserve an even speedier burial than they have been receiving, they need not be followed by a theoretical vacuum. The tool of Demonstrated Preference, in which economics deals only with preference as demonstrated by real action, combined with a strict Unanimity Rule for assertions of social utility, can serve to effect a thoroughgoing reconstruction of utility and welfare economics. Utility theory can finally be established as a theory of ordinal marginal utility. And welfare economics can become a vital *corpus* again, even though its new personality might not attract its previous creators. It must not be thought that we have, in our discussion of welfare economics, been attempting to set any ethical or political program. On the contrary, the proposed welfare economics has been put forward without inserting ethical judgments. Economics by itself and standing alone cannot establish an ethical system, and we must grant this regardless of what philosophy of ethics we hold. The fact that the free market maximizes social utility, or that State action cannot be considered voluntary, or that the *laissez-faire* economists were better welfare analysts than they are given credit for, in itself implies no plea for *laissez-faire* or for any other social system. What welfare economics does is to present these conclusions to the framer of ethical judgments as part of the data for his ethical system. To the person who scorns social utility or admires coercion, our analysis might furnish powerful arguments for a policy of thoroughgoing Statism.

## Section Three

# Property and the Public Sector

# 18

# The Politics of Political Economists

In the course of his interesting discussion of "The Politics of Political Economists," Professor Stigler challenges the alleged view of Professor Mises that "economic statistics, or more generally quantitative—economics, generates a radical political viewpoint."[1] Stigler asserts that the empirical student acquires a "real feeling" for the functioning of an economic system, and "has had the complexities of the economy burned into his soul." Without going into the question of Mises's precise viewpoint on this issue, I think it important to note that Stigler has overlooked several fundamental considerations.

In the first place, statistics are desperately needed for any sort of government planning of the economic system. In a free market economy, the individual business firm has little or no need of statistics. It need only know its prices and costs. Costs are largely discovered internally within the firm and are not the general data of the economy which we usually refer to as "statistics." The "automatic" market, then, requires virtually no gathering of statistics; government intervention, on the other hand, whether piecemeal or fully socialist, could do literally nothing without extensive ingathering of masses of statistics. Statistics are the bureaucrat's only form of economic knowledge, replacing the intuitive, "qualitative" knowledge of the entrepreneur, guided only by the quantitative profit-and-loss test.[2]

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Originally appeared as "The Politics of Political Economists: Comment" in *Quarterly Journal of Economics* 74, no. 4 (November 1960): 659–65.

[1]George Stigler, "The Politics of Political Economists," *Quarterly Journal of Economics* 73 (November 1959): 529.

[2]On the type of knowledge required of the entrepreneur in the market economy, see F.A. Hayek, *Individualism and the Economic Order* (Chicago: University of Chicago Press, 1948), chaps. 4 and 2.

Accordingly, the drive for government intervention, and the drive for more statistics, have gone hand in hand.[3]

The enormous expansion of governmental activity in the gathering and disseminating of statistics in the last twenty-five years, is surely more than coincidentally related to the similar expansion of the role of government in regulating and manipulating the economy. One of the leading authorities on the growth of government expenditures has put it this way:

> Advance in economic science and statistics improved our knowledge of interstate and intrastate differences in needs and capacities and may have helped stimulate the system of state and federal grants-in-aid. It strengthened belief in the possibilities of dealing with social problems by collective action. It made for increase in the statistical and other fact-finding activities of government.[4]

We need not detail here the extensive use that has been made of national income and gross national product statistics, as well as other statistical measures, in the attempts of the federal government at combating business cycles or unemployment.

Nor is this just a contemporary story. An authoritative work on British government puts the case thus:

> the minor role of government during the nineteenth century reflects more than the absence of violent economic disruption; it also reflects the infancy of the economic and social sciences. Compared with recent decades, the volume of systematic information about social conditions was very small, which meant that the existence of problems was hard to establish persuasively. . . . If the volume of unemployment is unknown, the gravity of the problem is in doubt. . . .

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[3]In this connection, we may note Professor Hutchison's distinction between Carl Menger's stress on the beneficent, unplanned, "unreflected" phenomena of society (which, of course, include the free market), and the growth of "social self-consciousness" and government planning. To Hutchison, a prominent component of "social self-consciousness" is social and economic statistics. T.W. Hutchison, *A Review of Economic Doctrines, 1870–1929* (Oxford: The Clarendon Press, 1953), pp. 150–51, 427.

[4]Solomon Fabricant, *The Trend of Government Activity in the United States since 1900* (New York: National Bureau of Economic Research, 1952), p. 143.

> The accumulation of factual information about social conditions and the development of economics and the social sciences increased the pressure for government intervention. . . . Surveys like Charles Booth's *Life and Labour of the People in London* revealed conditions which shocked public opinion in the late eighties and nineties. As statistics improved and students of social conditions multiplied, the continued existence of such conditions was kept before the public. Increasing knowledge of them aroused influential circles and furnished working class movements with factual weapons.[5]

Surely the role of the Fabian Society's industrious empirical studies in furthering the cause of socialism in Great Britain is too well known to need stressing here.

On the continent and in America in the late nineteenth century, it is well known that the rebels against *laissez-faire* and the classical political economy stressed their replacement with induction from economic history and statistics. That was the goal of the German Historical School and its *Verein für Sozialpolitik*, and of the young German-trained exponents of the "new political economy" of government intervention in the 1870s and 1880s.[6] One of their leaders, Richard T. Ely, who called the new approach the "look and see"

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[5]Moses Abramovitz and Vera F. Eliasberg, *The Growth of Public Employment in Great Britain* (Princeton, N.J.: National Bureau of Economic Research, 1957), pp. 22–23, 30.

[6]Thus, the new school

> found the deductive method of reasoning inadequate for its purposes. It championed the inductive method. . . . It rejected all a priori principles and looked to history and statistics to provide the facts of economic life. With the information thus obtained, the young economists approached economic problems in a pragmatic spirit, judging each case on its individual merits. In this way, they sought to prevent economic science from degenerating into a few abstract formulas, divorced from the realities of the age. (Sidney Fine, *Laissez-Faire and the General-Welfare State* [Ann Arbor: University of Michigan Press, 1956], p. 204)

Also see the principles of the new school as presented in Joseph Dorfman, "The Role of the German Historical School in American Economic Thought," *American Economic Review, Papers and Proceedings* XLV (May 1955): 21.

method, made it clear that the aim of fact-gathering was to "mold the forces at work in society and to improve existing conditions"; they believed that as economists they had a responsibility for "shaping the character of the national economy."[7] And let us not overlook the eminent interventionist sociologist Lester Frank Ward, whose proposed "scientific," "positive," planned economy, would consist of a "social engineering" based on statistical information fed from all parts of the country into a central bureau of statistics.[8]

Nor was it only abstract speculators who expressed such views. Statisticians themselves participated in this movement. As early as 1863, Samuel B. Ruggles, American delegate to the International Statistical Congress in Berlin, declared that "statistics are the very eyes of the statesman, enabling him to survey and scan with clear and comprehensive vision the whole structure and economy of the body politic." One of the founders of the *Verein für Sozialpolitik* was the famous statistician Ernst Engel, head of the Royal Statistical Bureau of Prussia.[9] And Carroll D. Wright, one of the early Commissioners of Labor in the United States and a man greatly influenced by Engel, urged the collection of statistics of unemployment because he wanted to find a remedy (presumably via government action). Wright hailed the new German School as including men of all lands "who seek by legitimate means, and without revolution, the

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[7]Fine, *Laissez-Faire and the General-Welfare State,* p. 207. We might add that the French laissez-faire economist Maurice Block attacked the German Historical School and their followers as "empirics" seeking to replace principle by sentiment and holding that "the state . . . should conduct everything, direct everything, decide everything." Dorfman, "The Role of the German Historical School in American Economic Thought," p. 20. And recently Professor Hildebrand has commented, on the inductive emphasis of the German School, that "perhaps there is, then, some connection between this kind of teaching and the popularity of crude ideas of physical planning in more recent times." George H. Hildebrand, "International Flow of Economic Ideas—Discussion," *American Economic Review, Papers and Proceedings* XLV (May 1955): 37. Also see F.A. Hayek, "History and Politics," in F.A. Hayek, ed., *Capitalism and the Historians* (University of Chicago Press, 1954), p. 23.

[8]Fine, *Laissez-Faire and the General-Welfare State*, p. 258.

[9]See Dorfman, "The Role of the German Historical School in American Economic Thought," p. 18.

amelioration of unfortunate industrial and social relations." Henry Carter Adams, a student of Engel's, who established the Statistical Bureau of the Interstate Commerce Commission, believed that "ever-increasing statistical activity by the government was essential not only for the sake of controlling naturally monopolistic industries, but also for the efficient functioning of competition wherever possible."[10] And certainly one of the great spurs toward constructing index numbers of wholesale and other prices was the desire to have government stabilize the price level.[11]

Unquestionably one of the prime founders of modern statistical inquiry in economics was Wesley C. Mitchell. There is no doubt that Mitchell aspired to lay the basis for "scientific" government planning. Thus:

> [quoting from Mitchell] . . . clearly the type of social invention most needed today is one that offers definite techniques through which the social system can be controlled and operated to the optimum advantage of its members." To this end he [Mitchell] constantly sought to extend, improve, and refine the gathering and compilation of data. . . . Mitchell believed that business-cycle analysis might indicate the means to the achievement of orderly social control of business activity.[12]

And:

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[10]Joseph Dorfman, *The Economic Mind in American Civilization* (New York: The Viking Press, 1949), vol. 3, pp. 172, 123. Dorfman notes that the accounting system of the Bureau devised by Adams "served as a model for the regulation of public utilities here and throughout the world." Dorfman, "The Role of the German Historical School in American Economic Thought," p. 23. We might also add that the first professor of statistics in the United States, Roland P. Falkner, was a devoted student of Engel's and a translator of the works of Engel's assistant, August Meitzen.

[11]"One of the greatest obstacles then standing in the way of stabilization was the prevalent idea that index numbers were unreliable. Until this difficulty could be met, stabilization could scarcely be expected to become a reality. In order to do my bit toward solving this problem, I wrote *The Making of Index Numbers* . . ." Irving Fisher, *Stabilised Money* (London: George Allen and Unwin, 1935), p. 383.

[12]Dorfman, *The Economic Mind in American Civilization*, vol. 4, pp. 76, 361.

> he [Mitchell] envisaged the great contribution that government could make to the understanding of economic and social problems if the statistical data gathered independently by various Federal agencies were systematized and planned so that the interrelationships among them could be studied. The idea of developing social statistics, *not merely as a record but as a basis for planning*, emerged early in his own work.[13]

The federal government's own account of the growth of its statistical agencies differs little from the above examples. The Bureau of the Budget, during President Eisenhower's not rabidly socialistic administration, explained the continued growth of federal statistics as follows:

> National growth and prosperity demanded an enlightened conduct of public affairs with the aid of factual information. The ultimate responsibility of the Federal Government for underwriting the health of the national economy has always been implicit in the American system.[14]

Then, speaking of the New Deal era after 1933, the Bureau added:

> A realization grew in the Congress and in high administration circles that sound and positive proposals to combat the depression required analysis based upon reliable information. As a result . . . statistical expansion was resumed at an accelerated pace.[15]

Suffice it then to say that a leading cause of the proliferation of governmental statistics is the need for statistical data in government economic planning. But the relationship works also in reverse: the growth of statistics, often developed originally for its own sake, ends by multiplying the avenues of government intervention and planning. In short, statistics do not have to be developed originally for politico-economic ends; their own autonomous development, directly or indirectly, opens up new fields for interventionists to

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[13]Lucy Sprague Mitchell, *Two Lives* (New York: Simon and Schuster, 1953), p. 363; my italics.

[14]Statement by the Bureau of the Budget, in *Economic Statistics*, Hearings Before the Subcommittee on Economic Statistics of the Joint Committee on the Economic Report, 83d Congress, 2d Session, July 12, 1954 (Washington, D.C.: United States Printing Office, 1954), pp. 10–12.

[15]Ibid.

exploit. Each new statistical technique, whether it be flow of funds, inter-industry economics, or activity analysis, soon acquires its own subdivision and application in government. A particular example is input-output analysis, which began as a purely theoretical attempt to lend empirical content to the Walrasian system of general equilibrium. It has now advanced to the point where its champions hail it as providing:

> an integrated picture of the industrial mechanism. They believe it can measure with fair accuracy the changes in inter-industry relations. . . that would follow assumed changes in the "final bill of goods. . . ." In practice, the most important change in the bill of goods is that called for by way of large-scale rearmament. It is hardly astonishing, therefore, that most of the development and application of input-output studies have been connected with industrial mobilization.[16]

There are other reasons why the statistically-oriented will tend to become interventionists. For one thing, the economic statistician will tend to be impatient of all theory as "armchair speculation," and hence will tend to advocate piecemeal, pragmatic, decide-every-case-on-its-"merits" type of government planning. It is perhaps true, as Stigler declares, that few empirical economists have become outright socialists or communists; such a course would be much too theoretical for them. But neither do they become adherents of *laissez*

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[16]Raymond W. Goldsmith, "Introduction," in *Input-Output Analysis, An Appraisal* (Princeton, N.J.: National Bureau of Economic Research, 1955), p. 5. As Evans and Hoffenberg state: "It is because of the necessity for doing a better job in industrial mobilization analysis . . . that most current developments in the field of interindustry economics are under way." W. Duane Evans and Marvin Hoffenberg, "The Nature and Uses of Interindustry-Relations Data and Methods," ibid., p. 102. Also see ibid., pp. 116ff., and the criticisms of input-output analysis by Clark Warburton and Milton Friedman, ibid., pp. 127, 174.

Another example of input-output analysis as a spur to statistics-gathering and government planning: "while there may be systematic thinking among economists about economic analysis as applied to regions, they can offer little guidance to policy-making unless the latter are prepared to make it easier to obtain statistical raw material." A.T. Peacock and D.G.M. Dosser, "Regional Input-Output Analysis and Government Spending," *Scottish Journal of Political Economy* (November 1959): 236.

*faire*; instead, a case-by-case *ad hoc* approach drives them down the path of a muddled government interventionism. I do not know whether, as Stigler asserts, "the most radical wing of the new dealers was not distinguished for its empirical knowledge of the American economy." But certainly the Tugwells and the Stuart Chases and the Veblenians proclaimed their empiricism often enough. And historians of the New Deal generally praise it highly for its flexible, pragmatic approach.

Another reason why statistics and political pragmatism are mutually congenial is that the very hallmark of the pragmatic approach is to begin by looking for problems or "problem areas" in the society. The pragmatist looks for areas where the economy and society fall short of the Garden of Eden, and these, of course, abound. Poverty, unemployment, old people with scurvy, young people with cavities—the list is indeed endless. And as each problem multiplies under the care of his eager research, the pragmatist calls ever more stridently for government to do something—quickly—to solve the problem. Only hard-headed, deductive, *a prioristic*, economic theory can teach him about ends and means, allocation of resources, opportunity cost, and the other rigors of the economic discipline.

Considering the above discussion, it is no wonder that conservative members of Congress, in the days before they were indoctrinated in the modern economic niceties by the Joint Committee on the Economic Report, were very suspicious of the seemingly harmless expansion of federal statistical activities. Thus, in 1945, Representative Frank Keefe, conservative Republican Congressman from Wisconsin was in the process of questioning Dr. A. Ford Hinrichs, head of the Bureau of Labor Statistics, on the latter's request for increased appropriations. In the course of the questioning Keefe's misgivings about government statistics emerged as a cry from the heart—unsophisticated perhaps, but at least of sound conservative instinct:

> There is no doubt but what it would be nice to have a whole lot of statistics. . . . I am just wondering whether we are not embarking on a program that is dangerous when we keep adding and adding and adding to this thing. . . .
>
> We have been Planning and getting statistics ever since 1932 to try to meet a situation that was domestic in character, but were never able to even meet that question. . . . Now we are involved in

> an international question. . . . It looks to me as though we spend a tremendous amount of time with graphs and charts and statistics and planning. What my people are interested in is, what is it all about? Where are we going, and where are you going?[17]

I think we can conclude that the nub of the difference between Stigler and myself is this: to him a radical or nonconservative is essentially a socialist or a communist. To me, a nonconservative is someone who advocates intervention rather than *laissez faire*. The difference is one of frame of reference If we define conservatism as Stigler does, then it is true that most economists are conservatives; if we define it as believing in *laissez faire*, then the conclusion must be very different. For the key then becomes not so much economics and noneconomics as theory versus empiricism. Empiricists will tend less to be full-scale socialists, but will also drift generally toward intervention.[18]

Still, when all is said and done, it is probably true that even the proportion of believers in *laissez faire* is much greater among economists than in other academic disciplines, and that the "average" point on the ideological spectrum in economics is considerably "to the right" of the average in other fields of study. It appears that the economic discipline, *per se*, imposes a rightward shift in ideological belief. And this, after all, is the main point of Stigler's article.

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[17]*Department of Labor—FSA Appropriation Bill for 1945*. Hearings Before the Subcommittee of the House Committee on Appropriations. 78th Congress, 2d Session, Part I (Washington, D.C.: United States Printing Office, 1945), pp. 258f., 276f.

[18]There are also profound epistemological reasons for empiricism in the "social sciences" tending toward statism. This involves the whole problem of positivism and "scientism." On this, see F.A. Hayek, *The Counter-Revolution of Science* (Glencoe, Ill.: The Free Press, 1952).

# 19

# Justice and Property Rights

## The Failure of Utilitarianism

Until very recently, free-market economists paid little attention to the entities actually being exchanged on the very market they have advocated so strongly. Wrapped up in the workings and advantages of freedom of trade, enterprise, investment, and the price system, economists tended to lose sight of the things being exchanged on that market. Namely, they lost sight of the fact that when $10,000 is being exchanged for a machine, or $1 for a hula hoop, what is actually being exchanged is the *title of ownership* to each of these goods. In short, when I buy a hula hoop for a dollar, what I am actually doing is exchanging my title of ownership to the dollar in exchange for the ownership title to the hula hoop; the retailer is doing the exact opposite.[1] But this means that economists' habitual attempts to be *Wertfrei*, or at the least to confine their advocacy to the processes of trade and exchange, cannot be maintained; for if I and the retailer are indeed to be free to trade the dollar for the hula hoop without coercive interference by third parties, then this can only be done if these economists will proclaim

Originally appeared in *Property in a Humane Economy*, Samuel Bluemenfeld, ed. (LaSalle, Ill.: Open Court, 1974), pp. 101–22.

[1]Economists failed to heed the emphasis on titles of ownership underlying exchange stressed by the social philosopher Spencer Heath. Thus: "Only those things which are owned can be exchanged or used as instruments of service or exchange. This exchange is not transportation; it is the transfer of ownership of title. This is a social and not a physical process." Spencer Heath, *Citadel, Market and Altar* (Baltimore, Maryland: Science of Society Foundation, 1957), p. 48.

the justice and the propriety of my original ownership of the dollar and retailer's ownership of the hula hoop.

In short, for an economist to say that X and Y should be free to trade Good A for Good B unmolested by third parties, he must *also* say that X legitimately and properly owns Good A and that Y legitimately owns Good B. But this means that the free-market economist must have some sort of theory of justice in property rights; he can scarcely say that X properly owns Good A without asserting some sort of theory of justice on behalf of such ownership.

Suppose, for example, that as I am about to purchase the hula hoop, the information arrives that the retailer had really stolen the hoop from Z. Surely not even the supposedly *Wertfrei* economist can continue to endorse blithely the proposed exchange of ownership titles between myself and the retailer. For now we find that retailer Y's title of ownership is improper and unjust and that he must be forced to return the hoop to Z, the original owner. The economist can then only endorse the proposed exchange between myself and Z, rather than Y, for the hula hoop, since he has to acknowledge Z as the proper owner of title to the hoop.

In short, we have two mutually exclusive claimants to the ownership of the hoop. If the economist agrees to endorse only Z's sale of the hoop, then he is implicitly agreeing that Z has the just, and Y the unjust, claim to the hoop. And even if he continues to endorse the sale by Y, then he is implicitly maintaining *another* theory of property titles: namely, that theft is justified. Whichever way he decides, the economist cannot escape a judgment, a theory of justice in the ownership of property. Furthermore, the economist is not really finished when he proclaims the injustice of theft and endorses Z's proper title. For what is the justification for Z's title to the hoop? Is it only because he is a nonthief?

In recent years, free-market economists Ronald Coase and Harold Demsetz have begun to redress the balance and to focus on the importance of a clear and precise demarcation of property rights for the market economy. They have demonstrated the importance of such demarcation in the allocation of resources and in preventing or compensating for unwanted imposition of "external costs" from the actions of individuals. But Coase and Demsetz have failed to develop any theory of justice in these property rights; or rather, they have

advanced two theories: one, that it "doesn't matter" *how* the property titles are allocated, so long as they are allocated precisely; and, two, that the title should be allocated to minimize "total social transaction costs," since a minimization of costs is supposed to be a *Wertfrei* way of benefiting all society.

There is no space here for a detailed critique of the Coase-Demsetz criteria. Suffice it to say that even if, say, in a conflict over property title between a rancher and a farmer for the same piece of land, the allocation of title "doesn't matter" for the allocation of resources (a point which itself could be challenged), it certainly matters from the point of view of the rancher and the farmer. And second, that it is impossible to weigh "total social costs" if we fully realize that all costs are subjective to the individual and therefore cannot be compared interpersonally.[2] Here the important point is that Coase and Demsetz, along with all other utilitarian free-market economists, implicitly or explicitly leave it to the hands of government to define and allocate the titles to private property.

It is a curious fact that utilitarian economists, generally so skeptical of the virtues of government intervention, are so content to leave the fundamental underpinning of the market process—the definition of property rights and the allocation of property titles—wholly in the hands of government. Presumably they do so because they themselves have no theory of justice in property rights and therefore place the burden of allocating property titles in the hands of government Thus, if Smith, Jones, and Doe each own property and are about to exchange their titles, utilitarians simply assert that if these titles are legal (that is, if the government puts the stamp of approval upon them), then they consider those titles to be justified, it is only if someone violates the government's definition of legality (for example, in the case of Y, the thieving retailer) that utilitarians are willing to agree with the general and governmental view of the injustice of such action. But this means, of course, that, once again, the utilitarians have failed in their wish to escape having a theory of justice in property; actually they *do* have such a theory, and it is the surely simplistic one that *whatever government defines as legal is right.*

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[2]For a welcome emphasis on the subjectivity of cost, see James M. Buchanan, *Cost and Choice* (Chicago: Markham, 1969).

As in so many other areas of social philosophy, then, we see that utilitarians, in pursuing their vain goal of being *Wertfrei*, of "scientifically" abjuring any theory of justice, actually *have* such a theory, namely, putting their stamp of approval on whatever the process by which the government arrives at its allocation of property rights: Furthermore, we find that, as on many similar occasions, utilitarians in their vain quest for the *Wertfrei*, really conclude by endorsing as right and just whatever the government happens to decide, that is, by blindly apologizing for the *status quo*.[3]

Let us consider the utilitarian stamp of approval on government allocation of property titles. Can this approval possibly achieve even the limited utilitarian goal of certain and precise allocation of property titles? Suppose that the government endorses the existing titles to their property held by Smith, Jones, and Doe. Suppose then that a faction of government calls for the confiscation of these titles and redistribution of that property to Roe, Brown, and Robinson. The reasons for this program may stem from any number of social theories or even from the brute fact that Roe, Brown, and Robinson have greater political power than the original trio of owners. The reaction to this proposal by free-market economists and other utilitarians is predictable: they will oppose this proposal on the ground that definite and certain property rights, so socially beneficial, are being endangered. But suppose that the government, ignoring the protests of our utilitarians, proceeds anyway and redistributes these titles to property. Roe, Brown, and Robinson are *now* defined by the government as the proper and legal owners, while any claims to that property by the original trio of Smith, Jones, and Doe are considered improper and illegitimate, if not subversive. What now will be the reaction of our utilitarians?

It should be clear that since the utilitarians base their theory of justice in property only on *whatever the government defines* as legal, they can have no groundwork whatever for any call for restoring the property in question to its original owners. They can only, willy-nilly,

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[3]I do not mean to imply here that *no* social science of economic analysis can be *Wertfrei*, only that any attempt whatever to apply the analysis to the political arena, however remote, *must* involve and imply some sort of ethical position.

and despite any emotional reluctance on their part, endorse the *new* allocation of property titles as defined and endorsed by government. Not only must utilitarians endorse the *status quo* of property titles, they must endorse whatever *status quo* exists and however rapidly the government decides to shift and redistribute such titles. Furthermore, considering the historical record, we may indeed say that relying upon government to be the guardian of property rights is like placing the proverbial fox on guard over the chicken coop.

We see, therefore, that the supposed defense of the free market and of property rights by utilitarians and free-market economists is a very weak reed indeed. Lacking a theory of justice that goes beyond the existing *imprimatur* of government, utilitarians can only go along with every change and shift of government allocation after they occur, no matter how arbitrary, rapid, or politically motivated such shifts might be. And since they provide no firm roadblock for governmental reallocations of property, the utilitarians, in the final analysis, can offer no real defense of property rights themselves. Since governmental redefinitions can and will be rapid and arbitrary, they cannot provide long-run certainty for property rights, and therefore they cannot even ensure the very social and economic efficiency which they themselves seek.[4] All this is implied in the pronouncements of utilitarians that any future free society must confine itself to whatever definitions of property titles the government may happen to be endorsing at that moment.

Let us consider a hypothetical example of the failure of utilitarian defense of private property. Suppose that somehow government becomes persuaded of the necessity to yield to a clamor for a free-market, *laissez-faire* society. Before dissolving itself, however, it redistributes property titles: granting the ownership of the entire territory of New York to the Rockefeller family, of Massachusetts to the Kennedy family, and so on. It then dissolves, ending taxation and all other forms of government intervention in the economy. However, while taxation has been abolished, the Rockefeller, Kennedy, and so on, families proceed to dictate to all the residents in what is now "their" territory, exacting what are now called "rents" over all the

[4]On the arbitrariness and uncertainty of all legislative law, see Bruno Leoni, *Freedom and the Law* (Los Angeles: Nash, 1972).

inhabitants.[5] It seems clear that our utilitarians could have no intellectual armor with which to challenge this new dispensation; indeed, they would have to endorse the Rockefeller, Kennedy, and so on, holdings as "private property" equally deserving of support as the ordinary property titles which they had endorsed only a few months previously. All this because the utilitarians have no theory of justice in property beyond endorsement of whatever *status quo* happens to exist.

Consider, furthermore, the grotesque box in which the utilitarian proponent of freedom places himself in relation to the institution of human slavery. Contemplating that institution and the "free" market that once existed in buying, selling, and renting slaves, the utilitarian who must rely on the legal definition of property can only endorse slavery on the ground that the slave masters had purchased their slave titles legally and in good faith. Surely, any endorsement of a "free" market in slaves indicates the inadequacy of utilitarian concepts of property and the need for a theory of justice to provide a groundwork for property rights and a critique of existing official titles of property.

## Toward a Theory of Justice in Property

We conclude that utilitarianism cannot be supported as a groundwork for property rights or, *a fortiori*, for the free-market economy. A theory of justice must be arrived at which goes beyond government allocations of property titles and which can therefore serve as a basis for criticizing such allocations. Obviously, in this space I can only outline what I consider to be the correct theory of justice in property rights. This theory has two fundamental premises: (a) the absolute property right of each individual in his own person, his own body: this may be called the *right of self-ownership*; and (b) the absolute right in material property of the person who first finds an unused material resource and then in some way occupies or transforms that resource by the use of his personal energy. This might be called the *homestead principle*—the case in which someone, in the phrase of John Locke, has "mixed his labor" with an unused resource. Let Locke summarize these principles:

[5]The point here is not, of course, to criticize all rents *per se*, but rather to call into question the legitimacy of property titles (here landed property) derived from the coercive actions of government.

> every man has a *property* in his own *person*. This nobody has any right to but himself. The *labor* of his body and the *work* of his hands, we may say, are properly his. Whatsoever, then, he removed out of the state that nature hath provided and left it in, he hath mixed his labor with it, and joined to it something that is his own, and thereby makes it his property. It being by him removed from the common state nature placed it in, it hath by this labor something annexed to it that excludes the common right of other men.[6]

Let us consider the first principle: the right of self-ownership. This principle asserts the absolute right of each man, by virtue of his (or her) being a human being, to "own" his own body, that is, to control that body free of coercive interference. Since the nature of man is such that each individual must use his mind to learn about himself and the world, to select values, and to choose ends and means in order to survive and flourish, the right to self-ownership gives each man the right to perform these vital activities without being hampered and restricted by coercive molestation.

Consider, then, the alternatives—the consequences of *denying* each man the right to own his own person. There are only two alternatives: either (1) a certain class of people, A, have the right to own another class, B, or (2) everyone has the right to own his equal quotal share of everyone else. The first alternative implies that while Class A deserves the rights of being human, Class B is in reality subhuman and therefore deserves no such rights. But since they are indeed human beings, the first alternative contradicts itself in denying natural human rights to one set of humans. Moreover, allowing Class A to own Class B means that the former is allowed to exploit, and therefore to live parasitically at the expense of the latter, but, as economics can tell us, this parasitism itself violates the basic economic requirement for human survival production and exchange.

The second alternative, which we might call "participatory communalism" or "communism," holds that every man should have the right to own his equal quotal share of everyone else. If there are three billion people in the world, then everyone has the right to own a three-billionth of every other person. In the first place, this ideal

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[6]John Locke, "An Essay Concerning the True, Original Extent and End of Civil Government," in *Social Contract*, Ernest Barker, ed. (New York: Oxford University Press, 1948), pp. 17–18.

itself rests upon an absurdity: proclaiming that every man is entitled to own a part of everyone else and yet is not entitled *to own himself.* Second, we can picture the viability of such a world: a world in which *no* man is free to take *any* action whatever without prior approval or indeed command by *everyone* else in society. It should be clear that in that sort of "community" world, no one would be able to do anything, and the human race would quickly perish. But if a world of zero self-ownership and 100 percent other-ownership spells death for the human race, then any steps in that direction also contravene the natural law of what is best for man and his life on earth.

Finally, however, the participatory communist world *cannot* be put into practice. For it is physically impossible for everyone to keep continual tabs on everyone else and thereby to exercise his equal quotal share of partial ownership over every other man. In practice, then, any attempt to institute universal and equal other-ownership is utopian and impossible, and supervision, and therefore control and ownership of others, would necessarily devolve upon a specialized group of people, who would thereby become a "ruling class." Hence, in practice, any attempt at communist society will automatically become class rule, and we of would be back at our rejected first alternative. We conclude, then, with the premise of absolute universal right of self-ownership as our first principle of justice in property. This principle, of course, automatically rejects slavery as totally incompatible with our primary right.[7]

Let us now turn to the more complex case of property in material objects. For even if every man has the right to self-ownership, people are not floating wraiths; they are not self-subsistent entities; they can only survive and flourish by grappling with the earth around

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[7]Equally to be rejected is a grotesque proposal by Professor Kenneth E. Boulding, which however is a typical suggestion of a market-oriented utilitarian economist. This is a scheme for the government to allow only a certain maximum number of baby-permits per mother, but then to allow a "free" market in the purchase and sale of these baby rights. This plan, of course, denies the right of every mother over her own body. Boulding's plan may be found in Kenneth E. Boulding, *The Meaning of the 20th Century* (New York: Harper and Row, 1964). For a discussion of the plan, see Edwin G. Dolan, *TANSTAAFL: The Economic Strategy for Environmental Crisis* (New York: Holt, Rinehart and Winston, 1971), p. 64.

them. They must, for example, *stand* on land areas; they must also, in order to survive, transform the resources given by nature into "consumer goods," into objects more suitable for their use and consumption. Food must be grown and eaten; minerals must be mined and then transformed into capital and finally into useful consumer goods, and so on. Man, in other words, must own not only his own person, but also material objects for his control and use. How, then, should property titles in these objects be allocated?

Let us consider, as our first example, the case of a sculptor fashioning a work of art out of clay and other materials; and let us simply assume for the moment that he owns these materials while waiving the question of the justification for their ownership. Let us examine the question; *who* should own the work of art, as it emerges from the sculptor's fashioning? The sculpture is, in fact, the sculptor's "creation," not in the sense that he has created matter *de novo*, but in the sense that he has transformed nature-given matter—the clay—into another form dictated by his own ideas and fashioned by his own hands and energy. Surely, it is a rare person who, with the case put thus, would say that the sculptor does *not* have the property right in his own product. For if every man has the right to own his own body, and if he must grapple with the material objects of the world in order to survive, then the sculptor has the right to own his own product which he has made, by his energy and effort, a veritable *extension* of his own personality. He has placed the stamp of his person upon the raw material, by "mixing his labor" with the clay.

As in the case of the ownership of people's bodies, we again have three logical alternatives: (1) either the transformer, the "creator," has the property right in his creation; or (2) another man or set of men have the right to appropriate it by force without the sculptor's consent; or (3) the "communal" solution—every individual in the world has an equal, quotal share in the ownership of the sculpture. Again, put baldly, there are very few who would not concede the monstrous injustice of confiscating the sculptor's property, either by one or more others, or by the world as a whole. For by what right do they do so? By what right do they appropriate to themselves the product of the creator's mind and energy? (Again, as in the case of bodies, any confiscation in the supposed name of the world as a whole would in practice devolve into an oligarchy of confiscators.)

But the case of the sculptor is not qualitatively different from *all* cases of "production." The man or men who extracted the clay from the ground and sold it to the sculptor were *also* "producers"; they too mixed their ideas and their energy and their technological know-how with the nature-given material to emerge with a useful product. As producers, the sellers of the clay and of the sculptor's tools also mixed their labor with natural materials to transform them into more useful goods and services. All the producers are therefore entitled to the ownership of their product.

The chain of material production logically reduces back, then, from consumer goods and works of art to the first producers who gathered or mined the nature-given soil and resources to use and transform them by means of their personal energy. And use of the soil logically reduces back to the legitimate ownership by first users of previously unowned, unused, virginal, nature-given resources. Let us again quote Locke:

> He that is nourished by the acorns he picked up under an oak, or the apples he gathered from the trees in the wood, has certainly appropriated them to himself. Nobody can deny but the nourishment is his. I ask then, when did they begin to be his? When he digested? or when he ate? or when he boiled? or when he brought them home? or when he picked them up? And 'tis plain, if the first gathering made them not his, nothing else could. That labor put the distinction between them and common. That added something to them more than Nature, the common mother of all, had done, and so they became his private right. And will any one say he had no right to those acorns or apples he thus appropriated because he had not the consent of all mankind to make them his? Was it a robbery thus to assume to himself what belonged to all in common? If such a consent as that was necessary, man has starved, notwithstanding the plenty God had given him. . . . Thus, the grass my horse has bit, the turfs my servant has cut, and the ore I have digged in my place, where I have a right to them in common with others, become my property without the assignation or consent of any body. The labor that was mine, removing them out of that common state they were in, hath fixed my property in them.[8]

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[8]Locke, "An Essay Concerning the True, Original, Extent and End of Civil Government," p. 18.

If every man owns his own person and therefore his own labor, and if by extension he owns whatever material property he has "created" or gathered out of the previously unused, unowned "state of nature," then what of the logically final question: who has the right to own or control the earth *itself*? In short, if the gatherer has the right to own the acorns or berries he picks, or the farmer the right to own his crop of wheat or peaches, *who* has the right to own the land on which these things have grown? It is at this point that Henry George and his followers, who would have gone all the way so far with our analysis, leave the track and deny the individual's right to own the piece of land itself, the ground on which these activities have taken place. The Georgists argue that, while every man should own the goods which he produces or creates, since Nature or God created the land itself, no individual has the right to assume ownership of that land. Yet again we are faced with our three logical alternatives: either the land itself belongs to the pioneer, the first user, the man who first brings it into production; *or* it belongs to a group of others; *or* it belongs to the world as a whole, with every individual owning an equal quotal part of every acre of land. George's option for the last solution hardly solves his moral problem: for if the land itself should belong to God or Nature, then why is it more moral for every acre in the world to be owned by the world as a whole, than to concede individual ownership? In practice, again, it is obviously impossible for every person in the world to exercise his ownership of his three-billionth portion of every acre of the world's surface; in practice a small oligarchy would do the controlling and owning rather than the world as a whole.

But apart from those difficulties in the Georgist position, our proposed justification for the ownership of ground land is the same as the justification for the original ownership of all other property. For, as we have indicated, no producer *really* "creates" matter; he takes nature-given matter and transforms it by his personal energy in accordance with his ideas and his vision. But *this* is precisely what the pioneer—the "homesteader"—does when he brings previously unused land into his private ownership. Just as the man who makes steel out of iron and transforms that ore out of his know-how and with his energy, and just as the man who takes the iron out of the ground does the same, so too does the homesteader who clears, fences, cultivates, or builds upon the land. The homesteader, too, has

transformed the character and usefulness of the nature-given soil by his labor and his personality. The homesteader is just as legitimately the owner of the property as the sculptor or the manufacturer; he is just as much a "producer" as the others.

Moreover, if a producer is *not* entitled to the fruits of his labor, who is? It is difficult to see why a newborn Pakistani baby should have a moral claim to a quotal share of ownership of a piece of Iowa land that someone has just transformed into a wheatfield—and *vice versa* of course for an Iowan baby and a Pakistani farm. Land in its original state is unused and unowned. Georgists and other land communalists may claim that the entire world population "really" owns it, but if no one has yet used it, it is in the real sense owned and controlled by no one. The pioneer, the homesteader, the first user and transformer of this land, is the man who first brings this simple valueless thing into production and use. It is difficult to see the justice of depriving him of ownership in favor of people who have never gotten within a thousand miles of the land and who may not even know of the existence of the property over which they are supposed to have a claim. It is even more difficult to see the justice of a group of outside oligarchs owning the property, and at the expense of expropriating the creator or the homesteader who had originally brought the product into existence.

Finally, no one can produce *anything* without the cooperation of ground land, if only to be used as standing room. No man can produce or create anything by his labor alone; he must have the cooperation of land and other natural raw materials. Man comes into the world with just himself and the world around him—the land and natural resources given him by nature. He takes these resources and transforms them by his labor and mind and energy into goods more useful to man. Therefore, if an individual cannot own original ground land, neither can he in the full sense own any of the fruits of his labor. Now that this labor has been inextricably mixed with the land, he cannot be deprived of one without being deprived of the other.

The moral issue involved here is even clearer if we consider the case of animals. Animals are "economic land," since they are original nature-given resources. Yet will anyone deny full title to a horse to the man who finds and domesticates it? This is no different from the acorns and berries which are generally conceded to the gatherer. Yet

in land, too, the homesteader takes the previously wild, undomesticated land, and tames it by putting it to productive use. Mixing his labor with land sites should give him just as clear a title as in the case of animals.

From our two basic axioms: the right of every man to self-ownership; and the right of every man to own previously unused natural resources that he first appropriates or transforms by his labor—the entire system of justification for property rights can be deduced. For if anyone justly owns the land himself and the property which he finds and creates, then he of course has the right to exchange that property for the similarly acquired just property of someone else. This establishes the right of free exchange of property, as well as the right to give one's property away to someone who agrees to receive it. Thus, X may own his person and labor and the farm be clears on which he grows wheat; Y owns the fish he catches; Z owns the cabbages he grows and the land under it. But then X has the right to exchange some of his wheat for some of Y's fish (if Y agrees) or Z's cabbages. And when X and Y make a voluntary agreement to exchange wheat for fish, then that fish becomes X's justly acquired property to do with what he wishes, and the wheat becomes Y's just property in precisely the same way. Further, a man may of course exchange not only the tangible objects he owns but also his own labor, which of course he owns as well. Thus, Z may sell his labor services of teaching farmer X's children in return for some of the farmer's produce.

We have thus established the property-right justification for the free-market process. For the free-market economy, as complex as the system appears to be on the surface, is yet nothing more than a vast network of voluntary and mutually agreed upon two-person or two-party exchanges of property titles, such as we have seen occurs between wheat and cabbage farmers, or between the farmer and the teacher. In the developed free-market economy, the farmer exchanges his wheat for money; the wheat is bought by the miller who processes and transforms the wheat into flour; the baker sells the bread to the wholesaler, who in turn sells it to the retailer, who finally sells it to the consumer. In the case of the sculptor, he buys the clay and the tools from the producers who dug the clay out of the ground or those who bought the clay from the original miners; and he

bought his tools from the manufacturers who in turn purchased the raw material from the miners of iron ore.

How "money" enters the equation is a complex process; but it should be clear here that conceptually the use of money is equivalent to any useful commodity that is exchanged for wheat, flour, and so on. Instead of money, the commodity exchanged could be cloth, iron or whatever. At each step of the way, mutually beneficial exchanges of property titles—to goods, services, or money—are agreed upon and transacted.

And what of the capital—labor relationship? Here, too, as in the case of the teacher selling his services to the farmer, the laborer sells his services to the manufacturer who has purchased the iron ore or the shipper who has bought logs from the loggers. The capitalist performs the function of saving money to buy the raw material, and then pays the laborers in advance of sale of the product to the eventual customers.

Many people, including such utilitarian free-market advocates as John Stuart Mill, have been willing to concede the propriety and the justice (if they are not utilitarians) of the producer owning and earning the fruits of his labor. But they balk at one point: inheritance. If Roberto Clemente is ten times as good and "productive" a ballplayer as Joe Smith, they are willing to concede the justice of Clemente's earning ten times the amount Smith earns; but what, they ask, is the justification for someone whose only merit is being born a Rockefeller inheriting far more wealth than someone born a Rothbard?

There are several answers that could be given to this question: for example, the natural fact that every individual must, of necessity, be born into a different condition, at a different time or place, and to different parents. Equality of birth or rearing, therefore, is an impossible chimera. But in the context of our theory of justice in property rights, the answer is to focus *not* on the recipient, not on the child Rockefeller or the child Rothbard, but to concentrate on the giver, the man who bestows the inheritance. For if Smith and Jones and Clemente have the right to their labor and their property and to exchange the titles to this property for the similarly obtained property of others, then they also have the right to give their property to whomever they wish. The point is not the right of "inheritance" but the right of *bequest*, a right which derives from the title of property itself. If Roberto Clemente owns his labor and the money he earns

from it, then he has the right to give that money to the baby Clemente.

Armed with a theory of justice in property rights, let us now apply it to the often vexing question of how we should regard existing titles to property.

## Toward a Critique of Existing Property Titles

Among those who call for the adoption of a free market and a free society, the utilitarians, as might be expected, wish to validate all existing property titles, as so defined by the government. But we have seen the inadequacy of this position, most clearly in the case of slavery, but similarly in the validation that it gives to *any* acts of governmental confiscation or redistribution, including our hypothetical Kennedy and Rockefeller "private" ownership of the territorial area of a state. But how much of a redistribution from existing titles would be implied by the adoption of our theory of justice in property, or of any attempt to put that theory into practice? Isn't it true, as some people charge, that all existing property titles, or at least all land titles, were the result of government grants and coercive redistribution? Would *all* property titles therefore be confiscated in the name of justice? And who would be granted these titles?

Let us first take the easiest case: where existing property has been stolen, as acknowledged by the government (and therefore by utilitarians) as well as by our theory of justice. In short, suppose that Smith has stolen a watch from Jones; in that case, there is no difficulty in calling upon Smith to relinquish the watch and to give it back to the true owner, Jones. But what of more difficult cases—in short, where existing property titles are ratified by state confiscation of a previous victim? This could apply either to money or especially to land titles, since land is a constant, identifiable, fixed quotal share of the earth's surface.

Suppose, first, for example, that the government has either taken land or money from Jones by coercion (either by taxation or its imposed redefinition of property) and has granted the land to Smith, or alternatively, has ratified Smith's direct act of confiscation. What would our policy of justice say then? We would say, along with the general view of crime, that the aggressor and unjust owner, Smith, must be made to disgorge the property title (either land or money)

and give it over to its true owner, Jones. Thus, in the case of an identifiable unjust owner and the identification of a victim or just owner, the case is clear: a restoration to the victim of his rightful property. Smith, of course, must not be compensated for this restitution, since compensation would either be enforced unjustly on the victim himself or on the general body of taxpayers. Indeed, there is a far better case for the additional punishment of Smith, but there is no space here to develop the theory of punishment for crime or aggression.

Suppose, next, a second case, in which Smith has stolen a piece of land from Jones but that Jones has died; he leaves, however, an heir, Jones II. In that case, we proceed as before; there is still the identifiable aggressor, Smith, and the identifiable heir of the victim, Jones II, who now is the inherited just owner of the title. Again, Smith must be made to disgorge the land and turn it over to Jones II.

But suppose a third, more difficult, case; Smith is still the thief, but Jones and his entire family and heirs have been wiped out, either by Smith himself or in the natural course of events. Jones is intestate; what then should happen to the property? The first principle is that Smith, being the thief, cannot keep the fruits of his aggression; but in that case, the property becomes unowned and is up for grabs in the same way as any piece of unowned property. The "homestead principle" becomes applicable, in the sense that the first user or occupier of the newly declared unowned property becomes the just and proper owner. The only stipulation is that Smith himself, being the thief, is not eligible for this homesteading.[9]

Suppose now a fourth case, and one generally more relevant to problems of land title in the modern world. Smith is not a thief, nor has he directly received the land by government grant; but his *title* is derived from his ancestor who *did* so unjustly appropriate title to the property; the ancestor, Smith I, let us say, stole the property from Jones I, the rightful owner. What should be the disposition of the property now? The answer, in our view, completely depends on

[9]Neither is the government eligible. There is no space here to elaborate our view that government can never be the just owner of property. Suffice it to say here that the government gains its revenue from tax appropriation of production rather than from production itself, and hence that the concept of just property can never apply to government.

whether or not Jones's heirs, the surrogates of the identifiable victims, still exist. Suppose, for example, that Smith VI legally "owns" the land, but that Jones VI is still extant and identifiable. Then we would have to say that, while Smith VI himself is not a thief and not punishable as such, his *title* to the land, being solely derived from the inheritance passed down from Smith I, does not give him true ownership, and that he too must disgorge the land—without compensation—and yield it into the hands of Jones VI.

But, it might be protested, what of the improvements that Smiths II–VI may have added to the land? Doesn't Smith VI deserve compensation for these legitimately owned additions to the original land received from Jones I? The answer depends on the moveability or separability of these improvements. Suppose, for example, that Smith steals a car from Jones and sells it to Robinson. When the car is apprehended, then Robinson, though he purchased it in good faith from Jones, has no title better than Smith's, which was nil, and therefore he must yield up the car to Jones without compensation. (He has been defrauded by Smith and must try to extract compensation out of Smith, *not* out of the victim Jones.) But suppose that Robinson, in the meantime, has improved the car? The answer depends on whether these improvements are separable from the car itself. If, for example, Robinson has installed a new radio which did not exist before, then he should certainly have the right to take it out before banding the car back to Jones. Similarly, in the case of land, to the extent that Smith VI has simply improved the land itself and mixed his resources inextricably with it, there is nothing he can do; but if, for example, Smith VI or his ancestors built new buildings upon the land, then he should have the right to demolish or cart away these buildings before handing the land over to Jones VI.

But what if Smith I did indeed steal the land from Jones I, but that all of Jones's descendants or heirs are lost in antiquity and cannot be found? What should be the status of the land then? In that case, since Smith VI is not himself a thief, he becomes the *legitimate* owner of the land on the basis of our homestead principle. For if the land is "unowned" and up for grabs, then Smith VI himself has been occupying and using it, and therefore he becomes the just and rightful owner on the homesteaded basis. Furthermore, all of his descendants have clear and proper title on the basis of being his heirs.

It is clear, then, that *even if* we can show that the origin of most existing land titles are in coercion and theft, the existing owners are still just and legitimate owners if (a) they themselves did not engage in aggression, and (b) if no identifiable heirs of the original victims can be found. In most cases of current land title this will probably be the case. *A fortiori*, of course, if we simply *don't know* whether the original land titles were acquired by coercion, then our homestead principle gives the current property owners the benefit of the doubt and establishes them as just and proper owners as well. Thus, the establishment of our theory of justice in property titles will not usually lead to a wholesale turnover of landed property.

In the United States, we have been fortunate enough to have largely escaped continuing aggression in land titles. It is true that originally the English Crown gave land titles unjustly to favored persons (for example, the territory roughly of New York State to the ownership of the Duke of York), but fortunately these grantees were interested enough in quick returns to subdivide and sell their lands to the actual settlers. As soon as the settlers purchased their land, their titles were legitimate, and so were the titles of all those who inherited or purchased them. Later on, the U.S. government unfortunately laid claim to all virgin land as the "public domain," and then unjustly sold the land to speculators who had not earned a homestead title. But eventually these speculators sold the land to the actual settlers, and from then on the land title was proper and legitimate.[10]

In South America and much of the undeveloped world, however, matters are considerably different. For here, in many areas, an invading state conquered the lands of peasants and then parcelled out such lands to various warlords as their private fiefs, from then on to extract rent from the hapless peasantry. The descendants of the *conquistadores* still presume to own the land tilled by the descendants of the original peasants, people with a clearly just claim to ownership of

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[10]This legitimacy, of course, does not apply to the vast amount of land in the West still owned by the federal government which it refuses to throw open to homesteading. Our response to this situation must be that the government should throw open all of its public domain to private homesteading without delay.

the land. In this situation, justice requires the vacating of the land titles by these feudal or coercive landholders (who are in a position equivalent to our hypothetical Rockefellers and Kennedys), and the turning over of the property titles without compensation to the individual peasants who are the true owners of their land.

Much of the drive for "land reform" by the peasantry of the undeveloped world is precisely motivated by an instinctive application of our theory of justice: by the apprehension of the peasants that the land they have tilled for generations is *their* land and that the landlord's claim is coercive and unjust. It is ironic that, in these numerous cases, the only response of utilitarian free-market advocates is to defend existing land titles, regardless of their injustice, and to tell the peasants to keep quiet and "respect private property." Since the peasants are convinced that the property is *their* private title, it is no wonder that they fail to be impressed; but since they find the supposed champions of property rights and free-market capitalism to be their staunch enemies, they generally are forced to turn to the only organized groups that at least rhetorically champion their claims and are willing to carry out the required rectification of property titles—the socialists and communists. In short, from simply a utilitarian consideration of consequences, the utilitarian free-marketeers have done very badly in the undeveloped world, the result of their ignoring the fact that others than themselves, however inconveniently, *do* have a passion for justice. Of course, after socialists or communists take power, they do their best to collectivize peasant land, and one of the prime struggles of socialist society is that of the state *versus* the peasantry. But even those peasants who are aware of socialist duplicity on the land question may still feel that with the socialists and communists they *at least* have a fighting chance. And sometimes, of course, the peasants have been able to win and to force communist regimes to keep hands off their newly gained private property: notably in the cases of Poland and Yugoslavia.

The utilitarian defense of the *status quo* will then be *least* viable—and therefore the least utilitarian—in those situations where the *status quo* is the most glaringly unjust. As often happens, far more than utilitarians will admit, justice and genuine utility are here linked together.

To sum up: all existing property titles may be considered just under the homestead principle, *provided* (a) that there may never be

any property *in people*; (b) that the existing property owner did not himself steal the property; and particularly (c) that any identifiable just owner (the original victim of theft or his heir) must be accorded his property.

It might be charged that our theory of justice in property titles is deficient because in the real world most landed (and even other) property has a history so tangled that it becomes *impossible* to identify who or what has committed coercion and therefore who the current just owner may be. But the point of the "homestead principle" is that if we *don't know* what crimes have been committed in acquiring the property in the past, or if we don't know the victims or their heirs, then the current owner becomes the legitimate and just owner on homestead grounds. In short, if Jones owns a piece of land at the present time, and we don't know what crimes were committed to arrive at the current title, then Jones, as the current owner, becomes as fully legitimate a property owner of this land as he does over his own person. Overthrow of an existing property title only becomes legitimate if the victims or their heirs can present an authenticated, demonstrable, and specific claim to the property. Failing such conditions, existing landowners possess a full moral right to their property.

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# Law, Property Rights, and Air Pollution

## Law as a Normative Discipline

Law is a set of commands; the principles of tort or criminal law, which we shall be dealing with, are negative commands or prohibitions, on the order of "thou shalt not" do actions, X, Y, or Z.[1] In short, certain actions are considered wrong to such a degree that it is considered appropriate to use the sanctions of violence (since law is the social embodiment of violence) to combat, defend against, and punish the transgressors.

There are many actions against which it is not considered appropriate to use violence, individual or organized. Mere lying (that is, where contracts to transfer property titles are not broken), treachery, base ingratitude, being nasty to one's friends or associates, or not showing up for appointments, are generally considered wrong, but few think of using violence to enjoin or combat them. Other sanctions—such as refusing to see the person or have dealings with him, putting him in Coventry, and so on—may be used by individuals or

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[1]Legal principles setting down certain prohibited actions as torts or crimes are to be distinguished from statutes or administrative edicts that lay down positive demands, such as "thou shalt pay X amount of taxes" or "thou shalt report for induction on such and such a date." In a sense, of course, *all* commands can be phrased in such a way as to appear negative, such as "thou shalt not refuse to pay X amount of taxes," or "thou shalt not disobey the order to appear for induction." Why such rephrasing would be inappropriate will be discussed below. See below also for a discussion of "torts" *vis-à-vis* "crimes."

groups, but using the violence of the law to prohibit such actions is considered excessive and inappropriate.

If ethics is a normative discipline that identifies and classifies certain sets of actions as good or evil, right or wrong, then tort or criminal law is a subset of ethics identifying certain actions as appropriate for using violence against them. The law says that action X should be illegal, and therefore *should* be combated by the violence of the law. The law is a set of "ought" or normative propositions.

Many writers and jurists have claimed the law is a value-free, "positive" discipline. Of course it is possible simply to list, classify and analyze existing law without going further into saying what the law should or should not be.[2] But that sort of jurist is not fulfilling his essential task. Since the law is ultimately a set of normative commands, the true jurist or legal philosopher has not completed his task until he sets forth what the law should be, difficult though that might be. If he does not, then he necessarily abdicates his task in favor of individuals or groups untrained in legal principles, who may lay down their commands by sheer fiat and arbitrary caprice.

Thus, the Austinian jurists proclaim that the king, or sovereign, is supposed to lay down the law, and the law is purely a set of commands emanating from his will. But then the question arises: On what principles does or should the king operate?[3] Is it ever possible to say that the king is issuing a "bad" or "improper" decree? Once the jurist admits that, he is going beyond arbitrary will to begin to frame a set of normative principles that should be guiding the sovereign. And then he is back to normative law.

Modern variants of positive legal theory state that the law should be what the legislators say it is. But what principles are to guide the

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[2]Ronald Dworkin, however, has pointed out that even positive legal analysis necessarily involves moral questions and moral standards. Dworkin, *Taking Rights Seriously* (Cambridge, Mass.: Harvard University Press, 1977), chaps. 2, 3, 12, 13. Also see Charles Fried, "The Law of Change: The Cunning of Reason in Moral and Legal History," *Journal of Legal Studies* (March 1980): 340.

[3]The Austinians, of course, are also smuggling in a normative axiom into their positive theory: The law should be what the king says it is. This axiom is unanalyzed and ungrounded in any set of ethical principles.

legislators? And if we say that the legislators should be the spokesmen for their constituents, then we simply push the problem one step back, and ask: What principles are supposed to guide the voters? Or is the law, and therefore everyone's freedom of action, to be ruled by arbitrary caprice of millions rather than of one man or a few?[4]

Even the older concept that the law should be determined by tribal or common-law judges, who are merely interpreting the custom of the tribe or society, cannot escape normative judgments basic to the theory. *Why* must the rules of custom be obeyed? If tribal custom requires the murder of all people over six feet tall, must this custom be obeyed regardless? Why cannot reason lay down a set of principles to challenge and overthrow mere custom and tradition? Similarly, why may it not be used to overthrow mere arbitrary caprice by king or public?

As we shall see, tort or criminal law is a set of prohibitions against the invasion of, or aggression against, private property rights; that is, spheres of freedom of action by each individual. But if that is the case, then the implication of the command, "Thou shall not interfere with A's property right," is that A's property right is just and therefore should not be invaded. Legal prohibitions, therefore, far from being in some sense value-free, actually imply a set of theories about justice, in particular the just allocation of property rights and property titles. "Justice" is nothing if not a normative concept.

In recent years, however, jurists and "Chicago School" economists have attempted to develop theories of value-free property rights, rights defined and protected not on the basis of ethical norms such as justice but of some form of "social efficiency." In one such variant, Ronald Coase and Harold Demsetz have asserted that "it doesn't make any difference" how property rights are allocated in cases of conflicting interests, provided that some property rights are assigned to *someone* and then defended. In his famous example, Coase discusses a railroad locomotive's blighting of nearby farms and orchards. To Coase and Demsetz, this damage of a farmer's crops by the railroad is an "externality" which should, according to the tenets of social efficiency, be internalized. But to these economists, it does

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[4]Again, these modern, democratic variants of positive legal theory smuggle in the unsupported normative axiom that statutes should be laid down by whatever the legislators or the voters wish to do.

not make any difference which of two possible courses of action one adopts. Either one says that the farmer has a property right in his orchard; therefore the railroad should have to pay damages for his loss, and the farmer should be able to enjoin the railroad's invasive actions. Or the railroad has the right to spew forth smoke wherever it wishes, and if the farmer wishes to stop the smoke, he must pay the railroad to install a smoke abatement device. It does not matter, from the point of view of expenditure of productive resources, which route is taken.

For example, suppose the railroad commits $100,000 worth of damage, and in Case 1, this action is held to invade the farmer's property. In that case, the railroad must pay $100,000 to the farmer or else invest in a smoke abatement device, whichever is cheaper. But in Case 2, where the railroad has the property right to emit the smoke, the farmer would have to pay the railroad up to $100,000 to stop damaging his farm. If the smoke device costs less than $100,000, say $80,000, then the device will be installed regardless of who was assigned the property right. In Case 1, the railroad will spend $80,000 on the device rather than have to pay $100,000 to the farmer; in Case 2 the farmer will be willing to pay the railroad $80,000 and up to $100,000 to install the device. If, on the other hand, the smoke device costs more than $100,000, say $120,000, then the device will not be installed anyway, regardless of which route is taken. In Case 1, the railroad will keep pouring out smoke and keep paying the farmer damages of $100,000 rather than spend $120,000 on the device; in Case 2, it will not pay the farmer to bribe the railroad $120,000 for the device, since this is more of a loss to him than the $100,000 damage. Therefore, regardless of how property rights are assigned—according to Coase and Demsetz—the allocation of resources will be the same. The difference between the two is only a matter of "distribution," that is, of income or wealth.[5]

There are many problems with this theory. First, income and wealth are important *to the parties involved*, although they might not be to uninvolved economists. It makes a great deal of difference to

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[5]See the article launching this analysis by Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (October 1960): 10. For a critique, see Walter Block, "Coase and Demsetz on Private Property Rights," *Journal of Libertarian Studies* (Spring, 1977): 111–15.

both of them who has to pay whom. Second, this thesis works only if we deliberately ignore psychological factors. Costs are not only monetary. The farmer might well have an attachment to the orchard far beyond the monetary damage. Therefore, the orchard might be worth far more to him than the $100,000 in damages, so that it might take $1 million to compensate him for the full loss. But then the supposed indifference totally breaks down. In Case 1, the farmer will not be content to accept a mere $100,000 in damages. He will take out an injunction against any further aggression against his property, and even if the law allows bargaining between the parties themselves to remove the injunction, he will insist on over $1 million from the railroad, which the railroad will not be willing to pay.[6] Conversely, in Case 2, there is not likely to be a way for the farmer to raise the $1 million needed to stop the smoke invasion of the orchard.

The love of the farmer for his orchard is part of a larger difficulty for the Coase-Demsetz doctrine: Costs are purely subjective and not measurable in monetary terms. Coase and Demsetz have a proviso in their indifference thesis that all "transaction costs" be zero. If they are not, then they advocate allocating the property rights to whichever route entails minimum social transaction costs. But once we understand that costs are subjective to each individual and therefore unmeasurable, we see that costs cannot be added up. But if all costs, including transaction costs, cannot be added, then there is no such thing as "social transaction costs," and they cannot be compared in Cases 1 or 2, or indeed, in any other situation.[7]

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[6]It is now illegal to bargain one's way out of an injunction by dealing with the injured party. In that case, of course, Coase-Demsetz cost internalization totally breaks down. But even with bargaining allowed, it would probably break down. Moreover, there may well be farmers so attached to their orchards that no price would compensate them, in which case the injunction would be absolute, and no Coase-Demsetz bargaining could remove it. On allowing bargaining to remove injunctions, see Barton H. Thompson, Jr., "Injunction Negotiations: An Economic, Moral and Legal Analysis," *Stanford Law Review* 27 (July 1975): 1563–95.

[7]On the impermissibility of the social cost concept and its application here, see Mario J. Rizzo, "Uncertainty, Subjectivity, and the Economic Analysis of Law," and Murray N. Rothbard, "Comment: The Myth of Efficiency," in *Time, Uncertainty, and Disequilibrium: Exploration of Austrian Themes*, Mario Rizzo, ed. (Lexington, Mass.: Lexington Books, 1979), pp.

Another serious problem with the Coase-Demsetz approach is that pretending to be value-free, they in reality import the ethical norm of "efficiency," and assert that property rights should be assigned on the basis of such efficiency. But even if the concept of social efficiency were meaningful, they don't answer the questions of why efficiency should be the overriding consideration in establishing legal principles or why externalities should be internalized above all other considerations. We are now out of *Wertfreiheit* and back to unexamined ethical questions.[8,9]

Another attempt by Chicago School economists to make legal public policy recommendations under the guise of *Wertfreiheit* is the contention that over the years common-law judges will always arrive at the socially efficient allocation of property rights and tort liabilities. Demsetz stresses rights that will minimize social transaction costs; Richard Posner stresses maximization of "social wealth." All this adds an unwarranted historical determinism, functioning as a kind of invisible hand guiding judges to the current Chicago School path, to the other fallacies examined above.[10]

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71–95; included in this volume as chapter 13. Also see John B. Egger, "Comment: Efficiency is not a Substitute for Ethics," in ibid., pp. 117–25.

[8]Social efficiency is a meaningless concept because efficiency is how effectively one employs means to reach given ends. But with more than one individual, who determines the ends toward which the means are to be employed? The ends of different individuals are bound to conflict, making any added or weighted concept of social efficiency absurd. For more on this, see Rothbard, "Myth of Efficiency."

[9]Charles Fried has pointed out that efficiency is, willy-nilly, an attempted moral criterion, albeit unexamined, wrong, and incoherent. Fried, "The Law of Change," p. 341.

[10]The concept of social wealth suffers from the same disabilities as Coase-Demsetz, as well as other problems of its own. For a devastating critique of Posner, see Ronald M. Dworkin, "Is Wealth a Value?" and Richard A. Epstein, "The Static Conception of the Common Law," in *Journal of Legal Studies* (March 1980): 191–226, 253–76. Also see Anthony J. Kronman, "Wealth Maximization as a Normative Principle"; Mario J. Rizzo, "Law Amid Flux: The Economics of Negligence and Strict Liability in Tort"; Fried, "The Law of Change"; and Gerald P. O'Driscoll, Jr., "Justice, Efficiency, and the Economic Analysis of Law: A Comment on Fried," in ibid.: 227–42, 291–318, 335–54, 355–66.

If the law is a set of normative principles, it follows that whatever positive or customary law has emerged cannot simply be recorded and blindly followed. All such law must be subject to a thorough critique grounded on such principles. Then, if there are discrepancies between actual law and just principles, as there almost always are, steps must be taken to make the law conform with correct legal principles.

## PHYSICAL INVASION

The normative principle I am suggesting for the law is simply this: No action should be considered illicit or illegal unless it invades, or aggresses against, the person or just property of another. Only invasive actions should be declared illegal, and combated with the full power of the law. The invasion must be concrete and physical. There are degrees of seriousness of such invasion, and hence, different proper degrees of restitution or punishment. "Burglary," simple invasion of property for purposes of theft, is less serious than "robbery," where armed force is likely to be used against the victim. Here, however, we are not concerned with the questions of degrees of invasion or punishment, but simply with invasion *per se*.

If no man may invade another person's "just" property, what is our criterion of justice to be?[11] There is no space here to elaborate on a theory of justice in property titles. Suffice it to say that the basic axiom of libertarian political theory holds that every man is a self-owner, having absolute jurisdiction over his own body. In effect, this means that no one else may justly invade, or aggress against, another's person. It follows then that each person justly owns whatever previously unowned resources he appropriates or "mixes his labor with." From these twin axioms—self-ownership and "homesteading"—stems the justification for the entire system of property rights titles in a free-market society. This system establishes the right of every man to his own person, the right of donation, of bequest

[11]The qualification of property being "just" must be made. Suppose, for example, that A steals B's watch and that several months later, B apprehends A and grabs the watch back. If A should prosecute B for theft of "his" watch, it would be an overriding defense on B's part that the watch was not really and justly A's because he had previously stolen it from B.

(and, concomitantly, the right to receive the bequest or inheritance), and the right of contractual exchange of property titles.[12]

Legal and political theory have committed much mischief by failing to pinpoint physical invasion as the only human action that should be illegal and that justifies the use of physical violence to combat it. The vague concept of "harm" is substituted for the precise one of physical violence.[13] Consider the following two examples. Jim is courting Susan and is just about to win her hand in marriage, when suddenly Bob appears on the scene and wins her away. Surely Bob has done great "harm" to Jim. Once a nonphysical-invasion sense of harm is adopted, almost any outlaw act might be justified. Should Jim be able to "enjoin" Bob's very existence?[14]

Similarly, A is a successful seller of razor blades. But then B comes along and sells a better blade, teflon-coated to prevent shaving cuts. The value of A's property is greatly affected. Should he be able to collect damages from B, or, better yet, to enjoin B's sale of a better blade? The correct answer is not that consumers would be

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[12]For more on this libertarian, or "neo-Lockian," view, see Murray N. Rothbard, "Justice and Property Rights," in *Property in a Humane Economy*, Samuel Blumenfeld, ed. (LaSalle, Ill.: Open Court, 1974), pp. 101–22. In a sense, Percy B. Lehning is right when he comments that rather than being two independent axioms, the homesteading principle really follows from the single axiom of self-ownership. Lehning, "Property Rights, Justice and the Welfare State," *Acta Politica* 15 (Rotterdam, 1980): 323, 352.

[13]Thus, John Stuart Mill calls for complete freedom of individual action "without impediment from our fellow-creatures, so long as what we do does not harm them." Mill, "On Liberty," in *Utilitarianism, Liberty, and Representative Government* (New York: E.P. Dutton, 1944), p. 175. Hayek, after properly defining freedom as the absence of coercion, unfortunately fails to define coercion as physical invasion and thereby permits and justifies a wide range of government interference with property rights. See Murray N. Rothbard, "F.A. Hayek and the Concept of Coercion," *Ordo* 31 (Stuttgart 1980): 43–50.

[14]Robert Nozick appears to justify the outlawry of all voluntary exchanges that he terms "nonproductive," which he essentially defines as a situation where A would be better off if B did not exist. For a critique of Nozick on this point, see Murray N. Rothbard, "Robert Nozick and the Immaculate Conception of the State," *Journal of Libertarian Studies* (Winter, 1977): 52ff.

hurt if they were forced to buy the inferior blade, although that is surely the case. Rather, no one has the right to legally prevent or retaliate against "harms" to his property unless it is an act of physical invasion. Everyone has the right to have the physical integrity of his property inviolate; no one has the right to protect the value of his property, for that value is purely the reflection of what people are willing to pay for it. That willingness solely depends on how *they* decide to use their money. No one can have a right to someone else's money, unless that other person had previously contracted to transfer it to him.

In the law of torts, "harm" is generally treated as physical invasion of person or property. The outlawing of defamation (libel and slander) has always been a glaring anomaly in tort law. Words and opinions are not physical invasions. Analogous to the loss of property *value* from a better product or a shift in consumer demand, no one has a property right in his "reputation." Reputation is strictly a function of the subjective opinions of other minds, and they have the absolute right to their own opinions whatever they may be. Hence, outlawing defamation is itself a gross invasion of the defamer's right of freedom of speech, which is a subset of his property right in his own person.[15]

An even broader assault on freedom of speech is the modern Warren-Brandeis-inspired tort of invasion of the alleged right of "privacy," which outlaws free speech and acts using one's own property that are not even false or "malicious."[16]

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[15]We may therefore hail the "absolutist" position of Mr. Justice Black in calling for the elimination of the law of defamation. The difference is that Black advocated an absolutist stand on the First Amendment because it is part of the Constitution, whereas we advocate it because the First Amendment embodies a basic part of the libertarian creed. On the significant weakening of the law of defamation in the last two decades, see Richard A. Epstein, Charles O. Gregory, and Harry Kalven, Jr., *Cases and Materials on Torts*, 3rd ed. (Boston: Little, Brown, 1977), pp. 977–1129 (hereafter cited as Epstein, *Cases on Torts*).

[16]There should be no assertion of a right to privacy that cannot be subsumed under protection of property rights of guarding against breach of contract. On privacy, see ibid., pp. 1131–90.

In the law of torts, "harm" is generally treated as physical invasion of person or property and usually requires payment of damages for "emotional" harm if and only if that harm is a consequence of physical invasion. Thus, within the standard law of *trespass*—an invasion of person or property—"battery" is the actual invasion of someone else's body, while "assault" is the creation by one person in another of a fear, or apprehension, of battery.[17]

To be a tortious assault and therefore subject to legal action, tort law wisely requires the threat to be near and imminent. Mere insults and violent words, vague future threats, or simple possession of a weapon cannot constitute an assault[18]; there must be accompanying

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[17]"Apprehension" of an imminent battery is a more appropriate term than "fear," since it stresses the awareness of a coming battery and of the action causing that awareness by the aggressor, rather than the subjective psychological state of the victim. Thus, Dean Prosser: "Apprehension is not the same thing as fear, and the plaintiff is not deprived of his action merely because he is too courageous to be frightened or intimidated." William L. Prosser, *Handbook of the Law of Torts*, 4th ed. (St. Paul, Minn.: West Publishing, 1971), p. 39.

[18]It is unfortunate that starting about 1930, the courts have succumbed to the creation of a brand new tort, "intentional infliction of mental disturbance by extreme and outrageous conduct." It is clear that freedom of speech and person should allow verbal insult, outrageous though it may be; furthermore, there is no cogent criterion to demarcate mere verbal abuse from the "outrageous" variety. Judge Magruder's statement is highly sensible: "Against a large part of the frictions and irritations and clashing of temperaments incident to participation in community life, a certain toughening of the mental hide is a better protection than the law could ever be." Magruder, "Mental and Emotional Disturbance in the *Law of Torts*," *Harvard Law Review* 40 (1936): 1033, 1035; cited in Prosser, *Law of Torts*, p. 51. Also see ibid., pp. 49–62; Epstein, *Cases on Torts*, pp. 933–52.

In general, we must look with great suspicion on any creation of new torts that are not merely application of old tort principles to new technologies. There is nothing new or modern about verbal abuse.

It seems that both the infliction-of-harm and the new invasion-of-privacy tort are part and parcel of the twentieth-century tendency to dilute the rights of the defendant in favor of excessive cossetting of the plaintiff—a systematic discrimination that has taken place in tort rather than criminal proceedings. See Epstein, "Static Conception of the Common Law," pp. 253–75. See also below.

overt action to give rise to the apprehension of an imminent physical battery.[19] Or, to put it another way, there must be a concrete threat of an imminent battery before the prospective victim may legitimately use force and violence to defend himself.

Physical invasion or molestation need not be actually "harmful" or inflict severe damage in order to constitute a tort. The courts properly have held that such acts as spitting in someone's face or ripping off someone's hat are batteries. Chief Justice Holt's words in 1704 still seem to apply: "The least touching of another in anger is a battery." While the actual damage may not be substantial, in a profound sense we may conclude that the victim's person was molested, was *interfered with*, by the physical aggression against him, and that hence these seemingly minor actions have become legal wrongs.[20]

## Initiation of an Overt Act: Strict Liability

If only a physical invasion of person or property constitutes an illicit act or tort, then it becomes important to demarcate *when* a person may act as if such a physical invasion is about to take place. Libertarian legal theory holds that A may not use force against B except in self-defense, that is, unless B is initiating force against A. But when is A's force against B legitimate self-defense, and when is it *itself* illegitimate and tortious aggression against B? To answer this question, we must consider what kind of tort liability theory we are prepared to adopt.

Suppose, for example, that Smith sees Jones frowning in his direction across the street, and that Smith has an abnormal fear of being frowned at. Convinced that Jones is about to shoot him, he therefore pulls a gun and shoots Jones in what he is sure is self-defense. Jones presses a charge of assault and battery against Smith. Was Smith an aggressor and therefore should he be liable? One theory of liability—

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[19]Prosser, *Law of Torts*, pp. 39–40.

[20]Hence, the wisdom of the court's decision in *South Brilliant Coal Co.* v. *Williams*: "If Gibbs kicked plaintiff with his foot, it cannot be said as a matter of law that there was no physical injury to him. In a legal sense, it was physical injury, though it may have caused no physical suffering, and though the sensation resulting therefrom may have lasted but for a moment" *South Brilliant Coal Co.* v. *Williams*, 206 Ala. 637, 638 (1921). In Prosser, *Law of Torts*, p. 36. Also see Epstein, *Cases on Torts*, pp. 903ff.

the orthodox "reasonable man" or "reasonable conduct" or "negligence" theory—says he should, because frowning would not rouse the apprehension of imminent attack in a "reasonable man." A competing theory, once held and now being revived—that of "strict liability" or "strict causal liability"—agrees because it should be clear to a judge or jury that Jones was *not* an imminent aggressor. And this would hold regardless of how sincere Smith was in his fear of attack.

Two serious flaws in the "reasonable man" theory are that the definition of "reasonable" is vague and subjective, and that guilty aggressors go unpunished, while their victims remain uncompensated. In this particular case, the two theories happen to coincide, but in many other cases they do not. Take, for example, the case of *Courvoisier* v. *Raymond* (1896).[21] In this case, the defendant, a storekeeper, was threatened by a rioting mob. When a man who happened to be a plainclothes policeman walked up to the defendant, trying to help him, the defendant, mistaking him for a rioter, shot the policeman. Should the storekeeper have been liable?

The trial court decided the case properly—on the basis of strict liability—and the jury decided for the policeman. For it is clear that the defendant committed a battery by shooting the plaintiff. In strict liability theory, the question is causation: Who initiated the tort or crime? An overriding defense for the defendant's action was if the plaintiff *in fact* had committed an assault, threatening an imminent initiation of a battery against him. The question traditionally then becomes a factual one for juries to decide: Did the plainclothesman in fact threaten battery against the storekeeper? The jury decided for the policeman.[22] The appeals court, however, reversed the trial court's decision. To the court, the storekeeper acted as a "reasonable

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[21]*Courvoisier* v. *Raymond*, 23 Colo. 113, 47 Pac. 284 (1896), and discussion by Epstein in *Cases on Torts*, pp. 21–23; and in Richard A. Epstein, "A Theory of Strict Liability," *Journal of Legal Studies* 2 (January 1973): 173.

[22]As Epstein puts it,

> Under a theory of strict liability, the statement of the *prima facie* case is evident: the defendant shot the plaintiff. The only difficult question concerns the existence of a defense which takes the form, the plaintiff assaulted the defendant. That question is a question of fact, and the jury found in effect that the plaintiff did not frighten the defendant into shooting him. (Ibid.)

man" when he concluded, though incorrectly, that the plainclothesman was out to attack him.

When is an act to be held an assault? Frowning would scarcely qualify. But if Jones had whipped out a gun and pointed it in Smith's direction, though not yet fired, this is clearly a threat of imminent aggression, and would properly be countered by Smith plugging Jones in self-defense. (In this case, our view and the "reasonable man" theory would again coincide.) The proper yardstick for determining whether the point of assault had been reached is this: Did Jones initiate an "overt act" threatening battery? As Randy Barnett has pointed out:

> In a case less than a certainty, the only justifiable use of force is that used to repel an overt act that is something more than mere preparation, remote from time and place of the intended crime. It must be more than "risky"; it must be done with the specific intent to commit a crime and directly tend in some substantial degree to accomplish it.[23]

Similar principles hold in innocent-bystander cases. Jones assaults and attacks Smith; Smith, in self-defense, shoots. The shot goes wild and accidentally hits Brown, an innocent bystander. Should Smith be liable? Unfortunately, the courts, sticking to the traditional "reasonable man" or "negligence" doctrine, have held that Smith is not liable if indeed he was reasonably intending self-defense against Jones.[24] But, in libertarian and in strict liability theory, Smith has indeed aggressed against Brown, albeit unintentionally, and must pay for this tort. Thus, Brown has a proper legal action against Smith: Since Jones coerced or attacked Smith, Smith also has an independent and proper action for assault or battery against Jones. Presumably, the liability or punishment against Jones would be considerably more severe than against Smith.

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[23]Randy E. Barnett, "Restitution: A New Paradigm of Criminal Justice," in *Assessing the Criminal: Restitution, Retribution, and the Legal Process*, R. Barnett and J. Hagel, eds. (Cambridge, Mass.: Ballinger, 1977), p. 377. Barnett has since pointed out that his article was in error in mentioning "specific intent to commit a crime"; the important emphasis is on action constituting a crime or tort rather than the intent involved.

[24]See *Morris* v. *Platt*, 32 Conn. 75 (1864), and the discussion by Epstein in *Cases on Torts*, pp. 22–23.

One of the great flaws in the orthodox negligence approach has been to focus on one victim's (Smith's) right of self-defense in repelling an attack, or on his good-faith mistake. But orthodox doctrine unfortunately neglects the other victim—the man frowning across the street, the plainclothesman trying to save someone, the innocent bystander. The *plaintiff's* right of self-defense is being grievously neglected. The proper point to focus on in all these cases is: Would the plaintiff have had the right to plug the defendant in *his* self-defense? Would the frowning man, the plainclothesman, the innocent bystander, if he could have done so in time, have had the right to shoot the sincere but erring defendants in self-defense? Surely, whatever our theory of liability, the answer must be "yes"; hence, the palm must go to the strict liability theory, which focuses on everyone's right of self-defense and not just that of a particular defendant. For it is clear that since these plaintiffs had the right to plug the defendant in self-defense, then the defendant must have been the tortious aggressor, regardless of how sincere or "reasonable" his actions may have been.

From various illuminating discussions of Professor Epstein, it seems evident that there are three contrasting theories of tort liability interwoven in our legal structure. The oldest, strict causal liability, apportioned blame and burden on the basis of identifiable cause: Who shot whom? Who assaulted whom? Only defense of person and property was a proper defense against a charge of using force. This doctrine was replaced during the nineteenth century by negligence or "reasonable man" theory, which let many guilty defendants off the hook if their actions were judged reasonable or did not exhibit undue negligence. In effect, negligence theory swung the balance excessively in favor of the defendant and against the plaintiff. In contrast, modern theory emerging increasingly in the twentieth century, anxious to help plaintiffs (especially if they are poor), seeks ways to find against defendants even if strict cause of physical invasion cannot be proven. If the oldest theory is termed "strict causal liability," the modern one might be termed "presumptive liability," since the presumption seems to be against the defendant, in flagrant violation of the Anglo-Saxon *criminal law* presumption of innocence on the part of the defendant.[25]

[25]On the relationship between the criminal and tort law, see the section here entitled "Collapsing Crime Into Tort."

Extending our discussion from crimes against the person to crimes against property, we may apply the same conclusion: Anyone has the right to defend his property against an overt act initiated against it. He may not move with force against an alleged aggressor—a trespasser against his land or chattels—until the latter initiates force by an overt act.

How much force may a victim use to defend either his person or his property against invasion? Here we must reject as hopelessly inadequate the current legal doctrine that he may use only "reasonable" force, which in most cases has reduced the victim's right to defend himself virtually to a nullity.[26] In current law, a victim is only allowed to use maximal, or "deadly" force, (a) in his own home, and then only if he is under direct personal attack; or (b) if there is no way that he can retreat when he is personally under attack. All this is dangerous nonsense. *Any* personal attack might turn out to be a murderous one; the victim has no way of knowing whether or not the aggressor is going to stop short of inflicting a grave injury upon him. The victim should be entitled to proceed on the assumption that *any* attack is implicitly a deadly one, and therefore to use deadly force in return.

In current law, the victim is in even worse straits when it comes to defending the integrity of his own land or movable property. For there, he is not even allowed to use deadly force in defending his own home, much less other land or properties, The reasoning seems to be that since a victim would not be allowed to kill a thief who steals his watch, he should therefore not be able to shoot the thief in the process of stealing the watch or in pursuing him. But punishment and defense of person or property are not the same, and must be treated differently. Punishment is an act of retribution after the crime has been committed and the criminal apprehended, tried, and convicted. Defense while the crime is being committed, or until property is recovered and the criminal apprehended, is a very different story.

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[26]While modern law discriminates against the defendant in economic cases, it discriminates heavily against the victim in his use of personal force in self-defense. In other words, the state is allowed to use excessive force through the courts in economic cases (where corporations or the wealthy are defendants), but individual victims are scarcely allowed to use force at all.

The victim should be entitled to use any force, including deadly force, to defend or to recover his property so long as the crime *is in the process of commission*—that is, until the criminal is apprehended and duly tried by legal process. In other words, he should be able to shoot looters.[27]

## The Proper Burden of Risk

We conclude, then, that no one may use force to defend himself or his property until the initiation of an overt act of aggression against him. But doesn't this doctrine impose an undue risk upon everyone?

The basic reply is that life is always risky and uncertain and that there is no way of getting round this primordial fact. Any shifting of the burden of risk away from one person simply places it upon someone else. Thus, if our doctrine makes it more risky to wait until someone begins to aggress against you, it also makes life *less* risky, because as a nonaggressor, one is more assured that no excited alleged victim will pounce upon you in supposed "self-defense." There is no way for the law to reduce risk overall; it then becomes important to use some other principle to set the limits of permissible action, and thereby to allocate the burdens of risk. The libertarian axiom that all actions are permissible except overt acts of aggression provides such a principled basis for risk allocation.

There are deeper reasons why overall risks cannot be reduced or minimized by overt legal action. Risk is a subjective concept unique to each individual; therefore, it cannot be placed in measurable quantitative form. Hence, no one person's quantitative degree of risk can be compared to another's, and no overall measure of social risk can be obtained. As a quantitative concept, overall or social risk is fully as meaningless as the economist's concept of "social costs" or social benefits.

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[27]For the current state of legal doctrine, see Prosser, *Law of Torts*, pp. 108–25, 134ff. As Epstein indicates, basing the proper limits of self-defense on permissible punishment would imply that in jurisdictions that have abolished capital punishment, no one may use deadly force even in self-defense against a deadly attack. So far the courts have not been willing to embrace this *reductio ad absurdum* of their own position. Epstein, *Cases on Torts*, p. 30.

In a libertarian world, then, everyone would assume the "proper burden of risk"[28] placed upon him as a free human being responsible for himself. That would be the risk involved in each man's person and property. Of course, individuals could voluntarily pool their risks, as in various forms of insurance, in which risks are shared and benefits paid to losers from the pool. Or, speculators could voluntarily assume risks of future price changes that are sloughed off by others in hedging operations on the market. Or, one man could assume another's risks for payment, as in the case of performance and other forms of bonding. What would not be permissible is one group getting together and deciding that another group should be forced into assuming their risks. If one group, for example, forces a second group to guarantee the former's incomes, risks are greatly increased for the latter, to the detriment of their individual rights. In the long run, of course, the whole system might collapse, since the second group can only provide guarantees out of their own production and incomes, which are bound to fall as the burden of social parasitism expands and cripples society.

## The Proper Burden of Proof

If every man's proper burden of risk is to refrain from coercion unless an overt act against his person or property has been initiated against him,[29] then what is the proper burden of proof against a defendant?

First, there must be *some* rational standards of proof for libertarian principles to operate. Suppose that the basic axiom of libertarianism

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[28]This is the same concept but a different name for Williamson Evers's pioneering phrase, "the proper assumption of risk." The current phrase avoids confusion with the concept of "assumption of risk" in tort law, which refers to risk voluntarily assumed by a plaintiff and that therefore negates his attempts at action against a defendant. The "proper burden of risk" is related to the legal concept but refers to what risk *should* be assumed by each person in accordance with the nature of man and of a free society, rather than what risk had voluntarily been incurred by a plaintiff. See Rothbard, "Nozick and the Immaculate Conception of the State," pp. 49–50.

[29]Or an overt act against someone else. If it is legitimate for a person to defend himself or his property, it is then equally legitimate for him to call upon other persons or agencies to aid him in that defense, or to pay for this defense service.

—no initiation of force against person or property—is enshrined in all judicial proceedings. But suppose that the only criterion of proof is that all persons under six feet tall are considered guilty while all persons over six feet tall are held to be innocent. It is clear that these procedural standards of proof would be in direct and flagrant violation of libertarian principles. So would tests of proof in which irrelevant or random occurrences would decide the case, such as the medieval trial by ordeal or trial by tea leaves or astrological charts.

From a libertarian point of view, then, proper procedure calls for rational proof about the guilt or innocence of persons charged with tort or crime. Evidence must be probative in demonstrating a strict causal chain of acts of invasion of person or property. Evidence must be constructed to demonstrate that aggressor A in fact initiated an overt physical act invading the person or property of victim B.[30]

Who, then, should bear the burden of proof in any particular case? And what criterion or standard of proof should be satisfied?

The basic libertarian principle is that everyone should be allowed to do whatever he or she is doing unless committing an overt act of aggression against someone else. But what about situations where it is unclear whether or not a person is committing aggression? In those cases, the only procedure consonant with libertarian principles is to do nothing; to lean over backwards to ensure that the judicial agency is not coercing an innocent man.[31] If we are unsure, it is far better to let an aggressive act slip through than to impose coercion and therefore

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[30]Thayer, in his classical treatise on evidence, wrote: "There is a principle . . . a presupposition involved in the very conception of a rational system of evidence which forbids receiving anything irrelevant, not logically probative," James Thayer, *Preliminary Treatise on Evidence* (1898), pp. 264ff., cited in *McCormick's Handbook of the Law of Evidence*, E.W. Cleary, ed., 2nd ed. (St. Paul, Minn.: West Publishing, 1972), p. 433.

[31]Benjamin R. Tucker, the leading individualist-anarchist thinker of the late nineteenth century, wrote: "No use of force, except against the invader; and in those cases where it is difficult to tell whether the alleged offender is an invader or not, still no use of force except where the necessity of immediate solution is so imperative that we must use it to save ourselves." Benjamin R. Tucker, *Instead of a Book* (New York: B.R. Tucker, 1893), p. 98. Also see ibid., pp. 74–75.

to commit aggression ourselves.[32] A fundamental tenet of the Hippocratic oath, "at least, do not harm," should apply to legal or judicial agencies as well.

The presumption of every case, then, must be that every defendant is innocent until proven guilty, and the burden of proof must be squarely upon the plaintiff.[33]

If we must always insist on *laissez-faire*, then it follows that such a weak standard of proof as "preponderance of evidence" must not be allowed to serve as a demonstration of guilt. If the plaintiff produces evidence adjudged in some sense to weigh a mere 51 percent on behalf of the guilt of the defendant, this is scarcely better than random chance as justification for the court's using force against the defendant. Presumption of innocence, then, must set a far higher standard of proof.

> At present, "preponderance of evidence" is used to decide civil cases, whereas a far tougher standard is used for criminal cases, since penalties are so much stiffer. But, for libertarians, the test of guilt must not be tied to the degree of punishment; regardless of punishment, guilt involves coercion of some sort levied against the

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[32]Cleary puts the point well, though he unfortunately applies it only to criminal cases:

> Society has judged that it is significantly worse for an innocent man to be found guilty of a crime than for a guilty man to go free. . . . Therefore, as stated by the Supreme Court in recognizing the inevitability of error in criminal cases . . . this margin of error is reduced as to him [the defendant] by the process of placing on the other party the burden . . . of persuading the factfinder at the conclusion of the trial of his guilt beyond a reasonable doubt. In so doing, the courts have . . . the worthy goal of decreasing the number of one kind of mistake—conviction of the innocent. (*McCormick's Handbook of Evidence*, pp. 798–99)

[33]The burden of proof is also on the plaintiff in contemporary law. Cleary writes: "The burdens of pleading and proof with regard to most facts have been and should be assigned to the plaintiff who generally seeks to change the present state of affairs and who therefore naturally should be expected to bear the risk of failure of proof or persuasion." Ibid., p. 786. Cleary also speaks of "the natural tendency to place the burdens on the party desiring change." Ibid., pp. 788–89.

convicted defendant. Defendants deserve as much protection in civil torts as in criminal cases.[34]

A few judges, properly shocked by the dominant view that a mere 51 percent of the evidence may serve to convict, have changed the criterion to make sure whoever is trying the case—-judge or jury—is *convinced* of guilt by the preponderance of evidence. A more satisfactory criterion, however, is that the trier must be convinced of the defendant's guilt by "clear, strong, and convincing proof."[35] Fortunately, this test has been used increasingly in civil cases in recent years. Better yet were stronger but generally rejected formulations of certain judges such as "clear, positive, and unequivocal" proof, and one judge's contention that the phrase means that the plaintiffs "must. . . satisfy you to a moral certainty."[36]

But the best standard for any proof of guilt is the one commonly used in criminal cases: Proof "beyond a reasonable doubt." Obviously, *some* doubt will almost always persist in gauging people's actions, so that such a standard as "beyond a scintilla of doubt" would be hopelessly unrealistic. But the doubt must remain small enough that any "reasonable man" will be convinced of the fact of the defendant's guilt. Conviction of guilt "beyond a reasonable doubt" appears to be the standard most consonant with libertarian principle.

The outstanding nineteenth-century libertarian constitutional lawyer, Lysander Spooner, was an ardent advocate of the "beyond a reasonable doubt" standard for all guilt:

> the lives, liberties, and properties of men are too valuable to them, and the natural presumptions are too strong in their favor to justify the destruction of them by their fellow men on a mere balancing of probabilities, *or on any ground whatever short of certainty beyond a reasonable doubt*. [Italics Spooner's][37]

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[34]See section here entitled "Collapsing Crime Into Tort."

[35]See McCormick's *Handbook of Evidence*, pp. 794ff.

[36]Ibid., p. 796. Here we must hail the scorned trial judges in *Molyneux* v. *Twin Falls Canal Co.*, 54 Idaho 619, 35 P. 2d 651, 94 A.L.R. 1264 (1934), and *Williams* v. *Blue Ridge Building & Loan Assn.*, 207 N.C. 362, 177 S.E. 176 (1934).

[37]C. Shiveley, ed., *The Collected Works of Lysander Spooner* (Weston, Mass.: M. and S. Press, 1971), vol. 2, pp. 208–09. It should be pointed out

While the reasonable doubt criterion generally has not been used in civil cases, a few precedents do exist for this seemingly bold and shocking proposal. Thus, in the claim of an orally offered gift in a probate case, the court ruled that the alleged gift "must be proven by forceful, clear and conclusive testimony which convinces the court beyond a reasonable doubt of its truthfulness." And in a suit to revise a written contract, the court ruled that the mistake must be "established by evidence so strong and conclusive as to place it beyond reasonable doubt."[38]

## Strict Causality

What the plaintiff must prove, then, beyond a reasonable doubt is a strict causal connection between the defendant and his aggression against the plaintiff. He must prove, in short, that A actually "caused" an invasion of the person or property of B.

In a brilliant analysis of causation in the law, Professor Epstein has demonstrated that his own theory of strict tort liability is intimately connected to a direct, strict, commonsense view of "cause." Causal proposition in a strict liability view of the law takes such form as, "A hit B," "A threatened B," or "A compelled B to hit C." Orthodox tort theory, in contrast, by stressing liability for "negligence" rather than for direct aggression action, is tangled up with vague and complex theories of "cause," far removed from the commonsense "A hit B" variety. Negligence theory postulates a vague, "philosophical" notion of "cause in fact" that virtually blames everyone and no one, past, present and future for every act, and then narrows cause in a vague and unsatisfactory manner to "proximate cause" in the specific case. The result, as Epstein trenchantly points out, is to vitiate the concept of cause altogether and to set the courts free to decide cases arbitrarily and in accordance with their own views of social policy.[39]

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that Spooner, too, made no distinction between civil and criminal cases in this regard. I am indebted to Williamson Evers for this reference.

[38]*St. Louis Union Co.* v. *Busch*, 36 Mo. 1237, 145 S.W. 2d426, 430 (1940); *Ward* v. *Lyman*, 108 Vt 464, 188 A. 892, 893 (1937). *McCormick's Handbook of Evidence*, pp. 797, 802.

[39]According to Epstein: "Once it is decided that there is no hard content to the term causation, the courts are free to decide particular lawsuits

To establish guilt and liability, strict causality of aggression leading to harm must meet the rigid test of proof beyond a reasonable doubt. Hunch, conjecture, plausibility, even mere probability are not enough. In recent years, statistical correlation has been commonly used, but it cannot establish causation, certainly not for a rigorous legal proof of guilt or harm. Thus, if lung cancer rates are higher among cigarette smokers than noncigarette smokers, this does not in itself establish proof of causation. The very fact that many smokers never get lung cancer and that many lung cancer sufferers have never smoked indicates that there are other complex variables at work. So that while the correlation is suggestive, it hardly suffices to establish medical or scientific proof; *a fortiori* it can still less establish any sort of legal guilt (if, for example, a wife who developed lung cancer should sue a husband for smoking and therefore injuring her lungs).[40]

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in accordance with the principles of 'social policy' under the guise of proximate-cause doctrine." Epstein, "A Theory of Strict Liability," p. 163. Such nebulous and unworkable concepts as "substantial factor" in a damage or "reasonably foreseeable" have been of little help in guiding decisions on "proximate cause." For an excellent critique of "but for" tests for "cause in fact" in negligence theory, as well as the Chicago-Posnerite attempt to scrap the concept of cause altogether in tort law, see ibid., pp. 160–62, 163–66.

[40]If a long-time smoker who develops lung cancer should sue a cigarette company, there are even more problems. Not the least is that the smoker had voluntarily assumed the risk, so that this situation could hardly be called an aggression or tort. As Epstein writes, "Suppose plaintiff smoked different brands of cigarettes during his life? Or always lived in a smog-filled city? And if plaintiff surmounts the causal hurdle, will he be able to overcome the defense of assumption of risk?" Epstein, *Cases on Torts*, p. 257. Also see Richard A. Wegman, "Cigarettes and Health: A Legal Analysis," *Cornell Law Quarterly* 51 (Summer, 1966): 696–724.

A particularly interesting cancer tort case that is instructive on the question of strict causality is *Kramer Service Inc.* v. *Wilkins* 184 Miss. 483,186 So. 625 (1939), in Epstein, *Cases on Torts*, p. 256. The court summed up the proper status of medical causal evidence in *Daly* v. *Bergstedt* (1964), 267 Minn. 244, 126 N. W. 2d 242. In Epstein, *Cases on Torts*, p. 257. Also see Epstein's excellent discussion, ibid., of *DeVere* v. *Parten* (1946), in which the plaintiff was properly slapped down in an absurd attempt to claim that the defendant was responsible for a disease she had contracted.

Milton Katz points out, in a case where the plaintiff sued for air pollution damage:

> Suppose the plaintiff should claim serious damage: for emphysema, perhaps, or for lung cancer, bronchitis or some other comparably serious injury to his lungs. He would face a problem of proof of causation. . . . Medical diagnoses appear to have established that sulphur dioxide and other air pollutants often play a significant role in the etiology of emphysema and other forms of lung damage. But they are by no means the only possible causative factors. Emphysema and lung cancer are complex illnesses which may originate in a variety of causes, for example, cigarette smoking, to name one familiar example. If and when the plaintiff should succeed in establishing that the defendants' conduct polluted the air of his home, it would not follow that the pollution caused his illness. The plaintiff would still have to meet the separate burden of proving the etiology of his lung damage.[41]

Thus, a strict causal connection must exist between an aggressor and a victim, and this connection must be provable beyond a reasonable doubt. It must be causality in the commonsense concept of strict proof of the "A hit B" variety, not mere probability or statistical correlation.

## Liability of the Aggressor Only

Under strict liability theory, it might be assumed that if "A hit B," then A is the aggressor and that therefore A and only A is liable to B. And yet the legal doctrine has arisen and triumphed, approved even by Professor Epstein, in which sometimes C, innocent and not the aggressor, is *also* held liable. This is the notorious theory of "vicarious liability."

Vicarious liability grew up in medieval law, in which a master was responsible for the torts committed by his servants, serfs, slaves, and wife. As individualism and capitalism developed, the common law changed, and vicarious liability disappeared in the sixteenth and seventeenth centuries, when it was sensibly concluded that "the master should not be liable for his servant's torts unless he had commanded the particular act."[42]

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[41]Milton Katz, "The Function of Tort Liability in Technology Assessment," *Cincinnati Law Review* 38 (Fall, 1969): 620.

[42]Prosser, *Law of Torts,* p. 458.

Since the eighteenth and nineteenth centuries, however, the vicarious liability of masters or employers is back with a vengeance. As long as the tort is committed by the employee in the course of furthering, even if only in part, his employer's business, then the employer is also liable. The only exception is when the servant goes "on a frolic of his own" unconnected with the employer's business. Prosser writes:

> The fact that the servant's act is expressly forbidden by the master, or is done in a manner which he has prohibited, is . . . usually not conclusive, and does not in itself prevent an act from being within the scope of employment [and therefore making the master liable]. A master cannot escape liability merely by ordering his servant to act carefully. . . . Thus instructions to a sales clerk never to load a gun while exhibiting it will not prevent liability when the clerk does so, in an effort to sell the gun. . . . [T]he master cannot escape responsibility no matter how specific, detailed, and emphatic his orders may have been to the contrary. This has been clear since the leading English cases (*Limpus* v. *London General Omnibus Co.*, [1862] 1H. & C. 526, 158 Eng. Rep. 993) in which an omnibus company was held liable notwithstanding definite orders to its driver not to obstruct other vehicles.[43]

Even more remarkably, the master is now held responsible even for intentional torts committed by the servant without the master's consent:

> In general, the master is held liable for any intentional tort committed by the servant where its purpose, however misguided, is wholly or in part to further the master's business.
>
> Thus he will be held liable where his bus driver crowds a competitor's bus into a ditch, or assaults a trespasser to eject him from the bus, or a salesman makes fraudulent statements about the products he is selling.[44]

Prosser is properly scornful of the tortured reasoning by which the courts have tried to justify a legal concept so at war with libertarianism, individualism, and capitalism, and suited only to a precapitalist society.

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[43]Ibid., p. 461.

[44]Ibid., p. 464.

> A multitude of very ingenious reasons have been offered for the vicarious liability of a master: he has a more or less fictitious "control" over the behavior of a servant; he has "set the whole thing in motion," and is therefore responsible for what has happened; he has selected the servant and trusted him, and so should suffer for his wrongs, rather than an innocent stranger who has had no opportunity to protect himself; it is a great concession that any man should be permitted to employ another at all, and there should be a corresponding responsibility as the price to be paid for it. . . . Most courts have made little or no effort to explain the result, and have taken refuge in rather empty phrases, such as . . . the endlessly repeated formula of "respondeat superior," which in itself means nothing more than "look to the man higher up."[45]

In fact, as Prosser indicates, the only real justification for vicarious liability is that employers generally have more money than employees, so that it becomes more convenient (if one is not the employer), to stick the wealthier class with the liability. In the cynical words of Thomas Baty: "In hard fact, the reason for the employers' liability is the damages are taken from a deep pocket."[46]

In opposition, too, we have Justice Holmes's lucid critique: "I assume that common sense is opposed to making one man pay for another man's wrong, unless he has actually brought the wrong to pass. . . . I therefore assume that common sense is opposed to the fundamental theory of agency."[47]

One would expect that in a strict causal liability theory, vicarious liability would be tossed out with little ceremony. It is therefore surprising to see Professor Epstein violate the spirit of his own theory. He seems to have two defenses for the doctrine of respondeat superior and vicarious liability. One is the curious argument that "just as the employer gets and benefits from the gains for his worker's activities, so too should he be required to bear the losses from these activities."[48] This statement fails to appreciate the nature of voluntary

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[45]Ibid., p. 459.

[46]Ibid.

[47]In his *Harvard Law Review* articles on "Agency," 1891. See Epstein, *Cases on Torts*, p. 705.

[48]Ibid., p. 707.

exchange: Both employer and employee benefit from the wage contract. Moreover, the employer does bear the "losses" in the event his production (and, therefore, his resources) turn out to be misdirected. Or, suppose the employer makes a mistake and hires an incompetent person, who is paid $10,000. The employer may fire this worker, but he and he alone bears the $10,000 loss. Thus, there appears to be no legitimate reason for forcing the employer to bear the *additional* cost of his employee's tortious behavior.

Epstein's second argument is contained in the sentence: "X corporation hurt me because its servant did so in the course of his employment." Here Epstein commits the error of conceptual realism, since he supposes that a "corporation" actually exists, and that it committed an act of aggression. In reality, a "corporation" does not act; only individuals act, and each must be responsible for his own actions and those alone. Epstein may deride Holmes's position as being based on the "nineteenth-century premise that individual conduct alone was the basis of individual responsibility," but Holmes was right nevertheless.[49]

## A Theory of Just Property: Homesteading

There are two fundamental principles upon which the libertarian theory of just property rests: (a) Everyone has absolute property right over his or her own body; and (b) everyone has an absolute property right over previously unowned natural resources (land) which he first occupies and brings into use (in the Lockean phrase, "Mixing his labor with the land").

The "first ownership to first use" principle for natural resources is also popularly called the "homesteading principle." If each man owns the land that he "mixes his labor with," then he owns the product of that mixture, and he has the right to exchange property titles with other, similar producers. This establishes the right of free contract in the sense of transfer of property titles. It also establishes the right to give away such titles, either as a gift or bequest.

Most of us think of homesteading unused resources in the old-fashioned sense of clearing a piece of unowned land and farming the soil. There are, however, more sophisticated and modern forms of

[49]Ibid., p. 705.

homesteading, which should establish a property right. Suppose, for example, that an airport is established with a great deal of empty land around it. The airport exudes a noise level of, say, X decibels, with the sound waves traveling over the empty land. A housing development then buys land near the airport. Some time later, the homeowners sue the airport for excessive noise interfering with the use and quiet enjoyment of the houses.

Excessive noise can be considered a form of aggression but in this case the airport has already homesteaded X decibels worth of noise. By its prior claim, the airport now "owns the right" to emit X decibels of noise in the surrounding area. In legal terms, we can then say that the airport, through homesteading, has earned an *easement right* to creating X decibels of noise. This homesteaded easement is an example of the ancient legal concept of "prescription," in which a certain activity earns a prescriptive property right to the person engaging in the action.

On the other hand, if the airport starts to *increase* noise levels, then the homeowners could sue or enjoin the airport from its noise aggression for the extra decibels, which had not been homesteaded. Of course if a new airport is built and begins to send out noise of X decibels onto the existing surrounding homes, the airport becomes fully liable for the noise invasion.

It should be clear that the same theory should apply to air pollution. If A is causing pollution of B's air, and this can be proven beyond a reasonable doubt, then this is aggression and it should be enjoined and damages paid in accordance with strict liability, unless A had been there first and had already been polluting the air before B's property was developed. For example, if a factory owned by A polluted originally unused property, up to a certain amount of pollutant X, then A can be said to have *homesteaded a pollution easement* of a certain degree and type.

Given a prescriptive easement, the courts have generally done well in deciding its limits. In *Kerlin* v. *Southern Telephone and Telegraph Co.* (1941), a public utility had maintained an easement by prescription of telephone poles and wires over someone else's land (called the "servient estate" in law). The utility wished to string up two additional wires, and the servient estate challenged its right to do so. The court decided correctly that the utility had the right because there was no proposed change in the "outer limits of space utilized by the

owner of the easement." On the other hand, an early English case decided that an easement for moving carts could not later be used for the purpose of driving cattle.[50]

Unfortunately, the courts have not honored the concept of homestead in a noise or pollution easement. The classic case is *Sturgis* v. *Bridgman* (1879) in England. The plaintiff, a physician, had purchased land in 1865; on the property next to him the defendant, a pharmacist, used a mortar and pestle, which caused vibrations on the physician's property. There was no problem, however, until the physician built a consultation room 10 years later. He then sued to enjoin the pharmacist, claiming that his work constituted a nuisance. The defendant properly argued that the vibrations were going on before the construction of the consultation room, that they then did not constitute a nuisance, and that therefore he had a prescriptive right to keep operating his business. Nevertheless, defendant's claim was denied.

Consequently, we have such injustice as compulsory changes of character in a business and a failure to provide prescription through first use. Thus, Prosser notes that "the character of a district may change with the passage of time, and the industry set up in the open country may become a nuisance, or be required to modify its activities, when residences spring up around it. It will acquire no prescriptive right."[51] A just law would tell the later arriving residents that they knew what they were getting into, and that *they* must adapt to the industrial ambience rather than vice-versa.

In some cases, however, the courts have held or at least considered that by the plaintiff's "coming to the nuisance," he has voluntarily entered a pre-existing situation, and that therefore the defendant is not guilty. Prosser states that "in the absence of a prescriptive right the defendant cannot condemn the surrounding premises to endure the nuisance," but our whole point here is that the homesteader of a noise

[50]*Kerlin* v. *Southern Telephone & Telegraph Co.* (Ga.), 191 Ga. 663, 13 S.E. 2d 790 (1941); *Ballard* v. *Dyson* (1808) 1 Taunt. 279, 127 Eng. Rep. 841. In William E. Burby, *Handbook of the Law of Real Property*, 3rd ed. (St. Paul, Minn.: West Publishing, 1965), pp. 84–85.

[51]Prosser, *Law of Torts*, pp. 600-1. Also see Burby, *Law of Real Property*, p. 78. *Sturges* v. *Bridgman* (1879), 11 Ch., Div. 852.

or a pollution easement has indeed earned that right in cases of "coming to the nuisance."[52]

Dominant court opinion, as in the case of *Ensign* v. *Walls* (1948), discards or minimizes "coming to the nuisance" and dismisses the idea of a homesteaded easement. But minority opinion has strongly supported it, as in the New York case of *Bove* v. *Donner-Hanna Coke Co.* (1932). Plaintiff had moved into an industrial region, where defendant was operating a coke oven on the opposite side of the street. When plaintiff tried to enjoin the coke oven out of existence, the court rejected the plea with these exemplary words:

> With all the dirt, smoke and gas which necessarily come from factory chimneys, trains and boats, and with full knowledge that this region was especially adapted for industrial rather than residential purposes, and that factories would increase in the future, plaintiff selected this locality as the site of her future home. She voluntarily moved into this district, fully aware of the fact that the atmosphere would constantly be contaminated by dirt, gas and foul odors; and that she could not hope to find in this locality the pure air of a strictly residential zone. She evidently saw certain advantages in living in this congested center. This is not the case of an industry, with its attendant noise and dirt, invading a quiet, residential district. This is just the opposite. Here a residence is built in an area naturally adapted for industrial purposes and already dedicated to that use. Plaintiff can hardly be heard to complain at this late date that her peace and comfort have been disturbed by a situation which existed, to some extent at least, at the very time she bought her property.[53]

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[52]Prosser, *Law of Torts*, p. 611.

[53]*Bove* v. *Donner-Hanna Coke Corp.*, 236 App. Div. 37, 258 N. Y.S. 229 (1932), quoted in Epstein, *Cases on Torts*, p. 535. Contrary to Epstein, however, the coming-to-nuisance is not simply an assumption of risk on the part of the plaintiff. It is a stronger defense, for it rests on an actual assignment of property right in the "nuisance" creating activity, which is therefore absolute, overriding, and indefeasible. Cf. Richard A. Epstein, "Defenses and Subsequent Pleas in a System of Strict Liability," *Journal of Legal Studies* 3 (1974): 197–201.

## Nuisances, Visible and Invisible

An invasion of someone else's land can be considered a *trespass* or a *nuisance*, and there is considerable confusion about the boundaries of each. For our purposes, the classic distinction between the two is important. Trespass occurs when "there is a physical entry that is a direct interference with the possession of land, which usually must be accomplished by a tangible mass."[54] On the other hand, "contact by minute particles or intangibles, such as industrial dust, noxious fumes, or light rays, has heretofore generally been held insufficient to constitute a trespassory entry, on the ground that there is no interference with possession, or that the entry is not direct, or that the invasion failed to qualify as an entry because of its imponderable or intangible nature."[55]

These more intangible invasions qualify as private nuisances and can be prosecuted as such. A nuisance may be, as Prosser points out:

> an interference with the physical condition of the land itself, as by vibration or blasting which damages a house, the destruction of crops, flooding, raising the water table, or the pollution of a stream or of an underground water supply. It may consist of a disturbance of the comfort or convenience of the occupant, as by unpleasant odors, smoke or dust or gas, loud noises, excessive light or high temperature, or even repeated telephone calls.[56]

Prosser sums up the difference between trespass and nuisance:

> Trespass is an invasion of the plaintiff's interest in the exclusive possession of his land, while nuisance is an interference with his use and enjoyment of it. The difference is that between . . . felling a tree across his boundary line and keeping him awake at night with the noise of a rolling mill.[57]

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[54]"Note: Deposit of Gaseous and Invisible Solid Industrial Wastes Held to Constitute Trespass," *Columbia Law Review* 60 (1960): 879.

[55]Ibid., pp. 879–80. Also see Glen Edward Clover, "Torts: Trespass, Nuisance and $E=mc^2$," *Oklahoma Law Review* 11 (1966): 118ff.

[56]Prosser, *Law of Torts*, pp. 591–92.

[57]Ibid., p. 595. A nuisance generally emanates from the land of A to the land of B; in short, stems from outside B's land itself. Prosser's attempt to rebut this point (defendant's dog howling under plaintiff's window or defendant's cattle roaming over the other's fields) misses the point. The offending

But what precisely does the difference between "exclusive possession" and "interference with use" mean? Furthermore, the practical difference between a tort action for trespass and for nuisance is that a trespass is illegal *per se*, whereas a nuisance, to be actionable, has to *damage* the victim beyond the mere fact of invasion itself. What, if any, is the justification for treating a trespass and nuisance so differently? And is the old distinction between tangible and invisible invasion really now obsolete as Prosser maintains, "in the light of modern scientific tests?"[58] Or, as a *Columbia Law Review* note put it:

> The federal court . . . suggested that historically the reluctance of courts to find that invasion by gases and minute particles were trespassory resulted from the requirement that to find a trespass a court must be able to see some physical intrusion by tangible matter; it then found that this difficulty no longer exists because courts may today rely on scientific detecting methods, which can make accurate quantitative measurements of gases and minute solids, to determine the existence of a physical entry of tangible matter.[59]

The distinction between visible and invisible, however, is not completely swept away by modern scientific detection methods. Let us take two opposite situations. First, a direct trespass: A rolls his car onto B's lawn or places a heavy object on B's grounds. Why is this an invasion and illegal *per se*? Partly because, in the words of an old English case, "the law infers some damage; if nothing more, the treading down of grass or herbage."[60] But it is not just treading down; a tangible invasion of B's property interferes with his exclusive use of the property, if only by taking up tangible square feet (or cubic feet). If A walks on or puts an object on B's land, then B cannot use the space A or his object has taken up. An invasion by a tangible mass is a *per se* interference with someone else's property and therefore illegal.

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dog and cattle themselves wandered over the land of A, the defendant, and since they are domesticated, their deeds are the responsibility of their owners. On animals, see ibid., pp. 496–503.

[58]Ibid., p. 66.

[59]"Note, Deposit of Wastes," pp. 880–81. Also see Clover, "Torts: Trespass, Nuisance and $E=mc^2$," p. 119.

[60]Prosser, *Law of Torts*, p. 66.

In contrast, consider the case of radio waves, which is a crossing of other people's boundaries that is invisible and insensible in every way to the property owner. We are all bombarded by radio waves that cross our properties without our knowledge or consent. Are they invasive and should they therefore be illegal, now that we have scientific devices to detect such waves? Are we then to outlaw all radio transmission? And if not, why not?

The reason why not is that these boundary crossings do not interfere with anyone's exclusive possession, use or enjoyment of their property. They are invisible, cannot be detected by man's senses, and do no harm. They are therefore not really invasions of property, for we must refine our concept of invasion to mean not just boundary crossing, but boundary crossings that in some way interfere with the owner's use or enjoyment of this property. What counts is whether the senses of the property owner are interfered with.

But suppose it is later discovered that radio waves are harmful, that they cause cancer or some other illness? Then they *would* be interfering with the use of the property in one's person and should be illegal and enjoined, provided of course that this proof of harm and the causal connection between the specific invaders and specific victims are established beyond a reasonable doubt.

So we see that the proper distinction between trespass and nuisance, between strict liability *per se* and strict liability only on proof of harm, is not really based on "exclusive possession" as opposed to "use and enjoyment." The proper distinction is between visible and tangible or "sensible" invasion, which interferes with possession and use of the property, and invisible, "insensible" boundary crossings that do not and therefore should be outlawed only on proof of harm.

The same doctrine applies to low-level radiation, which virtually everyone and every object in the world emanates, and therefore everyone receives. Outlawing, or enjoining, low-level radiation, as some of our environmental fanatics seem to be advocating, would be tantamount to enjoining the entire human race and all the world about us. Low-level radiation, precisely because it is undetectable by man's senses, interferes with no one's use or possession of his property, and therefore may only be acted against upon strict causal proof of harm beyond a reasonable doubt.

The theory of homestead easements discussed earlier would require no restriction upon radio transmissions or on people's low-level radiation. In the case of radio transmissions, Smith's ownership of land and all of its appurtenances does *not* entitle him to own all radio waves passing over and across his land, for Smith has not homesteaded or transmitted on radio frequencies here. Hence, Jones, who transmits a wave on, say, 1200 kilohertz, homesteads the ownership of that wave as far as it travels, even if it travels across Smith's property. If Smith tries to interfere with or otherwise disrupt Jones's transmissions, he is guilty of interfering with Jones's just property.[61]

Only if the radio transmissions are proven to be harmful to Smith's person beyond a reasonable doubt should Jones's activities be subject to injunction. The same type of argument, of course, applies to radiation transmissions.

Between tangible trespass and radio waves or low-level radiation, there is a range of intermediate nuisances. How should they be treated?

Air pollution, consisting of noxious odors, smoke, or other visible matter, definitely constitutes an invasive interference. These particles can be seen, smelled, or touched, and should therefore constitute invasion *per se*, except in the case of homesteaded air pollution easements. (Damages beyond the simple invasion would, of course, call for further liability.) Air pollution, however, of gases or particles that are invisible or undetectable by the senses should not constitute aggression *per se*, because being insensible they do not interfere with the owner's possession or use. They take on the status of invisible radio waves or radiation, *unless* they are proven to be harmful, and

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[61]During the 1920s, the courts were working out precisely such a system of homesteaded private property rights in airwave frequencies. It is because such a private property structure was evolving that Secretary of Commerce Hoover pushed through the Radio Act of 1927, nationalizing ownership of the airwaves. See Ronald H. Coase, "The Federal Communications Commission," *Journal of Law and Economics* 2 (October 1959): 1–40. For a modern study of how such frequencies could be allocated, see A. De Vany, et al., *A Property System Approach to the Electromagnetic Spectrum* (San Francisco: Cato Institute, 1980).

until this proof and the causal connection from aggressor to victim can be established beyond a reasonable doubt.[62]

Excessive noise is certainly a tort of nuisance; it interferes with a person's enjoyment of his property, including his health. However, no one would maintain that every man has the right to live as if in a soundproofed room; only *excessive* noise, however vague the concept, can be actionable.

In a sense, life itself homesteads noise easement. Every area has certain noises, and people moving into an area must anticipate a reasonable amount of noise. As Terry Yamada ruefully concedes:

> An urban resident must accept the consequences of a noisy environment situation. Courts generally hold that persons who live or work in densely populated communities must necessarily endure the usual annoyances and discomforts of those trades and businesses located in the neighborhood where they live or work; such annoyances and discomforts, however, must not be more than those reasonably expected in the community and lawful to the conduct of the trade or business.[63]

In short, he who wants a soundproof room must pay for its installation.

The current general rule of the civil courts on nuisance suits for noise is cogent:

> A noise source is not a nuisance *per se* but only becomes a nuisance under certain conditions. These conditions depend on a consideration of the surrounding area, the time of day or night when the noise-producing activities take place and the manner in which the activity is conducted. A private nuisance is compensable only

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[62]On prescriptive rights, tangibility, and the concept of "coming to the tort" in relation to air pollution, see William C. Porter, "The Role of Private Nuisance Law in the Control of Air Pollution," *Arizona Law Review* 10 (1968): 107–19; and Julian C. Juergensmeyer, "Control of Air Pollution Through the Assertion of Private Rights," *Duke Law Journal* (1967): 1126–55.

[63]Terry James Yamada, "Urban Noise: Abatement, Not Adaptation," *Environmental Law* 6 (Fall, 1975): 64. Unfortunately, like most authors writing on environmental law, Yamada writes like a fervent special pleader for environmental plaintiffs rather than as a searcher for objective law.

> when it is unreasonable or excessive and when it produces actual physical discomfort or injury to a person of ordinary sensibilities so as to interfere with the use and enjoyment of the property.[64]

## OWNING THE TECHNOLOGICAL UNIT: LAND AND AIR

In our discussion of homesteading, we did not stress the problem of the size of the area to be homesteaded. If A uses a certain amount of a resource, how much of that resource is to accrue to his ownership? Our answer is that he owns the technological unit of the resource. The size of that unit depends on the type of good or resource in question, and must be determined by judges, juries, or arbitrators who are expert in the particular resource or industry in question. If resource X is owned by A, then A must own enough of it so as to include necessary appurtenances. For example, in the courts' determination of radio frequency ownership in the 1920s, the extent of ownership depended on the technological unit of the radio wave—its width on the electromagnetic spectrum so that another wave would not interfere with the signal, and its length over space. The ownership of the frequency then was determined by width, length, and location.

American land settlement is a history of grappling, often unsuccessfully, with the size of the homestead unit. Thus, the homesteading provision in the federal land law of 1861 provided a unit of 160 acres, the clearing and use of which over a certain term would convey ownership to the homesteader. Unfortunately, in a few years, when the dry prairie began to be settled, 160 acres was much too low for any viable land use (generally ranching and grazing). As a result, very little Western land came into private ownership for several decades. The resulting overuse of the land caused the destruction of Western grass cover and much of the timberland.

With the importance of analyzing the technological unit in mind, let us examine the ownership of airspace. Can there be private ownership of the air, and if so, to what extent?

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[64]Ibid., p. 63. Note, however, that in our view the requirement of "reasonable" for actual injury or discomfort is correct for noise but not, say, for visible smoke or noxious odors, unless "discomfort" is interpreted broadly so as to include all interference with use.

The common-law principle is that every landowner owns all the airspace above him upward indefinitely unto the heavens and downward into the center of the earth. In Lord Coke's famous dictum: *cujus est solum ejus est usque ad coelum*; that is, he who owns the soil owns upward unto heaven, and, by analogy, downward to Hades. While this is a time-honored rule, it was, of course, designed before planes were invented. A literal application of the rule would in effect outlaw all aviation, as well as rockets and satellites.[65]

But is the practical problem of aviation the only thing wrong with the *ad coelum* rule? Using the homesteading principle, the *ad coelum* rule never made any sense, and is therefore overdue in the dustbin of legal history. If one homesteads and uses the soil, in what sense is he also using all the sky above him up into heaven? Clearly, he isn't.

The *ad coelum* rule unfortunately lingered on in the *Restatement of Torts* (1939), adopted by the Uniform State Law for Aeronautics and enacted in 22 states during the 1930s and 1940s. This variant continued to recognize unlimited ownership of upward space, but added a superior public privilege to invade the right. Aviators and satellite owners would still bear the burden of proof that they possessed this rather vague privilege to invade private property in airspace. Fortunately, the Uniform Act was withdrawn by the Commissioners on Uniform State Laws in 1943, and is now on the way out.

A second solution, adopted by the Ninth Circuit Federal Court in 1936, scrapped private property in airspace altogether and even allowed planes to buzz land close to the surface. Only actual interference with present enjoyment of land would constitute a tort.[66] The most popular nuisance theory simply outlaws interference with land use, but is unsatisfactory because it scraps any discussion whatever of ownership of airspace.

The best judicial theory is the "zone," which asserts that only the lower part of the airspace above one's land is owned; this zone is the limit of the owner's "effective possession." As Prosser defines it,

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[65]See the discussion of various theories of land and air ownership in Prosser, *Law of Torts*, pp. 70–73.

[66]In *Hinman* v. *Pacific Air Transport*, 9 Cir. (1936), 84 F.2d 755, cert. denied 300 U.S. 654. In ibid., p. 71.

"effective possession" is "so much of the space above him as is essential to the complete use and enjoyment of the land."[67] The height of the owned airspace will vary according to the facts of the case and therefore according to the "technological unit." Thus, Prosser writes:

> This was the rule applied in the early case of *Smith* v. *New England Aircraft Co.*, where flights at the level of one hundred feet were held to be trespass, since the land was used for cultivation of trees which reached that height. A few other cases have adopted the same view.
>
> The height of the zone of ownership must vary according to the facts of each case.[68]

On the other hand, the nuisance theory should be added to the strict zone of ownership for cases such as where excess aircraft noise injures people or activities in an adjoining area, not directly underneath the plane. At first, the federal courts ruled that only low flights overhead could constitute a tort against private landowners, but the excessive noise case of *Thornburg* v. *Port of Portland* (1962) corrected that view. The court properly reasoned in *Thornburg*:

> If we accept . . . the validity of the propositions that a noise can be a nuisance; that a nuisance can give rise to an easement; and that a noise coming straight down from above one's land can ripen into a taking if it is persistent enough and aggravated enough, then logically the same kind and degree of interference with the use and enjoyment of one's land can also be a taking even though the noise vector may come from some direction other than the perpendicular.[69]

While there is no reason why the concept of ownership of airspace cannot be used to combat air pollution torts, this has rarely been done. Even when *ad coelum* was riding high, it was used against airplane overflights but not to combat pollution of one's air, which was inconsistently considered as a communal resource. The law of

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[67]Ibid., p. 70.

[68]Ibid., pp. 70–71. See *Smith* v. *New England Aircraft Co.*, (1930), 270 Mass. 511,170 N.E. 385. Also see Prosser, *Law of Torts*, pp. 514–15.

[69]*Thornburg* v. *Port of Portland* (1962), 233 Ore. 178, 376 P.2d 103. Quoted in Clover, "Torts: Trespass, Nuisance and $E=mc^2$, p. 121. The previous view was based on *United States* v. *Causby* (1946). Also see Prosser, *Law of Torts*, pp. 72–73.

nuisance could traditionally be used against air pollution, but until recently it was crippled by "balancing of the equities," negligence rules against strict liability, and by declaration that "reasonable" air pollution was not actionable. In the classic case of *Holman* v. *Athens Empire Laundry Co.* (1919), the Supreme Court of Georgia declared: "The pollution of the air, so far as reasonably necessary to the enjoyment of life and indispensable to the progress of society, is not actionable."[70] Fortunately, that attitude is now becoming obsolete.

Although air pollution should be a tort subject to strict liability, it should be emphasized that statements like "everyone has the right to clean air" are senseless. There are air pollutants constantly emerging from natural processes, and one's air is whatever one may happen to possess. The eruption of Mount St. Helens should have alerted everyone to the ever-present processes of natural pollution. It has been the traditional and proper rule of the common-law courts that no landowner is responsible for the harm caused by natural forces originating on his property. As Prosser writes, a landowner

> is under no affirmative duty to remedy conditions of purely natural origin upon his land, although they may be highly dangerous or inconvenient to his neighbors. . . . Thus it has been held that the landowner is not liable for the existence of a foul swamp, for falling rocks, for the spread of weeds or thistles growing on his land, for harm done by indigenous animals, or for the normal, natural flow of surface water.[71]

In sum, no one has a right to clean air, but one does have a right to not have his air invaded by pollutants generated by an aggressor.

## Air Pollution: Law and Regulation

We have established that everyone may do as he wishes provided he does not initiate an overt act of aggression against the person or property of anyone else. Anyone who initiates such aggression must be strictly liable for damages against the victim, even if the action is

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[70]*Holman* v. *Athens Empire Laundry Co.*, 149 G. 345, 350, 100 S.E. 207, 210 (1919). Quoted in Jack L. Landau, "Who Owns the Air? The Emission Offset Concept and Its Implications," *Environmental Law* 9 (1979): 589.

[71]Prosser, *Law of Torts*, p. 354.

"reasonable" or accidental. Finally, such aggression may take the form of pollution of someone else's air, including his owned effective airspace, injury against his person, or a nuisance interfering with his possession or use of his land.

This is the case, *provided that*: (a) the polluter has not previously established a homestead easement; (b) while visible pollutants or noxious odors are *per se* aggression, in the case of invisible and insensible pollutants the plaintiff must prove actual harm; (c) the burden of proof of such aggression rests upon the plaintiff; (d) the plaintiff must prove strict causality from the actions of the defendant to the victimization of the plaintiff; (e) the plaintiff must prove such causality and aggression beyond a reasonable doubt; and (f) there is no vicarious liability, but only liability for those who actually commit the deed.

With these principles in mind, let us consider the current state of air pollution law. Even the current shift from negligence and "reasonable" actions to strict liability has by no means satisfied the chronic special pleaders for environmental plaintiffs. As Paul Downing says, "Currently, a party who has been damaged by air pollution must prove in court that emitter A damaged him. He must establish that he was damaged and emitter A did it, and not emitter B. This is almost always an impossible task."[72] If true, then we must assent uncomplainingly. After all, proof of causality is a basic principle of civilized law, let alone of libertarian legal theory.

Similarly, James Krier concedes that even if requirement to prove intent or unreasonable conduct or negligence is replaced by strict liability, there is still the problem of *proving the causal link* between the wrongful conduct and the injury. Krier complains that "cause and effect must still be established."[73] He wants to "make systematic reallocation of the burden of proof," that is, take the burden off the plaintiff, where it clearly belongs. Are defendants now to be guilty until they can prove themselves innocent?

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[72]Paul B. Downing, "An Introduction to the Problem of Air Quality," in *Air Pollution and the Social Sciences*, Downing, ed. (New York: Praeger, 1971), p. 13.

[73]James E. Krier, "Air Pollution and Legal Institutions: An Overview," in ibid., *Air Pollution and the Social Sciences*, pp. 107–08.

The prevalence of multiple sources of pollution emissions is a problem. How are we to blame emitter A if there are other emitters or if there are natural sources of emission? Whatever the answer, it must not come at the expense of throwing out proper standards of proof, and conferring unjust special privileges on plaintiffs and special burdens on defendants.[74]

Similar problems of proof are faced by plaintiffs in nuclear radiation cases. As Jeffrey Bodie writes, "In general the courts seem to require a high degree of causation in radiation cases which frequently is impossible to satisfy given the limited extent of medical knowledge in this field."[75] But as we have seen above, it is precisely this "limited extent of knowledge" that makes it imperative to safeguard defendants from lax canons of proof.

There are, of course, innumerable statutes and regulations that create illegality besides the torts dealt with in common-law courts.[76] We have not dealt with laws such as the Clean Air Act of 1970 or regulations for a simple reason: None of them can be permissible under libertarian legal theory. In libertarian theory, it is only permissible to proceed coercively against someone if he is a proven aggressor, and that aggression must be proven in court (or in arbitration) beyond a reasonable doubt. Any statute or administrative regulation necessarily makes actions illegal that are not overt initiations of crimes or torts according to libertarian theory. Every statute or administrative rule is therefore illegitimate and itself invasive and a criminal interference with the property rights of noncriminals.

Suppose, for example, that A builds a building, sells it to B, and it promptly collapses. A should be liable for injuring B's person and property and the liability should be proven in court, which can then enforce the proper measures of restitution and punishment. But if the legislature has imposed building codes and inspections in the name of "safety," innocent builders (that is, those whose buildings

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[74]See section entitled "Joint Torts and Joint Victims" for a discussion of joint tortfeasors, multiple torts, and class actions suits.

[75]Jeffrey C. Bodie, "The Irradiated Plaintiff: Tort Recovery Outside Price-Anderson," *Environmental Law* 6 (Spring, 1976): 868.

[76]With respect to air pollution regulations, see Landau, "Who Owns the Air?" pp. 575–600.

have not collapsed) are subjected to unnecessary and often costly rules, with no necessity by government to prove crime or damage. They have committed no tort or crime, but are subject to rules, often only distantly related to safety, *in advance* by tyrannical governmental bodies. Yet, a builder who meets administrative inspection and safety codes and then has a building of his collapse, is often let off the hook by the courts. After all, has he not obeyed all the safety rules of the government, and hasn't he thereby received the advance *imprimatur* of the authorities?[77]

The only civil or criminal system consonant with libertarian legal principles is to have judges (and/or juries and arbitrators) pursuing charges of torts by plaintiffs made against defendants.

It should be underlined that in libertarian legal theory, only the victim (or his heirs and assigns) can legitimately press suit against alleged transgressors against his person or property. District attorneys or other government officials should not be allowed to press charges against the wishes of the victim, in the name of "crimes" against such dubious or nonexistent entities as "society" or the "state." If, for example, the victim of an assault or theft is a pacifist and refuses to press charges against the criminal, no one else should have the right to do so against his wishes. For just as a creditor has the right to "forgive" an unpaid debt voluntarily, so a victim, whether on pacifist grounds or because the criminal has bought his way out of a suit[78] or any other reason, has the right to "forgive" the crime so that the crime is thereby annulled.

Critics of automobile emissions will be disturbed by the absence of government regulation, in view of the difficulties of proving harm to victims from individual automobiles.[79] But, as we have stressed, utilitarian considerations must always be subordinate to the requirements of justice. Those worried about auto emissions are in even

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[77]For an excellent discussion of judicial as opposed to statutory or administrative remedies for adulteration of products, see Wordsworth Donisthorpe, *Law in a Free Society* (London: Macmillan, 1895), pp. 132–58.

[78]Criminals should have the right to buy off a suit or enforcement by the victim, just as they should have the right to buy out an injunction from a victim after it has been issued. For an excellent article on the latter question, see Thompson, "Injunction Negotiations," pp. 1563–95.

[79]See section entitled "Joint Torts and Joint Victims."

worse shape in the tort law courts, because libertarian principle also requires a return to the now much scorned nineteenth-century rule of *privity*.

The privity rule, which applies largely to the field of products liability, states that the buyer of a defective product can only sue the person with whom he had a contract.[80] If the consumer buys a watch from a retailer, and the watch does not work, it should only be the retailer whom he can sue, since it was the retailer who transferred ownership of the watch in exchange for the consumer's money. The consumer, in contrast to modern rulings, should not be able to sue the manufacturer, with whom he had no dealings. It was the retailer who, by selling the product, gave an implied warranty that the product would not be defective. And similarly, the retailer should only be able to sue the wholesaler for the defective product, the wholesaler the jobber, and finally the manufacturer.[81]

In the same way, the privity role should be applied to auto emissions. The guilty polluter should be each individual car owner and not the automobile manufacturer, who is not responsible for the actual tort and the actual emission. (For all the manufacturer knows, for example, the car might only be used in some unpopulated area or used mainly for aesthetic contemplation by the car owner.) As in the product liability cases, the only real justification for suing the manufacturer rather than the retailer is simply convenience and deep pockets, with the manufacturer presumably being wealthier than the retailer.

While the situation for plaintiffs against auto emissions might seem hopeless under libertarian law, there is a partial way out. In a libertarian society, the roads would be privately owned. This means that the auto emissions would be emanating from the road of the road owner into the lungs or airspace of other citizens, so that the road owner would be liable for pollution damage to the surrounding

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[80]For hostile accounts of privity and a discussion of implied warranty, see Richard A. Epstein, *Modern Products Liability Law* (Westport, Conn.: Quorum Books, 1980), pp. 9–34; and Prosser, *Law of Torts*, pp. 641ff.

[81]Some of the practical difficulties involved in such suits could be overcome by joinder of the various plaintiffs. See section entitled "Joint Torts and Joint Victims."

inhabitants. Suing the road owner is much more feasible than suing each individual car owner for the minute amount of pollutants he might be responsible for. In order to protect himself from these suits, or even from possible injunctions, the road owner would then have the economic incentive to issue anti-pollution regulations for all cars that wish to ride on his road. Once again, as in other cases of the "tragedy of the commons," private ownership of the resource can solve many "externality" problems.[82]

## Collapsing Crime Into Tort

But if there is no such entity as society or the state, or no one except the victim that should have any standing as a prosecutor or plaintiff, this means that the entire structure of criminal law must be dispensed with, and that we are left with tort law, where the victim indeed presses charges against the aggressor.[83] However, there is no reason why parts of the law that are now the province of criminal law cannot be grafted onto an enlarged law of torts. For example, restitution to the victim is now considered the province of tort law, whereas punishment is the realm of criminal law.[84] Yet, punitive damages for intentional torts (as opposed to accidents) now gener-

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[82]On the "tragedy of the commons" and private ownership, see, for example, Garrett Hardin, "The Tragedy of the Commons," *Science* 162 (1968): 1243–48; Robert J. Smith, "Resolving the Tragedy of the Commons by Creating Private Property Rights in Wildlife," *Cato Journal* 1 (Fall, 1981): 439–68.

[83]Notes Prosser:

> A crime is an offense against the public at large, for which the state, as the representative of the public, will bring proceedings in the form of a criminal prosecution. The purpose of such a proceeding is to protect and vindicate the interests of the public as a whole. . . . A criminal prosecution is not concerned in any way with compensation of the injured individual against whom the crime is committed. (Prosser, *Law of Torts*, p. 7)

[84]For an illuminating discussion of the roots of the modern split between criminal and tort law, with the former as pursuing crimes against the "king's peace," see Barnett, "Restitution: A New Paradigm of Criminal Justice," pp. 350–54.

ally are awarded in tort law. It is therefore conceivable that more severe punishments, such as imprisonment, forced labor to repay the victim, or transportation, could be grafted onto tort law as well.[85]

One cogent argument against any proposal to collapse criminal into tort law is that, in the reasoning against allowing punitive damages in tort cases, they are "fixed only by the caprice of the jury and imposed without the usual safeguards thrown about criminal procedure, such as proof of guilt beyond a reasonable doubt [and] the privilege against self-incrimination."[86] But, as argued above, standards such as proof beyond a reasonable doubt should be applied to tort law cases as well.[87]

Professor Epstein, in attempting to preserve a separate realm for criminal law as against a proposed collapse into tort law, rests much of his case on the law of attempts. In criminal law, an attempted crime that for some reason fails and results in no damage or invasion of the rights of the victim, is still a crime and can be prosecuted. And yet, Epstein charges, such an attempted crime would not be an invasion of rights and therefore could not be a tort and could not be prosecuted under tort law.[88]

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[85]On punitive damages in tort law, see Prosser, *Law of Torts*, pp. 9ff. This is not the place to set forth a theory of punishment. Theories of punishment among libertarian philosophers and legal theorists range from avoiding any coercive sanctions whatever to restitution only, restitution plus proportional punishment, and allowing unlimited punishment for any crime whatever.

For my own view on proportional punishment, see Murray N. Rothbard, "Punishment and Proportionality," in Barnett and Hagel, eds., *Assessing the Criminal*, pp. 259–70. On the concept of transporting criminals, see Leonard P. Liggio, "The Transportation of Criminals: A Brief Politico-Economic History," in ibid, pp. 273–94.

[86]Ibid., p. 11. Also see Epstein, *Cases on Torts*, p. 906.

[87]As would the privilege against self-incrimination. In fact, the ban against compulsory testimony should not only be extended to tort cases, it should be widened to include all compulsory testimony, against others as well as against oneself.

[88]Richard A. Epstein, "Crime and Tort: Old Wine in Old Bottles," in Barnett and Hagel, eds., *Assessing the Criminal*, pp. 231–57.

Randy Barnett's rebuttal, however, is conclusive. Barnett points out, first, that most unsuccessful attempts at invasion result nevertheless in "successful" though lesser invasion of person or property, and would therefore be prosecutable under tort law. "For example, attempted murder is usually an aggravated assault and battery, attempted armed robbery is usually an assault, attempted car theft or burglary is usually a trespass."[89] Second, even if the attempted crime created no invasion of property *per se*, if the attempted battery or murder became *known* to the victim, the resulting creation of fear in the victim would be prosecutable as an assault. So the attempted criminal (or tortfeasor) could not get away unscathed.

Therefore, the only attempted invasion that could not be prosecuted under the law of torts would be one that *no one ever knew anything about*. But if no one knows about it, it cannot be prosecuted, under any law.[90]

Furthermore, as Barnett concludes, potential victims would not be prevented under libertarian law from defending themselves from

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[89]Barnett, "Restitution: A New Paradigm of Criminal Justice," p. 376. Barnett adds:

> In this way the law of attempt is actually a form of double counting whose principal function is to enable the police and prosecutor to overcharge a crime for purposes of a later plea negotiation. Furthermore, some categories of attempt, such as conspiracy laws and possessory laws—for example, possession of burglarious instruments—are short-cuts for prosecutors unable or unwilling to prove the actual crime and are a constant source of selective, repressive prosecutions. (Ibid.)

We might add that the latter always would be illegitimate under libertarian law.

[90]According to Barnett:

> The only type of unsuccessful attempt that would escape liability [under tort law] would be the case of someone who unsuccessfully tried to commit a crime without otherwise violating anyone's rights and without anyone knowing about it. . . . In any case, no system governed by any principle can prosecute acts that no one knows about. (Ibid., pp. 376–77)

Professor Ronald Hamowy of the University of Alberta should also be mentioned as contributing significantly to this solution to the problem.

attempts at crime. As Barnett says, it is justifiable for a victim or his agents to repel an overt act that has been initiated against him, and that in fact is what an attempt at crime is all about.[91]

## Joint Torts and Joint Victims

So far in discussing invasions of person or property, we have confined ourselves to single aggressors and single victims, of the "A hit B" or "damaged B" variety. But actual air pollution cases often have multiple alleged aggressors and multiple victims. On what principles may they be prosecuted or convicted?

When more than one aggressor has contributed to a tort, it is generally more convenient for the plaintiffs to join the defendants together in one suit ("joinder"). Convenience, however, should not be allowed to override principle or rights, and in our view the original common-law rule of joinder was correct: Defendants can be compulsorily joined *only* when all the parties acted in concert in a joint tortious enterprise.

In the case of truly joint torts, it also makes sense to have each of the joint aggressors equally liable for the entire amount of the damages. If it were otherwise, each criminal could dilute his own liability in advance by simply adding more criminals to their joint enterprise. Hence, since the action of all the aggressors was in concert, the tort was truly joint, so that

> "all coming to do an unlawful act and of one part, the act of one is the act of the same part being present." Each was therefore liable for the entire damage done, although one might have battered the plaintiff, while another imprisoned him, and a third stole his silver buttons. All might be joined as defendants in the same action at law. [92]

Unfortunately, for purposes of convenience, the joinder rule has been weakened, and the courts in many cases have permitted plaintiffs to compel joinder of defendants even in cases where torts are

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[91]One can agree with Barnett here without adopting his own pure-restitution-without-punishment variant of tort law. In our own view, elements of criminal law such as punishment could readily be incorporated into a reconstructed tort law.

[92]Prosser, *Law of Torts*, p. 291. Also see, ibid., pp. 293ff.

committed separately and not in concert.[93] The confusion in joinder for both joint and separate torts has caused many courts to apply the full or "entire" liability rule to each aggressor. In the case of separate torts impinging upon a victim, this makes little sense. Here the rule should always be what it has traditionally been in nuisance cases, that the courts apportion damage in accordance with the separate causal actions contributed by each defendant.

Air pollution cases generally are those of separate torts impinging upon victims; therefore, there should be no compulsory joinder and damages should be apportioned in accordance with the separate causal factors involved. As Prosser writes:

> Nuisance cases, in particular, have tended to result in apportionment of the damages, largely because the interference with the plaintiff's use of his land has tended to be severable in terms of quantity, percentage, or degree. Thus defendants who independently pollute the same stream or who flood the plaintiff's land from separate sources, are liable only severally for the damages individually caused, and the same is true as to nuisance due to noise, or pollution of the air.[94]

But because the injuries are multiple and separate, it is then up to the plaintiffs to show a rational and provable basis for apportioning the damage among the various defendants and causative factors. If this rule is properly and strictly adhered to, and proof is beyond a reasonable doubt, the plaintiffs in air pollution cases generally will be able to accomplish very little. To counter this, environmental lawyers have proposed a weakening of the very basis of our legal system by shifting the burden of proof for detailed allocation of damages from the plaintiffs to the various defendants.[95]

Thus, compulsory joinder of defendants may proceed on the original common-law rule only when the defendants have allegedly committed a truly joint tort, in concerted action. Otherwise, defendants may insist on separate court actions.

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[93]In this situation, joinder is compulsory upon the defendants, even though the plaintiffs may choose between joinder and separate actions.

[94]Prosser, *Law of Torts*, pp. 317–18.

[95]See Katz, "Function of Tort Liability," pp. 619–20.

What about joinder of several *plaintiffs* against one or more defendants? When may that take place? This problem is highly relevant to air pollution cases, where there are usually many plaintiffs proceeding against one or more defendants.

In the early common law, the rules were rigorous on limiting permissible joinder of plaintiffs to cases where all causes in action had to affect all the parties joined. This has now been liberalized to permit joint action by plaintiffs where the joint action arises out of the same transaction or series of transactions, and where there is at least one question of law of fact common to all plaintiffs. This appears to be a legitimate liberalization of when plaintiffs shall be allowed voluntary joinder.[96]

While permissive joinder of plaintiffs in this sense is perfectly legitimate, this is not the case for "class action" suits, where the outcome of the suit is binding even upon those members of the alleged class of victims who did not participate in the suit. It seems the height of presumption for plaintiffs to join in a common suit and to press a "class action" suit, in which even those other alleged victims who never heard of or in some way did not consent to a suit are bound by the result. The only plaintiffs who should be affected by a suit are those who voluntarily join. Thus, it would not be permissible for 50 residents of Los Angeles to file a pollution suit on behalf of the class of "all citizens of Los Angeles," without their knowledge or express consent. On the principle that only the victim and his heirs and assigns may press suit or use force on his behalf, class action suits binding on anyone except voluntary plaintiffs are impermissible.[97]

Unfortunately, while the 1938 Federal Rule of Civil Procedure 23 provided for at least one type of nonbinding class action, the "spurious class action," the revised 1966 rules make all class action suits binding upon the class as a whole, or rather on all those members of

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[96]However, a better course would be to require that common interests predominate over separate individual interests, as is now being required for class action suits. See the discussion of *City of San Jose* v. *Superior Court* below.

[97]The type of class action suit once known as "spurious class action," in which a judgment binds only those members actually before the court, was not actually a class action suit but a permissive joinder device. Fed. R. Civ. P. 23 (1938).

the class who do not specifically request exclusion. In an unprecedented step, voluntary action is now being assumed if *no* action is taken. The residents of Los Angeles, who might not even know about the suit in question, are required to take steps to exclude themselves from the suit, otherwise the decision will be binding upon them.[98] Furthermore, most states have followed the new federal rules for class action suits.

As in the case of voluntary joinder, the post-1966 class action must involve questions of law or fact common to their entire class. Fortunately, the courts have placed further limits on the use of class action. In most cases, all identifiable members of the class must be given individual notice of the suit, giving them at least an opportunity to opt out of the action; also, the class must be definitely identifiable, ascertainable, and manageable. Under this rule, the federal courts generally would not allow "all residents of the city of Los Angeles" to be party to a class action suit.[99] Thus, a suit allegedly on behalf of all residents of Los Angeles County (over seven million persons) to enjoin 293 companies from polluting the atmosphere was dismissed by the court "as unmanageable because of the number of parties (plaintiffs and defendants), the diversity of their interests, and the multiplicity of issues involved."[100]

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[98]The 1938 Rules provided that in some cases any class action must be of the spurious kind mentioned in the previous footnote. The revised 1966 Rules made all class action suits binding by eliminating the spurious action category. See Fed. R. Civ. P. 23 (1966).

[99]Fed. R Civ. P. 23(a) (1966). On the question of whether individual notice to class manners is or is not mandatory, see Fed. R Civ. P23(d)(2), Fed. R. Civ. P. 23(e), *Mattern* v. *Weinberger*, 519F.2d 150 (3d Cir.1975), *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 156 (1974), *Cooper* v. *American Savings & Loan Association*, 55 Cal. App. 3d 274 (1976).

[100]The case was *Diamond* v. *General Motors Corp*. 20 Cal. App. 2d 374 (1971). On the other hand, some state court decisions, such as in California, have been highly favorable toward class action suits. The California court actually allowed a class action of one man against a defendant taxi company for alleged overcharges, on behalf of himself and several thousand unidentifiable customers of the company. *Dear* v. *Yellow Cab Co.*, 67 Cal. 2d 695 (1967).

Another sensible limitation placed on most class action suits is that common class interests in the suit must *predominate* over separate individual interests. Thus, a class suit will not be allowed where separate individual issues are "numerous and substantial," and therefore common issues do not predominate. In the case of *City of San Jose* v. *Superior Court* (1974), the court threw out a class action suit of landowners near an airport, suing for damages to their land resulting from airport noise, pollution, traffic, and so on. Even though the airport affected each of the landowners, the court properly ruled that "the right of each landowner to recover for the harm to his land involved too many individual facts (for example, proximity to flight paths, type of property, value, use, and so on)" to permit a class suit.[101]

Thus, class action suits should not be allowed except where every plaintiff actively and voluntarily joins and where common interests predominate over separate and individual ones.[102]

How, then, have the recent class action rules been applied to the question of air pollution? Krier says with dismay that while the 1966 Federal Rule 23 is indeed more liberal than its predecessor in allowing class action, the U.S. Supreme Court has virtually nullified its impact by ruling that class members may aggregate individual claims for federal courts *only* when they share a common undivided interest.[103] According to Krier, this cogent limitation rules out most class action suits in air pollution cases. He adds that while this restriction does not apply to state suits, these are often even less viable than federal class suits before

[101]*City of San Jose* v. *Superior Court*, 12 Cal. 3d 447 (1974).

[102]Epstein provides an interesting note on ways in which plaintiffs, in a purely libertarian way, were able to overcome the fact that neither joinder nor class action suit were permitted because of the extent and diversity of individual interests involved. The drug MER/29 was taken off the market in 1962, after which about 1,500 lawsuits were initiated against the drug company for damage. While the defendant successfully objected to a voluntary joinder, most of the attorneys voluntarily coordinated their activities through a central clearinghouse committee with fees for services assessed upon all lawyers in the group. Epstein reports that the lawyers who participated in the group were usually more successful in their respective suits than those who did not. Epstein, *Cases on Torts*, p. 274.

[103]In *Snyder* v. *Harris*, 394 U.S. 332 (1970). Krier, "Air Pollution and Legal Institutions."

the new rules. Krier complains, in an unconsciously humorous note, that some class action suits don't attract *any* plaintiffs at all.[104]

But the major problem of class action suits for the plaintiffs, Krier concedes, is the manageability and ascertainability rules for suits with a large number of plaintiffs in the class, citing in particular the *Diamond* v. *General Motors* case. But whereas Krier attributes the problem solely to the lack of competence and facilities judges possess to balance the various interests, he fails to realize the still larger problem of lack of identifiability and lack of clear proof of guilt and causality between defendant and plaintiff.

## Conclusion

We have attempted to set forth a set of libertarian principles by which to gauge and reconstruct the law. We have concluded that everyone should be able to do what he likes, except if he commits an overt act of aggression against the person and property of another. Only this act should be illegal, and it should be prosecutable only in the courts under tort law, with the victim or his heirs and assigns pressing the case against the alleged aggressor. Therefore, no statute or administrative ruling creating illegal actions should be permitted. And since any prosecution on behalf of "society" or the "state" is impermissible, the criminal law would be collapsed into a reconstituted tort law, incorporating punishment and part of the law of attempts.

The tortfeasor or criminal is to be strictly liable for his aggression, with no evasion of liability permissible on the basis of "negligence" or "reasonability" theories. However, the liability must be proven on the basis of strict causality of the defendant's action against the plaintiff, and it must be proven by the plaintiff beyond a reasonable doubt.

The aggressor and only the aggressor should be liable, and not the employer of an aggressor, provided, of course, that the tort was not committed at the direction of the employer. The current system

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[104]In short, what if they filed a pollution class action suit and nobody came? Krier cites the case of *Riter* v. *Keokuk Electro-Metals Co.* 248 Iowa 710, 82 N.W. 2d 151 (1957). Krier, "Air Pollution and Legal Institutions," p. 217. Also see John Esposito, "Air and Water Pollution: What to Do While Waiting for Washington," *Harvard Civil Rights/Civil Liberties Law Review* (January 1970): 36.

of vicarious employer liability is a hangover from pre-capitalist master/serf relations and is basically an unjust method of finding deep pockets to plunder.

These principles should apply to all torts, including air pollution. Air pollution is a private nuisance generated from one person's landed property onto another and is an invasion of the airspace appurtenant to land and, often, of the person of the landowner. Basic to libertarian theory of property rights is the concept of homesteading, in which the first occupier and user of a resource thereby makes it his property. Therefore, where a "polluter" has come first to the pollution and has preceded the landowner in emitting air pollution or excessive noise onto empty land, he has thereby homesteaded a pollution or excessive noise easement. Such an easement becomes his legitimate property right rather than that of the later, adjacent landowner. Air pollution, then, is not a tort but only the ineluctable right of the polluter if he is simply acting on a homestead easement. But where there is no easement and air pollution is evident to the senses, pollution is a tort *per se* because it interferes with the possession and use of another's air. Boundary crossing—say by radio waves or low-level radiation—cannot be considered aggression because it does not interfere with the owner's use or enjoyment of his person or property. Only if such a boundary crossing commits provable harm—according to principles of strict causality and beyond a reasonable doubt—can it be considered a tort and subject to liability and injunction.

A joint tort, in which defendants are compelled to defend themselves jointly, should apply only if all acted in concert. Where their actions are separate, the suits must be separate as well, and the liability apportioned separately. Plaintiffs should be able to join their suits against a defendant only if their cases have a common element predominating over the separate and individual interests. Class action suits are impermissible beyond a voluntary joinder of plaintiffs because they presume to act for and bind class members who have not agreed to join in the suit.

Finally, we must renounce the common practice of writers on environmental law of acting as special pleaders for air pollution plaintiffs, lamenting whenever plaintiffs are not allowed to ride roughshod over defendants. The overriding factor in air pollution law, as in other parts of the law, should be libertarian and property rights principles rather than the convenience or special interests of one set of contestants.

# 21

# The Fallacy of the "Public Sector"

We have heard a great deal in recent years of the "public sector," and solemn discussions abound through the land on whether or not the public sector should be increased *vis-à-vis* the "private sector." The very terminology is redolent of pure science, and indeed it emerges from the supposedly scientific, if rather grubby, world of "national income statistics." But the concept is hardly *wertfrei*; in fact, it is fraught with grave, and questionable, implications.

In the first place, we may ask: "public sector" of *what*? Of something called the "national product." But note the hidden assumptions: that the national product is something like a pie, consisting of several "sectors," and that these sectors, public and private alike, are added to make the product of the economy as a whole. In this way, the assumption is smuggled into the analysis that the public and private sectors are equally productive, equally important, and on an equal footing altogether, and that "our" deciding on the proportions of public to private sector is about as innocuous as any individual's decision on whether to eat cake or ice cream. The State is considered to be an amiable service agency, somewhat akin to the corner grocer, or rather to the neighborhood lodge, in which "we" get together to decide how much "our government" should do for (or to) us. Even those neoclassical economists who tend to favor the free market and free society often regard the State as a generally inefficient, but still amiable, organ of social service, mechanically registering "our" values and decisions.

One would not think it difficult for scholars and laymen alike to grasp the fact that government is *not* like the Rotarians or the Elks;

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that it differs profoundly from all other organs and institutions in society; namely, that it lives and acquires its revenues by coercion and not by voluntary payment. The late Joseph Schumpeter was never more astute than when he wrote: "The theory which construes taxes on the analogy of club dues or of the purchase of the services of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind."[1]

Apart from the public sector, what constitutes the productivity of the "private sector" of the economy? The productivity of the private sector does not stem from the fact that people are rushing around doing "something," anything, with their resources; it consists in the fact that they are using these resources to satisfy the needs and desires of the consumers. Businessmen and other producers direct their energies, on the free market, to producing those products which will be most rewarded by the consumers, and the sale of these products may therefore roughly "measure" the importance which the consumers place upon them. If millions of people bend their energies to producing horses-and-buggies, they will, in this day and age, not be able to sell them, and hence the productivity of their output will be virtually zero. On the other hand, if a few million dollars are spent in a given year on Product X, then statisticians may well judge that these millions constitute the productive output of the X-part of the "private sector" of the economy.

One of the most important features of our economic resources is their scarcity: land, labor, and capital goods factors are all scarce, and may all be put to various possible uses. The free market uses them "productively" because the producers are guided, on the market, to produce what the consumers most need: automobiles, for example, rather than buggies. Therefore, while the statistics of the total output of the private sector *seem* to be a mere adding of numbers, or counting units of output, the measures of output actually involve the

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[1]In the preceding sentences, Schumpeter wrote:

> The friction of antagonism between the private and the public sphere was intensified from the first by the fact that … the state has been living on a revenue which was being produced in the private sphere for private purposes and had to be deflected from these purposes by political force. (Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* [New York: Harper and Bros., 1942], p. 198)

important qualitative decision of considering as "product" what the consumers are willing to buy. A million automobiles, sold on the market, are productive because the consumers so considered them; a million buggies, remaining unsold, would *not* have been "product" because the consumers would have passed them by.

Suppose now, that into this idyll of free exchange enters the long arm of government. The government, for some reasons of its own, decides to ban automobiles altogether (perhaps because the many tailfins offend the aesthetic sensibilities of the rulers) and to compel the auto companies to produce the equivalent in buggies instead. Under such a strict regimen, the consumers would be, in a sense, compelled to purchase buggies because no cars would be permitted. However, in this case, the statistician would surely be purblind if he blithely and simply recorded the buggies as being just as "productive" as the previous automobiles. To call them equally productive would be a mockery; in fact, given plausible conditions, the "national product" totals might not even show a statistical decline, when they had actually fallen drastically.

And yet the highly-touted "public sector" is in even worse straits than the buggies of our hypothetical example. For most of the resources consumed by the maw of government have not even been seen, much less used, by the consumers, who were at least allowed to ride in their buggies. In the private sector, a firm's productivity is gauged by how much the consumers voluntarily spend on its product. But in the public sector, the government's "productivity" is measured—*mirabile dictu*—by how much *it spends*! Early in their construction of national product statistics, the statisticians were confronted with the fact that the government, unique among individuals and firms, could not have its activities gauged by the voluntary payments of the public—because there were little or none of such payments. Assuming, without any proof, that government *must* be as productive as anything else, they then settled upon its expenditures as a gauge of its productivity. In this way, not only are government expenditures just as useful as private, but all the government need to do in order to increase its "productivity" is to add a large chunk to its bureaucracy. Hire more bureaucrats, and see the productivity of the public sector rise! Here, indeed, is an easy and happy form of social magic for our bemused citizens.

The truth is exactly the reverse of the common assumptions. Far from adding cozily to the private sector, the public sector can only

feed off the private sector; it necessarily lives parasitically upon the private economy. But this means that the productive resources of society—far from satisfying the wants of consumers—are now directed, by compulsion, *away from* these wants and needs. The consumers are deliberately thwarted, and the resources of the economy diverted from them to those activities desired by the parasitic bureaucracy and politicians. In many cases, the private consumers obtain nothing at all, except perhaps propaganda beamed to them at their own expense. In other cases, the consumers receive something far down on their list of priorities—like the buggies of our example. In either case, it becomes evident that the "public sector" is actually *anti*productive: that it *subtracts from*, rather than adds to, the private sector of the economy. For the public sector lives by continuous attack on the very criterion that is used to gauge productivity: the voluntary purchases of consumers.

We may gauge the fiscal impact of government on the private sector by subtracting government expenditures from the national product. For government payments to its own bureaucracy are hardly additions to production; and government absorption of economic resources takes them out of the productive sphere. This gauge, of course, is only fiscal; it does not begin to measure the anti-productive impact of various government regulations, which cripple production and exchange in other ways than absorbing resources. It also does not dispose of numerous other fallacies of the national product statistics. But at least it removes such common myths as the idea that the productive output of the American economy increased during World War II. Subtract the government deficit instead of add it, and we see that the real productivity of the economy declined, as we would rationally expect during a war.

In another of his astute comments, Joseph Schumpeter wrote, concerning anticapitalist intellectuals, "capitalism stands its trial before judges who have the sentence of death in their pockets. They are going to pass it, whatever the defense they may hear; the only success a victorious defense can possibly produce is a change in the indictment."[2] The indictment has certainly been changing. In the 1930s, we heard that government must expand because capitalism had brought about mass poverty. Now, under the aegis of John Kenneth Galbraith,

[2]Ibid, p. 144.

we hear that capitalism has sinned because the masses are too affluent. Where once poverty was suffered by "one-third of a nation," we must now bewail the "starvation" of the public sector.

By what standards does Dr. Galbraith conclude that the private sector is too bloated and the public sector too anemic, and therefore that government must exercise further coercion to rectify its own malnutrition? Certainly, his standard is not historical. In 1902, for example, net national product of the United States was $22.1 billion; government expenditure (Federal, state, and local) totalled $1.66 billion, or 7.1 percent of the total product. In 1957, on the other hand, net national product was $402.6 billion, and government expenditures totalled $125.5 billion, or 31.2 percent of the total product. Government's fiscal depredation on the private product has therefore multiplied from four to five-fold over the present century. This is hardly "starvation" of the public sector. And yet, Galbraith contends that the public sector is being increasingly starved, relative to its status in the non-affluent nineteenth century!

What standards, then, does Galbraith offer us to discover when the public sector will finally be at its optimum? The answer is, nothing but personal whim:

> There will be question as to what is the test of balance—at what point may we conclude that balance has been achieved in the satisfaction of private and public needs. The answer is that no test can be applied, for none exists. . . . The present imbalance is clear. . . . This being so, the direction in which we move to correct matters is utterly plain.[3]

To Galbraith, the imbalance of today is "clear." Clear why? Because he looks around him and sees deplorable conditions wherever government operates. Schools are overcrowded, urban traffic is congested and the streets littered, rivers are polluted; he might have added that crime is increasingly rampant and the courts of justice clogged. All of these are areas of government operation and ownership. The one supposed solution for these glaring defects is to siphon more money into the government till.

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[3]John Kenneth Galbraith, *The Affluent Society* (Boston: Houghton Mifflin, 1958), pp. 320–21.

But how is it that only *government* agencies clamor for more money and denounce the citizens for reluctance to supply more? Why do we never have the private-enterprise equivalents of traffic jams (which occur on government streets), mismanaged schools, water shortages, and so on? The reason is that private firms acquire the money that they deserve from two sources: voluntary payment for the services by consumers, and voluntary investment by investors in expectation of consumer demand. If there is an increased demand for a privately-owned good, consumers pay more for the product, and investors invest more in its supply, thus "clearing the market" to everyone's satisfaction. If there is an increased demand for a publicly-owned good (water, streets, subway, and so on), all we hear is annoyance at the consumer for wasting precious resources, coupled with annoyance at the taxpayer for balking at a higher tax load. Private enterprise makes it its business to court the consumer and to satisfy his most urgent demands; government agencies denounce the consumer as a troublesome user of their resources. Only a government, for example, would look fondly upon the prohibition of private cars as a "solution" for the problem of congested streets. Government's numerous "free" services, moreover, create permanent excess demand over supply and therefore permanent "shortages" of the product. Government, in short, acquiring its revenue by coerced confiscation rather than by voluntary investment and consumption, is not and *cannot* be run like a business. Its inherent gross inefficiencies, the impossibility for it to clear the market, will insure its being a mare's nest of trouble on the economic scene.[4]

In former times, the inherent mismanagement of government was generally considered a good argument for keeping as many things as possible out of government hands. After all, when one has invested in a losing proposition, one tries to refrain from pouring good money after bad. And yet, Dr. Galbraith would have us redouble our determination to pour the taxpayer's hard-earned money down the rathole of the "public sector," and uses the very defects of government operation as his major argument!

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[4]For more on the inherent problems of government operations, see Murray N. Rothbard, "Government in Business," in *Essays on Liberty* (Irvington-on-Hudson, N.Y: Foundation for Economic Education, 1958), vol. 4, pp. 183–87.

Professor Galbraith has two supporting arrows in his bow. First, he states that, as people's living standards rise, the added goods are not worth as much to them as the earlier ones.This is standard knowledge; but Galbraith somehow deduces from this decline that people's private wants are now worth nothing to them. But if that is the case, then why should *government* "services," which have expanded at a much faster rate, still be worth so much as to require a further shift of resources to the public sector? His final argument is that private wants are all artificially induced by business advertising which automatically "creates" the wants that it supposedly serves. In short, people, according to Galbraith, would, if let alone, be content with nonaffluent, presumably subsistence-level living; *advertising* is the villain that spoils this primitive idyll.

Aside from the philosophical problem of how A can "create" B's wants and desires without B's having to place his own stamp of approval upon them, we are faced here with a curious view of the economy. *Is* everything above subsistence "artificial"? By what standard? Moreover, why in the world should a business go through the extra bother and expense of inducing a change in consumer wants, when it can profit by serving the consumer's existing, un"created" wants? The very "marketing revolution" that business is now undergoing, its increased and almost frantic concentration on "market research," demonstrates the reverse of Galbraith's view. For if, by advertising, business production automatically creates its own consumer demand, there would be no need whatever for market research—and no worry about bankruptcy either. In fact, far from the consumer in an affluent society being more of a "slave" to the business firm, the truth is precisely the opposite: for as living standards rise above subsistence, the consumer gets more particular and choosy about what he buys. The businessman must pay even greater court to the consumer than he did before: hence the furious attempts of market research to find out what the consumers want to buy.

There is an area of our society, however, where Galbraith's strictures on advertising may almost be said to apply—but it is in an area that he curiously never mentions. This is the enormous amount of advertising and propaganda *by government*. This is advertising that beams to the citizen the virtues of a product which, unlike business advertising, he never has a chance to test. If Cereal Company X prints a picture of a pretty girl declaiming that "Cereal X is yummy,"

the consumer, even if doltish enough to take this seriously, has a chance to test that proposition personally. Soon his *own* taste determines whether he will buy or not. But if a government agency advertises its own virtues over the mass media, the citizen has no direct test to permit him to accept or reject the claims. If any wants are artificial, they are those generated by government propaganda. Furthermore, business advertising is, at least, paid for by investors, and its success depends on the voluntary acceptance of the product by the consumers. Government advertising is paid for by means of taxes extracted from the citizens, and hence can go on, year after year, without check. The hapless citizen is cajoled into applauding the merits of the very people who, by coercion, are forcing him to pay for the propaganda. This is truly adding insult to injury.

If Professor Galbraith and his followers are poor guides for dealing with the public sector, what standard does our analysis offer instead? The answer is the old Jeffersonian one: "that government is best which governs least." Any reduction of the public sector, any shift of activities from the public to the private sphere, is a net moral and economic gain.

Most economists have two basic arguments on behalf of the public sector, which we may only consider very briefly here. One is the problem of "external benefits." A and B often benefit, it is held, if they can force C into doing something. Much can be said in criticism of this doctrine; but suffice it to say here that any argument proclaiming the right and goodness of, say, three neighbors, who yearn to form a string quartet, forcing a fourth neighbor at bayonet point to learn and play the viola, is hardly deserving of sober comment. The second argument is more substantial; stripped of technical jargon, it states that some essential services simply *cannot* be supplied by the private sphere, and that therefore government supply of these services is necessary. And yet, every single one of the services supplied by government has been, in the past, successfully furnished by private enterprise. The bland assertion that private citizens cannot possibly supply these goods is never bolstered, in the works of these economists, by any proof whatever. How is it, for example, that economists, so often given to pragmatic or utilitarian solutions, do not call for social "experiments" in this direction? Why must political experiments always be in the direction of more government? Why not give the free market a county or even a state or two, and see what it can accomplish?

# 22

# Statistics: Achilles's Heel of Government

Ours is truly an Age of Statistics. In a country and an era that worships statistical data as super-"scientific," as offering us the keys to all knowledge, a vast supply of data of all shapes and sizes pours forth upon us. Mostly, it pours forth from government. While private agencies and trade associations do gather and issue some statistics, they are limited to specific wants of specific industries. The vast bulk of statistics is gathered and disseminated by government. The over-all statistics of the economy, the popular "gross national product" data that permits every economist to be a soothsayer of business conditions, come from government. Furthermore, many statistics are by-products of other governmental activities: from the Internal Revenue bureau come tax data, from unemployment insurance departments come estimates of the unemployed, from customs offices come data on foreign trade, from the Federal Reserve flow statistics on banking, and so on. And as new statistical techniques are developed, new divisions of government departments are created to refine and use them.

The burgeoning of government statistics offers several obvious evils to the libertarian. In the first place, it is clear that too many resources are being channeled into statistics-gathering and statistics-production. Given a wholly free market, the amount of labor, land, and capital resources devoted to statistics would dwindle to a small fraction of the present total. It has been estimated that the federal government alone spends over $48,000,000 on statistics, and that

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statistical work employs the services of over 10,000 full-time civilian employees of the government.[1]

## Hidden Costs of Reporting

Second, the great bulk of statistics is gathered by government coercion. This not only means that they are products of unwelcome activities; it also means that the true cost of these statistics to the American public is much greater than the mere amount of tax money spent by the government agencies. Private industry, and the private consumer, must bear the burdensome costs of record-keeping, filing, and the like, that these statistics demand. Not only that; these fixed costs impose a relatively great burden on small business firms, which are ill-equipped to handle the mountains of red tape. Hence, these seemingly innocent statistics cripple small business enterprise and help to rigidify the American business system. A Hoover Commission task force found, for example, that:

> No one knows how much it costs American industry to compile the statistics that the Government demands. The chemical industry alone reports that each year it spends $8,850,000 to supply statistical reports demanded by three departments of the Government. The utility industry spends $32,000,000 a year in preparing reports for Government agencies . . .
>
> All industrial users of peanuts must report their consumption to the Department of Agriculture. . . . Upon the intervention of the Task Force, the Department of Agriculture agreed that henceforth only those that consume more than ten thousand pounds a year need report . . .
>
> If small alterations are made in two reports, the Task Force says one industry alone can save $800,000 a year in statistical reporting.
>
> Many employees of private industry are occupied with the collection of Government statistics. This is especially burdensome to small businesses. A small hardware store owner in Ohio estimated that 29 per cent of his time is absorbed in filling out such reports.

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[1]Cf. Neil Macneil and Harold W. Metz, *The Hoover Report, 1953–1955* (New York: Macmillan, 1956), pp. 90–91; Commission on Organization of the Executive Branch of the Government, *Task Force Report on Paperwork Management* (Washington, D.C.: June 1955); and idem, *Report on Budgeting and Accounting* (Washington, D.C.: February 1949).

> Not infrequently people dealing with the Government have to keep several sets of books to fit the diverse and dissimilar requirements of Federal agencies.[2]

## Other Objections

But there are other important, and not so obvious, reasons for the libertarian to regard government statistics with dismay. Not only do statistics-gathering and producing go beyond the governmental function of defense of persons and property; not only are economic resources wasted and misallocated, and the taxpayers, industry, small business, and the consumer burdened. But, furthermore, statistics are, in a crucial sense, critical to all interventionist and socialist activities of government. The individual consumer, in his daily rounds, has little need of statistics; through advertising, through the information of friends, and through his own experience, he finds out what is going on in the markets around him. The same is true of the business firm. The businessman must also size up his particular market, determine the prices he has to pay for what he buys and charge for what he sells, engage in cost accounting to estimate his costs, and so on. But none of this activity is really dependent upon the *omnium gatherum* of statistical facts about the economy ingested by the federal government. The businessman, like the consumer, knows and learns about his particular market through his daily experience.

## A Substitute for Market Data

Bureaucrats as well as statist reformers, however, are in a completely different state of affairs. They are decidedly outside the market. Therefore, in order to get "into" the situation that they are trying to plan and reform, they must obtain knowledge that is not personal, day-to-day experience; the only form that such knowledge can take is statistics.[3] Statistics are the eyes and ears of the bureaucrat, the politician, the socialistic reformer. Only by statistics can they know, or at

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[2]Macneil and Metz, *The Hoover Report*, pp. 90–91.

[3]On the deficiencies of statistics as compared to the personal knowledge of all participants utilized on the free market, see the illuminating discussion in F.A. Hayek, *Individualism and the Economic Order* (Chicago: University Press, 1948), chap. 4. Also see Geoffrey Dobbs, *On Planning the Earth* (Liverpool: K.R.P. Pubs., 1951), pp. 77–86.

least have any idea about, what is going on in the economy.[4] Only by statistics can they find out how many old people have rickets, or how many young people have cavities, or how many Eskimos have defective sealskins—and therefore only by statistics can these interventionists discover who "needs" what throughout the economy, and how much federal money should be channeled in what directions.

## THE MASTER PLAN

Certainly, only by statistics, can the federal government make even a fitful attempt to plan, regulate, control, or reform various industries—or impose central planning and socialization on the entire economic system. If the government received no railroad statistics, for example, how in the world could it even start to regulate railroad rates, finances, and other affairs? How could the government impose price controls if it didn't even know what goods have been sold on the market, and what prices were prevailing? Statistics, to repeat, are the eyes and ears of the interventionists: of the intellectual reformer, the politician, and the government bureaucrat. Cut off those eyes and ears, destroy those crucial guidelines to knowledge, and the whole threat of government intervention is almost completely eliminated.[5]

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[4]As early as 1863, Samuel B. Ruggles, American delegate to the International Statistical Congress in Berlin, declared: "Statistics are the very eyes of the statesmen, enabling him to survey and scan with clear and comprehensive vision the whole structure and economy of the body politic." For more on the interrelation of statistics—and statisticians—and the government, see Murray N. Rothbard, "The Politics of Political Economists: Comment," *Quarterly Journal of Economics* (November 1960): 659–65; included in this volume as chapter 18. Also see Dobbs, *On Planning the Earth*.

[5]
> Government policy depends upon much detailed knowledge about the Nation's employment, production, and purchasing power. The formulation of legislation and administrative progress . . . supervision . . . regulation . . . and control . . . must be guided by knowledge of a wide range of relevant facts. Today as never before, statistical data play a major role in the supervision of Government activities. Administrators not only make plans in the light of known facts in their field of interest, but also they must have reports on the actual progress achieved in accomplishing their goals. (*Report on Budgeting and Accounting*, pp. 91–92)

## Without Statistics Bureaucracy Would Wither Away

It is true, of course, that even deprived of all statistical knowledge of the nation's affairs, the government could still try to intervene, to tax and subsidize, to regulate and control. It could try to subsidize the aged even without having the slightest idea of how many aged there are and where they are located; it could try to regulate an industry without even knowing how many firms there are or any other basic facts of the industry; it could try to regulate the business cycle without even knowing whether prices or business activity are going up or down. It could try, but it would not get very far. The utter chaos would be too patent and too evident even for the bureaucracy, and certainly for the citizens. And this is especially true since one of the major reasons put forth for government intervention is that it "corrects" the market, and makes the market and the economy more rational. Obviously, if the government were deprived of all knowledge whatever of economic affairs, there could not even be a pretense of rationality in government intervention. Surely, the absence of statistics would absolutely and immediately wreck any attempt at socialistic planning. It is difficult to see what, for example, the central planners at the Kremlin could do to plan the lives of Soviet citizens if the planners were deprived of all information, of all statistical data, about these citizens. The government would not even know to whom to give orders, much less how to try to plan an intricate economy.

Thus, in all the host of measures that have been proposed over the years to check and limit government or to repeal its interventions, the simple and unspectacular abolition of government statistics would probably be the most thorough and most effective. Statistics, so vital to statism, its namesake, is also the State's Achilles's heel.

# 23

# How and How Not to Desocialize

Everyone in Eastern Europe and the Soviet Union is seemingly anxious to desocialize, to institute free markets and privatization. Plans proliferate, and innumerable Western economists are being consulted on how to go about this daunting task. It is generally acknowledged that bureaucrats are obstructing the process, but confusion abounds among free-market proponents themselves. Matters are scarcely helped by the fact that Western economists, to whom the former Eastern bloc is looking for wisdom, have themselves done virtually nothing to study, let alone solve, this problem during the sixty years since Stalin established socialism in the Soviet Union and the half-century since the Soviets imposed it on Eastern Europe. For ever since the mid-1930s, almost all Western economists have accepted the view that there is no calculation problem under socialism, and most have accepted the subsequent notion that the Soviet economy has been successful and growing, and would shortly overtake that of the United States.[1]

## How Not to Desocialize

We may first clear the way on how to desocialize by examining various paths that have become popular, and yet are decidedly *not* the way to arrive at our presumably common goal.

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Originally appeared in *Review of Austrian Economics* 6, no. 1 (1992): 65–78.

[1]Murray N. Rothbard, "Ludwig von Mises and the Collapse of Socialism," delivered at the annual meeting of the Allied Social Science Association, at Washington, D.C., 1990, and published as "The End of Socialism and the Calculation Debate Revisited," *Review of Austrian Economics* 5, no. 2 (1991): 51–76; included in this volume as chapter 44.

How *not* to go about desocialization may be highlighted by the story of a friend of mine, who told me recently about a Soviet colleague in his department, who came to the United States to study diligently the problem of how to create a futures market in the U.S.S.R. He has been stymied by the fact that he cannot seem to figure out what laws or edicts the Soviet state should lay down, so as to replicate the futures market in the United States. In short, he cannot find a way to plan a futures market. Here then is a crucial point: *you cannot plan markets*. By their very nature, you can only set people free so that they can interact and exchange, and thereby develop markets themselves. Similarly, several of the socialist countries, seeing the importance of the capital markets in the West, have been trying to develop stock exchanges, but with little success. First, again, because stock markets cannot be planned, and, second, because, as we will see further, you cannot have markets in titles to capital if there are still virtually no private *owners* of capital in existence.

## Do Not Phase In

It is, again, generally accepted that free markets must be arrived at quickly, and that phasing them in slowly and gradually will only delay the goal indefinitely. It is well known that the giant socialist bureaucracy will only seize upon such delay to obstruct the goal altogether. But there are further important reasons for speed. One, because the free market is an interconnected web or lattice-work; it is made of innumerable parts which intricately mesh together through a network of producers and entrepreneurs exchanging property titles, motivated by a search for profits and avoidance of losses, and calculating by means of a free price system. Holding back, freeing only a few areas at a time, will only impose continuous distortions that will cripple the workings of the market and discredit it in the eyes of an already fearful and suspicious public. But there is also another vital point: the fact that you cannot plan markets applies also to planning for phasing them in. Much as they might delude themselves otherwise, governments and their economic advisers are not in a position of wise Olympians above the economic arena, carefully planning to install the market step by measured step, deciding what to do first, what second, etc. Economists and bureaucrats are no better at planning phase-ins than they are at dictating any other aspect of the market. To achieve genuine freedom, the role of government and its

advisers must be confined to setting their subjects free, as fast and as completely as it takes to unlock their shackles. After that, the proper role of government and its advisers is to get and keep out of the subjects' way.

### *Do Not Crack Down on Black Markets*

One route toward freedom that former President Gorbachev had adopted was to crack down on the villains of the black market. We might conclude that the mindset of the Eastern bloc has a long way to go in understanding freedom, except that there are precious few Westerners who understand this problem either. For the black marketeers are not villains; if they sometimes look and act like villains, it is only because their entrepreneurial activities have been made illegal. The "black market" is simply the market, the market which Soviets claim to be searching for, but which has turned "black" precisely because it has been declared illegal. It is the market crippled and distorted, but it is there, in this despised "black" area, that the Soviets will find the market most readily. Instead of cracking down, then, the governments should, immediately, set the black market free.

### *Do Not Confiscate the People's Money*

The Soviet Union suffers from the problem of "ruble overhang," that is too many rubles chasing too few goods. It is generally admitted that the "overhang" is the result of comprehensive price fixing, by which the government has set prices far below market-clearing levels. Over the years, the Soviet government has been rapidly printing new money to finance its expenditures, and this increased money supply, coupled with ever-dwindling supply of goods resulting from the breakdown of socialist planning, has created aggravated shortages and an excess supply of money over goods available.

It is commonly acknowledged that the shortages will be relieved and the overhang abolished, if prices were set free to move. But the government fears the wrath of unhappy consumers. Perhaps, but it is scarcely a solution to do what Gorbachev did, that is, follow the uninspired path of the Brazilian "free market" President Collor de Mello, who in the spring of 1990, in an attempt to reverse hyperinflation, arbitrarily froze 80 percent of all bank accounts. Gorbachev did one better by suddenly making useless all large-ruble bills, allowing only a small number to be exchanged for smaller dominations. This

is no way to eliminate an overhang; at best, the cure is much worse than the disease. In the first place, in this supposed strike at black marketers, it has been rather the savings of the average Soviet that has been destroyed, since the black marketeers were shrewd enough to have moved already into precious metals and foreign currency. But even more important: By this action, the government delivers the second body blow of a one-two punch at the average citizen, and at the economy. The first punch was for the government to inflate the money supply so as to engage in its usual, wasteful expenditures. Then, after the money has been spent, and prices driven up—in either open or repressed fashion—then the government, in its wisdom, begins to exclaim at the horrors of inflation, blames black marketeers, greedy consumers, the rich, or whatever, and proceeds to the second monstrous punch of confiscating the money long after it has come into private ownership. Whether or not one calls this process "free market," it remains confiscatory, unjust, statist, and a double set of implicit taxes and burdens upon the economy.

### *Do Not Increase Taxes*

Unfortunately, one of the "lessons" that many East Europeans have absorbed from Western economists is the alleged necessity of sharply raising taxes and making them progressive. Taxes are parasitic and statist; they cripple energies, savings, and production. Taxes invade and aggress against the rights of private property. The higher the taxes, the more the economy becomes socialistic; the lower they are, the closer the economy approaches true freedom and genuine privatization, which means a system of complete rights of private property. The Mazowiecki attempt to achieve privatization and free markets in Poland was greatly hampered by the imposition of far higher and progressive taxes.

As part of the shift toward freedom and desocialization, then, taxes should be drastically lowered, not raised.

### *Government Firms Owning Each Other is Not Privatization*

I owe to Dr. Yuri Maltsev the information that the much-vaunted Shatalin plan for the Soviet Union, which was supposed to bring about privatization and free markets in 500 days, was really not privatization at all. Apparently, existing government firms in each industry, instead of being actually privatized—that is, owned by private

individuals—would have been owned (or 80 percent owned) by other firms in the same industry. This would mean that giant state monopoly firms would continue to be state monopoly firms, and be self-perpetuating oligarchies rather than truly privately owned. Privatization must mean private property.[2]

## How to Desocialize

The following points of desocialization must necessarily be written or read sequentially, but they need not be carried out in that manner: all the following points could, and should, be instituted immediately and all at once.

### *Legalize the Black Market*

The first two planks are implicit in the previous part of this paper. One, is to legalize the black market, that is to make all markets free and legal. That means that the private property of all those engaging in such markets must, along with everyone else, be made secure from government depredation, secure as a right of ownership. It means also that all goods and services hitherto illegal are now to be legal, whether they are legal in the West or not, and that all transactions are to be engaged in freely, that is, that prices are to be set voluntarily by the exchanging parties. Thus, all government price control is to be abolished forthwith. If such genuine prices for real transactions are to be higher than pseudo-"prices" set by the government for non-existent transactions, then so be it. Consumer griping should simply be ignored; any consumers who still prefer the previous regime of fixed prices for nonexistent goods will, of course, be free to boycott the

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[2]Maltsev writes: "When the Soviets say privatization, however, they don't mean what we do by the term. The [Shatalin] plan would mandate that 80 percent of the stock of any enterprise be owned by other enterprises in the same field, not the public. To use a U.S. analogy, it would be as if General Motors owned 80 percent of Ford's stock and vice versa, and it were illegal to have it otherwise." Maltsev notes that Stanislav Shatalin, and the original author of his plan for the Russian Republic, Grigory Yavlinsky, "are both econometricians whose . . . lives have been spent in anathematizing the delusions of Marxism-Leninism. They are both long-time central planners who became disillusioned with full-blown socialism. Yuri N. Maltsev, "A 500-Day Failure?" *The Free Market* 8 (November 1990): 6.

new prices and try to find cheaper sources of supply elsewhere. My hunch, however, is that consumers will adjust soon enough to these one-shot changes, especially since unprecedented abundance of consumer goods will quickly pour forth onto the markets.

By "legalizing," by the way, I mean simply abolishing a previous outlaw status; I do not propose to engage in semantic exercises trying to distinguish between "legalizing" and "decriminalizing."

### *Drastically Lower All Taxes*

Another implication of our previous analysis is that taxation should be cut drastically. There is, in the literature on taxation, far too much discussion about which types of taxes are to be imposed, and who is to pay them and why, and not nearly enough on the height or amount of taxes to be levied. If the tax rate is low enough, then the form or principles of tax distribution really makes very little difference. To put it starkly, if all tax rates are kept below one percent, then it really does not matter much economically whether the taxes are on incomes, sales, excises, property, or capital gains. It is important instead to focus on how much of the social product is to be siphoned off to the unproductive maw of government, and to keep that burden ultra-minimal.

While the form of taxation would not then matter economically, it would still matter *politically*. An income tax, for example, however low, would still maintain an oppressive system of secret police ready and willing to investigate everyone's income and spending and hence his entire life. Economists' opinion to the contrary, there is no tax or system of taxes that could be neutral to the market.[3] Whatever taxation that might exist after desocialization should, however, be as close to neutral as possible. This would mean, in addition to very low rates and amounts, that the taxation be as unobtrusive and harmless as possible, and imitate the market as closely as it can. Such imitation might include the voluntary sale of goods and services at a price, or setting a price for participating in voting. The sale of goods or services by the government would, of course, be drastically limited in our desocialized system, because of the enormous scope of privatization of government activities. Privatization will be treated below.

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[3]See Murray N. Rothbard, "The Myth of Neutral Taxation," *Cato Journal* 1 (Fall, 1981): 519–84; included in this volume as chapter 24.

### *Abolish the Government's Ability to Create Money*

There are three parts to any government's ability to generate revenue: taxation, the creation of new money, and the sale of goods or services.[4] There can be no genuine free market or desocialization so long as government is permitted to *counterfeit* money, that is create new money, whether it be paper tickets or bank deposits, out of thin air. Such money creation functions as a hidden and insidious form of taxation and expropriation of the property and resources of producers. Ending counterfeiting means getting the government out of the money business, which in turn implies eliminating both government paper money and central banking. It also means denationalizing currency units, such as the ruble, forint, zloty, etc., and returning them to private market hands. Denationalizing currency can only be achieved by redefining paper currencies in terms of units of weight of a market metal, preferably gold. When the central banks are liquidated, they could disgorge their gold hoards; as their last act on earth they could redeem all their paper tickets at the redefined weight in gold coins.

While, given the will to desocialize, this monetary denationalizing process is not as complex or difficult as it may first seem, it might indeed take longer than the one day required for the other parts of our plan.[5] There could then be transitional steps of a few days' length: that is, the ruble or forint could be allowed to fluctuate freely and be convertible at market exchange rates into other currencies. It would still be imperative to take the money-creating power out of the hands of the national government; a possible way of doing that, and a second transitional step, would be to make the ruble convertible into harder currencies, such as the dollar, at some fixed rate. Pending return to a pure gold standard and liquidation of the central bank, it would also be important to curb the government's power to create money by freezing permanently all central bank activities including open market operations, loans, and note issues. It need hardly be added that a law or edict limiting or freezing the

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[4]A fourth form of revenue, borrowing from the public, is strictly dependent on the other three sources.

[5]See Yuri N. Maltsev, "A One Day Plan for the Soviet Union," *Antithesia* 2 (January/February 1991): 4, and in the earlier account, "The Maltsev One-Day Plan," *The Free Market* (November 1990): 7.

government itself is not an act of intervention into the economy or society. Quite the contrary.

Just as black markets and all private markets would be set free, so too private credit institutions, for the lending of savings or the channeling of the savings of others, would be set free to develop.

### *Fire the Bureaucracy*

A question may have occurred to the reader: If taxation is to be drastically lowered, and the government is to be deprived of its power to print or create money, then how is the government going to finance its expenditures and operations? The answer is: It wouldn't have to, because there would be precious little left for government to do. (This will be explained further in the discussion of privatization below.) The socialist economy is a command economy, staffed and run by a gigantic bureaucracy. That bureaucracy would immediately be fired, its members set free at long last to find productive jobs, and develop whatever productive abilities they might have, in the now rapidly expanding and flourishing private sector.

This brings us to a fascinating problem which, while resting long in the hearth and minds of the oppressed subjects of socialism, has now unexpectedly become a live political issue. What is to be done with and to the top Communist party cadre, to the *nomenklatura*, to the vast apparatus of the once all-powerful secret police? Should justice at last be meted out to them by a series of state-crime trials, followed by proper and condign punishment? Or should bygones be bygones, a general amnesty be declared, and ex-KGB men hired as private guards or detectives? I confess an ambivalence on this issue, in weighing the competing claims of justice and of social peace. Fortunately, the decision can be left to the peoples of the former Soviet Union and of Eastern Europe. There is not much that an economist, even a free-market economist, can say to resolve this issue.

### *Privatize or Abolish Government Operations*

This brings us to the final, but scarcely the least important, plank of our proposed desocialization platform: privatizing government operations. Since theoretically all, or in practice *most*, production in socialist countries has been in the hands of the State, the most important desideratum, the crucial route for attaining a system of

private property and free market, must be to privatize government operations.

But simply to say "privatize" is not enough. In the first place, there are many government operations, especially in socialist states, that we don't *want* to privatize, but rather to abolish completely. For example, we would not, as libertarians and desocializers, wish to privatize concentration camps, or the Gulag, or the KGB. God forbid that we should ever have an *efficient* supply of concentration-camp or secret police "services"!

Here is a point that needs to be underlined. The basic assumption of national income and GNP analysis is that all government operations are productive, that they contribute their expenses to the national output and the common weal. But if we truly believe in freedom and private property, we must conclude that many of these operations are not social "services" at all but *dis*services to the economy and society, "bads" rather than "goods."

This means that desocialization must involve the abolition, not the privatization, of such operations as (in addition to concentration camps and secret police facilities) all regulatory commissions, central banks, income tax bureaus, and, of course, all the bureaus administering those functions that are going to be privatized.[6]

### *Principles of Privatization*

Genuine goods and services, then, are to be privatized. How is this to be accomplished? In the first place, private competition with previous government monopolies is to be free and unhampered. This would legalize not only the black market, but all competition with existing government operations. But what about the massive

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[6]It is important to realize that if a government activity is a bad rather than a good, we would want its exercise, so long as it exists, to be as inefficient rather than as efficient as possible. One of the most hated organizations in early modern Europe was the "tax farmer," who purchased from the king the right to collect taxes for a certain term of years. We might consider: would we want income taxes to be privatized, and collected, fully armed with state power, by IBM or McDonald's rather then the IRS? The industrialist Charles F. Kettering is supposed to have cheered up a friend in the hospital, who was complaining about the accelerated growth of government: "Cheer up, Jim, thank God we don't get as much government as we pay for."

accumulation of government firms and capital assets themselves? How are they to be privatized?

Several possible routes have been suggested, but they can be grouped into three basic types. One is egalitarian handouts. Every Soviet or Polish citizen receives in the mail one day an aliquot share of ownership of various previously state-owned properties. Thus, if the XYZ steel works is to be privately owned, then, if there are 300 million shares of XYZ steel company issues, and 300 million inhabitants, each citizen receives one share, which immediately becomes transferable or exchangeable at will. That this system would be impossibly unwieldy is evident. The number of people would be too much and shares too few to allow every person to have a share, and there would be shares of innumerably large numbers and varieties that would quickly descend upon the heads of the average citizen. Much of this chaos would be eliminated in the suggestion of Czech finance minister Vaclav Klaus, who proposes that each citizen receive basic certificates, which could be exchanged for a certain number or variety of shares of ownership of various companies on the market.

But even under the Klaus plan, there are grave philosophical problems with this solution. It would enshrine the principle of government handouts, and egalitarian handouts at that, to undeserving citizens. Thus would an unfortunate principle form the very base of a brand new system of libertarian property rights.

It would be far better to enshrine the venerable *homesteading* principle at the base of the new desocialized property system. Or, to revive the old Marxist slogan: "all land to the peasants, all factories to the workers!" This would establish the basic Lockean principle that ownership of owned property is to be acquired by "mixing one's labor with the soil" or with other unowned resources. Desocialization is a process of depriving the government of its existing "ownership" or control, and devolving it upon private individuals. In a sense, abolishing government ownership of assets puts them immediately and implicitly into an *unowned* status, out of which previous homesteading can quickly convert them into private ownership. The homestead principle asserts that these assets are to devolve, not upon the general abstract public as in the handout principle, but upon those who have actually worked upon these resources: that is, their respective workers, peasants, and managers. Of course, these rights are to be genuinely *private*; that is, land to individual peasants, while capital goods

or factories go to workers in the form of private, negotiable shares. Ownership is not to be granted to collectives or cooperatives or workers or peasants holistically, which would only bring back the ills of socialism in a decentralized and chaotic syndicalist form.

It should go without saying that these ownership shares, to be truly private property, must be transferable and exchangeable at will by their holders. Many current plans in the socialist countries envision "shares" which must be held by the worker or peasant and, for a term of years, could only be sold back to the government. This clearly violates the very point of desocialization. Other suggested plans impose severe restrictions upon the transfer of ownership to foreigners. Once again, genuine privatization requires complete private property, including sale to foreigners. There is, furthermore, nothing wrong with "selling the country" to foreigners. In fact, the more that foreigners purchase "the country" the better, for it would mean rapid injections of foreign capital, and therefore more rapid prosperity and economic growth in the impoverished socialist bloc.

A problem immediately arises in granting shares to workers in the factories, a problem akin to the question what is to be done with the Communist cadres and the KGB: Should the managing *nomenklatura* be cut in on the shares of ownership? In advising the Soviets in an address in Moscow in early 1990, the economist Paul Craig Roberts observed that the Soviet people could either cut the throats of the *nomenklatura* or cut them in on shares of ownership; for the sake of social peace and smooth transition to a free economy, he recommended the latter. As I wrote above, I would not be that quick to thwart the demands of justice; but I would like to point out again a third possible route: not doing either one, and freeing the *nomenklatura* to find productive jobs in the private sector. The philosophic point in contention is to what extent, if at all, the managers' activities in the old Soviet economy were productive, and therefore participant in homesteading-labor, and to what extent they were crippling and counter-productive, and therefore deserving of nothing better than a curt dismissal.[7]

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[7]Yuri Maltsev recommends adoption of the homesteading plan, with the Vaclav Klaus distribution scheme to be adopted in cases where homesteading would not be feasible. Maltsev, "A One-Day Plan for the Soviet Union."

A third commonly suggested route to privatization deserves to be rejected out of hand: that the government sell all its assets to the public at auction, to the highest bidder. One grave flaw in this approach is that since the government owns virtually all the assets, where would the public get the money to purchase them, except at a very low price that would be tantamount to free distribution? But another, even more important flaw hasn't been sufficiently stressed: why does the government deserve to own the revenue from the sale of these assets? After all, one of the main reasons for desocialization is that the government does not deserve to own the productive assets of the country. But if it does not deserve to own the assets, why in the world does it deserve to own their monetary value? And we do not even consider the question: What is the government supposed to do with the funds after they have been received?[8]

A fourth principle of privatization should not be neglected; indeed, it should take priority. Unfortunately, by the nature of the case this fourth route cannot be made into a general principle. That would be for the government to return all stolen, confiscated property to its original owners, or to their heirs. While this can be done for many parcels of land, which are fixed in land area, or for particular jewels, in most cases, especially capital goods, there are no identifiable original owners to whom to restore property.[9] In the nature of the case, finding original landowners is easier in Eastern Europe than in the Soviet Union, since far less time has elapsed since the original theft. In the case of capital goods built by the State, there are no owners to identify. The reason why this principle should take priority wherever it applies is because property rights imply above all restoring stolen property to original owners. Or to put it another way:

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[8]One leading argument for the government selling its assets is that this process would have the anti-inflationary effect of sopping up the dread "ruble overhang." The fallacy in this egregious argument is that, unless the government officials propose to have a mass public bonfire of the rubles, the overhang would not be reduced at all. The government would spend the rubles, and they would remain in circulation.

[9]In Hungary the Smallholders Party was formed to stress priority in privatization to returning land to the expropriated landholders of Southern Hungary.

An asset becomes philosophically unowned, and therefore available to be homesteaded, only where an original owner, if one had existed, cannot be found.

There is one nagging remaining problem: How large should the newly private firms be? Every industry in socialistic countries is generally locked into a monopoly firm, so that if each firm is privatized into an equivalent-sized firm, the size of each will be far larger than the optimum on the free market. A fundamental problem, of course, is that there is no way for anyone in a socialized economy to figure out what the optimum size or number of firms is going to be under freedom. In a sense, of course, mistakes made in the shift to freedom will tend to iron themselves out after a free market is established, with tendencies to break up or to consolidate in the direction of optimum size and number. On the other hand, we must not make the mistake of blithely assuming that the costs or inefficiencies of this process may be disregarded. It would be preferable to come as close as possible to the optimum in the initial privatization. Perhaps each plant, or each group of plants in an area, may be initially privatized as a separate firm. It goes without saying that a very important aspect of a free market and of this optimizing process is to allow the market complete freedom to work: e.g., to merge, combine, or dissolve firms as it proves profitable.

## Conclusion

The dimensions of the proffered Rothbard Plan for desocialization should now be clear: (1) Enormous and drastic reductions in taxes, government employment, and government spending. (2) Complete privatization of government assets: where possible to return them to the original expropriated owners or their heirs; failing that, granting shares to productive workers and peasants who had worked on these assets. (3) Honoring complete and secure property rights for all owners of private property. Since full property rights imply the complete freedom to make exchanges and transfer property, there must be no government interference in such exchanges. (4) Depriving the government of the power to create new money, best done by a fundamental reform that at one and the same time liquidates the central bank and uses its gold to redeem its notes and deposits at a newly defined unit of gold weight of existing currencies.

All this could and should be done in one day, although the monetary reform could be done in steps taking a few days.

One point we have not specified: precisely how low should taxes or government employment or spending be set, and how complete should be the privatization? The best answer is that of the great Jean-Baptiste Say, who should be known for many other things than Say's Law: "The best scheme of [public] finance is, to spend as little as possible; and the best tax is always the lightest."[10] In short, that government is best that spends and taxes and employs the least, and privatizes the most.

A final point: I have been criticized by libertarian colleagues for proposals of this sort because they involve action by government. Isn't it inconsistent and statist for a libertarian to advocate any government action whatever? This seems to me a silly argument. If a thief has stolen someone's property, it is scarcely upholding "robber-action" to advocate that the robber disgorge his stolen property and return it to its owners. In a socialist state, the government has arrogated to itself virtually all property and power of the country. Desocialization, and a move to a free society, necessarily involves the action of that government's surrendering its property to its private subjects, and freeing those individuals from the government's network of controls. In a deep sense, getting rid of the socialist state requires that state to perform one final, swift, glorious act of self-immolation, after which it vanishes from the scene. This is an act which can be applauded by any lover of freedom, act of government though it may be.

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[10]Jean-Baptiste Say, *A Treatise on Political Economy*, 6th ed. (Philadelphia: Claxton, Remsen & Haffelfinger, 1880), p. 449. Also see Rothbard, "The Myth of Neutral Taxation," pp. 551–54.

# Section Four

# Taxation

# 24

# The Myth of Neutral Taxation

> A neutral mode of taxation is conceivable that would not divert the operation of the market from the lines in which it would develop in the absence of any taxation.
>
> Ludwig von Mises, *Human Action* (1949)

Economists have long believed that government's tax and expenditure policy either is, or can readily be made to be, neutral to the market. Free-market economists have advocated such neutrality of government, and even economists favoring redistributive actions by government have believed that the service activities and the redistributive activities of government can easily be distinguished, at least in concept. The purpose of this paper is to examine the nature and implications of fiscally neutral government; the paper argues that all government activities necessarily divert incomes, resources, and assets from the market, and therefore that the quest for a neutral tax or expenditure policy is an impossible one and the concept a myth.

## Structure of the Free Market: Consumers and Incomes

To evaluate the idea of a neutral government, we must first define what neutrality to the market may be. Any firm or institution is neutral to the market when it functions as *part* of the market. That is, both General Motors and Mom and Pop's Candy Store are part of the market, and insofar as their activities remain within the market, they are neutral to it.[1]

Originally appeared in *Cato Journal* (Fall, 1981): 519–64.

[1]Thus lobbying or other government-related activities by any business firm would not be neutral to the market.

We may analyze market institutions according to the following categories: (a) what and how much they produce, and (b) how much and from where the institution receives monetary funds. For every institution produces goods or services and receives money.

There are two types of market institutions. One is the business firm. The firm is guided by its expectations of monetary income from customers in payment for its products. The firm receives funds from two sources: ($b_1$) customer expenditures, and ($b_2$) entrepreneurial investments. Entrepreneurial investments are monies invested in the firm to purchase or hire factors of production to make goods and services to be sold to customers. The investments are savings spent in anticipation of greater returns from selling products to customers. Although the conspicuous resource and production decisions in the market are made by capitalist-entrepreneurs—by the owners of the firm and its capital assets—these decisions are made in accordance with their expectations of monetary income from customers. In short, businessmen are guided by the quest for monetary profits and the wish to avoid monetary losses, and their forecasting and anticipations must turn out to be good enough to reap profits from their production decisions. The intake of investment funds into the firm, then, is subordinate to the expected profit to be made from sales to customers.

Business firms and the structure of capital assets in the economy, as Austrian School economists have shown, are *not* a homogeneous lump: Production is a structure of stages, a latticework that moves from the most "roundabout" processes of production—the stages of production most remote from the consumers—down to nearer processes, and finally down to the production and sale of goods and services to the ultimate consumers.[2] The ham sandwich at the local coffee shop begins with the mining of ore for tools and machines and the growing of grain to feed hogs, and continues in stage after stage down through the wholesale and retail stages, until it arrives in the maw of the final buyer, the consumer. Thus, for our purposes, we can short-circuit the structure and refer to the *consumer* as the basic source of the income of business firms; ultimately, it is consumer

[2]On the structure of production and capital, see among other works, Eugen von Böhm-Bawerk, *Capital and Interest*, 3 vols. (South Holland, Ill.: Libertarian Press, 1959), and Ludwig M. Lachmann, *Capital and Its Structure* (Kansas City: Sheed Andrews and McMeel, 1978).

demand that provides profits or losses to business firms and either vindicates or not prior production decisions by investors.

Investments that bring money into the firm in anticipation of consumer demand, ($b_2$), consist of two parts. The basic investment ($b_{2a}$) is investment by the owner or owners of the firm in the form of personal savings, partnerships, or investment in corporate stock. Auxiliary investment ($b_{2b}$), are loans to the owners of the firm by other capitalists, either in the form of short-term credit or long-term debentures. The willingness of the firm's owners to pay a fixed-interest return to lenders is, of course, a function of their anticipated profit in selling the product to the consumers. Willingness to pay interest will always be less than or equal to the anticipated profit rate; and in the long-run general-equilibrium world of changeless certainty—a world that has never and can never come into existence—the rate of return would be equal throughout the market economy. In that world, the rate of profit in every firm would be equal to the rate of interest on loans.[3]

For market firms, therefore, there is no mystery about the determination of their production decisions and income. The former are determined by firms' anticipation of consumer demand, and the latter by the reality of that demand. Hence, firms receive their income, in the final analysis, from serving consumers. The more efficiently and ably the firms anticipate and serve consumer demand, the greater their profits; the less ably, the less their profits and the more they suffer losses.

Finally, the owners of the factors of production—land, labor, and capital goods—receive their income *in advance of production* from the investor-owners of the firm. The more ably and productively a factor or factors are believed to serve consumer demand, the greater the

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[3]Both would be determined by the social rate of time preference as determined on the market, the premium of present as compared with future goods—an agio which would be the resultant of all the time-preference schedules by individuals on the market, in much the same way as consumer demand is the embodiment of the marginal-utility schedules of individuals. See Murray N. Rothbard, *Man, Economy, and State*, 2nd ed. (Los Angeles: Nash, 1970), vol. 1, chap. 6; Frank A. Fetter, *Capital, Interest, and Rent: Essays in the Theory of Distribution* (Kansas City: Sheed Andrews and McMeel, 1977), pt. 2.

demand for those factors by the owners, and the higher their income. Since capital goods themselves form part of the structure of production, ultimately factor incomes consist of the income from the exertion of labor energy (wages, salaries), the use of land (land rents), and the transfer of money (a present good) in exchange for anticipated future income (a future good)—that will yield interest (or long-run profit) for time preference, and entrepreneurial profits or losses. All these factor incomes then, are tied to the efficient service of anticipated consumer demand.[4]

Incomes to factors and entrepreneurs on the market, therefore, are tied inextricably to the effective satisfaction of consumer demand, a satisfaction that depends on the successful forecasting of the market conditions that will exist when and after the goods or services are produced. Income to the firm and to factors from consumers is linked inextricably to the satisfaction the consumers derive. In a deep sense, therefore, income to producers on the market reflects benefits to consumers.

The crucial point is that when consumers spend, they benefit, because the expenditures are voluntary. The consumers buy product X because they decide that, for whatever reason, it would benefit them to buy that product rather than use the money on some other product or save or add to their cash balances. They give up money for product X because they expect to prefer that product to whatever they could have done with the money elsewhere; their preference reflects a judgment of relative benefit from that, as compared to another, purchase. In my own terms, spending choices by consumers demonstrate their preference for one, as compared to another, way of using their money.[5]

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[4]That is, each unit of each factor will tend to receive its discounted marginal revenue product, its marginal value productivity discounted by the rate of interest. So each unit of land and labor will tend to receive its DMRP, and the capitalist (or lender) will receive the discount (in the form of interest or long-run profit). Only in the never-never land of general equilibrium would each factor always receive its DMRP; in the real world, the positive or negative differences would reflect entrepreneurial profits and losses. See Rothbard, *Man, Economy, and State*, chap. 7.

[5]On the concept and implications of "demonstrated preference," see Murray N. Rothbard, *Toward a Reconstruction of Utility and Welfare Economics*

And that is not all. The profit-and-loss tests of the market, the rewarding of effective producers and forecasters and the punishing of ineffective ones, ensures that the overall ability at any time of entrepreneurs to forecast and satisfy consumer demands will be high. Good forecasters will be rewarded with higher profits and incomes; poor forecasters will suffer losses and finally leave the business. So that the market *tendency* is toward a high level of fit between anticipation and reality, and for a minimum of erroneous investment. Producer income, therefore, reflects consumer benefit even more closely than we might at first realize.[6]

The second type of market institution—after the business firm—is the voluntary nonprofit membership organization: the bridge club, lodge, ideological organization, or charitable agency. Here, too, income and benefit are cognate. Income is no longer divided between investors and consumers. All income is obtained from members, either in the form of regular dues or systematic or occasional donations. The purpose of the organization is not to earn a monetary profit, but to pursue various purposes desired by the income-paying members. In a sense, then, the members are the "consumers," except that they consume the services of the organization not by purchasing a product but by helping the organization pursue its goals. The member-donors are at the same time the consumers and the investors, the consumers and the makers of the production decisions.[7] The organization will employ as much of its resources as the member-consumer-donors desire to contribute to the pursuit of their goals.

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(New York: Center for Libertarian Studies, 1977), esp. pp. 2–7, 26–30; included in this volume as chapter 17.

[6]This, however, is a long way from saying, with conventional neoclassical economists, that general equilibrium and perfect knowledge are facts of reality, or, with the rational-expectations economists, that the market always perfectly forecasts the future. If this were true, there would be no room for entrepreneurship at all, and the most dynamic and vital aspect of the market economy would go unremarked and unexplained. See Gerald P. O'Driscoll, Jr., "Rational Expectations, Politics, and Stagflation," in *Time, Uncertainty, and Disequilibrium: Exploration of Austrian Themes*, Mario J. Rizzo, ed. (Lexington, Mass.: Lexington Books, 1979), pp. 153–76.

[7]For convenience, "members" and "donors" shall be used interchangeably throughout, although in many cases donors are technically not "members" of the organization.

Membership organizations, while clearly part of the market, are necessarily limited in their scope, for they do not follow the division of labor necessary for most market production. In virtually all other cases of production, the producers and the consumers are not one and the same: The producers of steel bars do not, Heaven forfend, use up those selfsame bars in their own consumption. They sell the bars for money and exchange the money for other goods that they would like to consume. In the case of membership organizations, however, the member-investors are the consumers of the service.

Even where the explicit goals of the organization are to help non-donors, this rule—that the consumers guiding production decisions are the donors—still applies. Suppose, for example, the organization is a charity giving alms to the poor. In a sense, the purpose is to benefit the poor, but the actual consumers here, the guides to production decisions, are the donors, not the recipients of charity. The charity serves the purposes of the donors, and *these* purposes are in turn to help the poor. But it is the *donors* who are consuming, the donors who are demonstrating their preference for sacrificing a lesser benefit (the use of their money elsewhere) for a greater (giving money to the charity to help the poor). It is the donors whose production decisions guide the actions of the charity.

In this case, presumably, the donors themselves will be guided, in their turn, by how effective the organization is in ministering to the poor. But the ways of judging this effectiveness lack the precision of monetary purchase, or profit and loss. They depend on subjective interpretation by the donors, an interpretation that is necessarily subject to a great deal of error. Donors, in the same way, are the consumers regardless of the purpose of the nonprofit organization, whether it is chess playing, medical research, or ideological agitation. In all these cases, precise profit-and-loss tests of effectiveness are lacking; in all these cases, too, donors voluntarily pursue their activity, preferring it to other uses of their resources.[8]

Nonprofit organizations also purchase and hire factors of production. To a large extent, these organizations compete with business

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[8]The lack of precise guidance in nonprofit organizations is not a criticism of their existence; this lack is simply a part of the nature of the case, and it is taken into account by the donors when they make their "investment" decisions in the organization.

firms for factors; to that extent, they must pay the factors at least the discounted marginal product they can earn elsewhere. To some extent, however, the factors may be specific to these organizations; to that extent their marginal product incorporates their service to the donor-consumers, that is, the extent to which they pursue the same goal as the sources of income. Thus, in both the profit-making and the nonprofit sectors, in their different forms, production decisions are guided by service to the consumers. The main difference is that in the case of business firms, the consumers are separate from the producers, and (we hope) recoup producers' investments by buying the products of the firm; while in nonprofit organizations, the consumers are the donor-investors.

We have been describing two polar cases: the business firm, and the nonprofit organization. Probably most real-world institutions on the market fall into one of these categories. In some cases, however, an organization can partake of both modes. Let us consider two cases. First, a charitable organization, instead of, or in addition to, giving away alms, may sell some products to the poor at a low, subsidized price. In this case, while the donors provide the overall thrust and guidance, part of the feedback gained by the firm is willingness to buy goods by the recipients. In some sense, the recipients of alms provide a guide to their interest in the organization. There are now two sets of consumers: the donors, and the charity recipients, each of whom demonstrates its preference for this organization in contrast to other uses for its money.[9] But the overall purpose of the organization is not to make a profit, but rather to serve the values and goals of the donors, and so the donors must be considered the regnant consumers in this situation.

Another case is a profit-making business firm where the owner or owners decide to accept a lesser monetary profit on behalf of some other goals of the owners: for example, because a certain line of product is considered immoral by the owners or because the owner wishes to hire incompetent relatives in order to keep peace in the family.

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[9]In a trivial sense, of course, being willing to accept a free gift by a charity is *also* a demonstration of preference by the recipient, but only in the trivial sense that he prefers more of a good to less. The recipient is not sacrificing any good or service in exchange.

Here once again, these are two sets of consumers—the buyers of the product, and the producers or owners themselves. Because of his own values as a "consumer," the owner decides to forego monetary profit because of his own moral principles or because he holds keeping peace in the family high on his value scale. In either case, the owner is forgoing some monetary profit in order to achieve *psychic* profit. Which motive will dominate depends on the facts of each particular case. Since the market is generally characterized by a division of labor between producers and consumers, however, the general tendency will be for monetary profit, or service to nonowning consumers, to dominate the decisions of business firms.[10]

It is a basic fact that all voluntary actions are undertaken because actors expect to benefit from them. When two persons make a voluntary exchange of goods or services, they do so because each expects to benefit from the exchange. When A trades commodity X for B's commodity Y, A is demonstrating a preference—an expected net benefit—for Y over X, while B is demonstrating the opposite, a preference for X over Y. The free market is a vast latticework of two-person (or two-group) exchanges, an array of mutually beneficial exchanges up and down and across the structure of production.[11]

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[10]It is curious that statist critics of the market invariably denounce "production for [monetary] profit" as greedy and selfish, and instead uphold "production for use" as unselfish and altruistic. On the contrary, producers can only make monetary profits to the extent that they serve *other* consumers. Logically, altruists should deeply admire the successful pursuit of monetary gain on the market.

It is also curious that many writers believe that the maximum-(monetary)-profit assumption for business motivation may have been true for personally owned nineteenth-century firms, but that it no longer holds for the modern corporation. On the contrary, it is precisely the modern corporation where "impersonality" of investment and producer decision will tend to dominate, since the personal wishes of single owners are no longer nearly as important. Unprofitable nepotism, for example, is far more likely to reign in the mom and pop store than in the large corporation.

[11]In a voluntary gift transaction, both parties also benefit; the donee benefits from the receipt of the gift and demonstrates this benefit by accepting it; the donor benefits psychically from the fact of having made the gift, and demonstrates that benefit by making it.

## Robbery and the Market

Having dealt with this idyll of harmonious and mutually beneficial exchanges, let us now introduce a discordant note. A thief now appears, making his living by robbing and coercively preying on others: The robber obtains his income by presenting the victim with a choice: your money or your life (or, at least, your health)—and the victim then yields his assets. Or, to be more precise, the robber presents the victim with a choice between paying immediately or waiting until the robber injures him.[12] In this situation both parties do not benefit; instead, the robber benefits precisely *at the expense of* the victim. Instead of the consumer's paying, guiding, and being benefited by the producer's activity, the robber is benefiting from the victim's payment. The robber benefits to the extent that the victim pays and loses. Instead of helping expand the amount and degree of production in society, the robber is parasitically draining off that production. Whereas an expanded market encourages increases in production and supply, theft discourages production and contracts the market.

It should be clear that the robber is not producing any goods and services at all. In contrast to consumers who purchase goods and services, or who contribute voluntarily to a nonprofit organization, no one is voluntarily purchasing from or contributing to our criminals at all. If they were, the criminals would not be criminal. In fact, what distinguishes a criminal group is that its income, in contrast to that of all other organizations, is extracted by the use of violence, against the wishes or consent of the victims. The criminals, then, are "producing" nothing, except their own income at the expense of others.

It has been maintained that the payments by the victims are "really" voluntary because the victim decides to transfer his funds under penalty of violence by the robber. This kind of sophistry, however, destroys the original, as well as the common-sense, meaning of the term "coercion" and renders *all* actions whatever "voluntary." But if there is no such thing as coercion and all conceivable actions are voluntary, then the distinctive meaning of both terms is destroyed. In this paper, we are defining "voluntary" and "coercion"

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[12]Burglars, as distinct from robbers, do not confront their victims directly and so present him with no choice; but they employ physical coercion by seizing his property without his consent.

in a common-sense way: that is, "voluntary" are all actions not taken under the threat of coercion; and "coercion" is the use of violence or threat of violence to compel actions of others. Robbery at gunpoint, then, is "coercion"; the universal need to work and produce is not. In a trivial sense, the victim agrees to be victimized rather than lose his life; but surely, to call such a choice or decision "voluntary" is a corruption of ordinary language. In contrast to truly voluntary decisions, where each person is better off than he was before the prospect of exchange came into view, the robbery victim is simply struggling to cut his losses, for, in any case, he is worse off because of the entry of the robber onto the scene than he was before.

Just as the claim that the victim's payment to the thief is "voluntary" is patently sophistical, so is it absurd to claim that the robber is "producing" some service to the victim or anyone else. The fact that the victim paid him revenue proves no demonstrated preference or value; it proves only that the victim prefers the imposition to being shot.

The robber may well spin elaborate arguments for his productivity and for his alleged benefit to the victim. He may claim that by extracting money he is providing the victim a defense from other robbers. In attempting to achieve and maintain his monopoly of loot, he may very well act against other robbers trying to muscle in on his territory. But this "service" scarcely demonstrates his productivity to the victims. Only if the victims pay the robber voluntarily can any case be made for a nexus of payment and benefit. Since payments are now coercive instead of voluntary, since the consumer has now become the victim, all arguments offered by the criminal and his apologists about why the victim should have been eager to pay the criminal voluntarily are in vain, for the stark and overriding fact is that these payments are compulsory.

The robber takes the funds extracted from the victims and spends them for his own consumption purposes. The total revenue collected by theft we may call tribute; the expenditures of the robbers, apart from the small sums spent on burglars' tools, weapons, planning, and so on, are consumption expenses by the robbers. In this way, just as income and assets are diverted from the productive sector to the robbers, so the robbers are able to use that money (in their purchasing) to extract productive resources from the market.

We conclude, then, that the activities of thieves are most emphatically *not* neutral to the market. In fact, the robbers divert income and resources from the market by the use of coercive violence, and thereby skew and distort production, income, and resources from what they would have been in the absence of coercion. If, on the contrary, we adhere to the view that theft is voluntary and criminals productive, then criminal activities, too, would be neutral to the market, in which case the entire problem of neutrality would disappear by semantic legerdemain, and *everything* by definition would be neutral to the market because the rubric of the market would encompass all conceivable activities of man. In that case, nothing could be called "intervention" into the market. By labeling aggressive violence as "coercion" and as an interference into the market, we avoid this kind of absurd trap, and we cleave closely to the commonsense view of such concepts as "coercion," "voluntary," "market," and "intervention."

## Government as Robber

We are now in a position to analyze government and its relationship to the market. Economists have generally depicted the government as a voluntary social institution providing important services to the public. The modern "public choice" theorists have perhaps gone furthest with this approach. Government is considered akin to a business firm, supplying its services to the consumer-voters, while the voters in turn pay voluntarily for these services. All in all, government is treated by conventional economists as a part of the market, and therefore, as in the case of a business firm or a membership organization, either totally or in part neutral to the market.

It is true that if taxation were voluntary and the government akin to a business firm, the government would be neutral to the market. We contend here, however, that the model of government is akin, not to the business firm, but to the criminal organization, and indeed that the State is the organization of robbery systematized and writ large. The State is the only legal institution in society that acquires its revenue by the use of coercion, by using enough violence and threat of violence on its victims to ensure their paying the desired tribute. The State benefits itself at the expense of its robbed victims. The State is, therefore, a centralized, regularized organization of theft. Its payments extracted by coercion are called "taxation"

instead of tribute, but their nature is the same. The German sociologist Franz Oppenheimer saw this clearly when he wrote that

> there are two fundamentally opposed means whereby man, requiring sustenance, is impelled to obtain the necessary means for satisfying his desires. These are work and robbery, one's own labor and the forcible appropriation of the labor of others. . . . I propose . . . to call one's own labor and the equivalent exchange of one's own labor for the labor of others, the "economic means" for the satisfaction of needs, while the unrequited appropriation of the labor of others will be called the "political means."[13]

Oppenheimer then proceeded to identify the State as the "organization of the political means."[14] Or, as the libertarian writer Albert Jay Nock vividly put it:

> The State claims and exercises the monopoly of crime. . . . It forbids private murder, but itself organizes murder on a colossal scale. It punishes private theft, but itself lays unscrupulous hands on anything it wants, whether the property of citizen or alien.[15]

Or, as Ludwig von Mises points out, this regularization establishes a systematic coercive hegemonic bond between the rulers of the State and the subject that contrasts vividly with the contractual bond of mutual benefit.

> There are two different kinds of social cooperation: cooperation by virtue of contract and coordination, and cooperation by virtue of command and subordination or hegemony. Where and as far as cooperation is based on contract, the logical relation between the cooperating parties is symmetrical. They are all parties to interpersonal exchange contracts. John has the same relation to Tom as Tom has to John. Where and as far as cooperation is based on command and subordination, there is the man who commands and there are those who obey his order. The logical relation between these two classes of men is asymmetrical. There is a director and

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[13]Franz Oppenheimer, *The State* (New York: Vanguard Press, 1926), pp. 24–27.

[14]Ibid.

[15]Albert Jay Nock, *On Doing the Right Thing, and Other Essays* (New York: Harper and Bros., 1928), p. 145.

> there are people under his care. The director alone chooses and directs; the others—the wards—are mere pawns in his actions.[16]

In this coercive, hegemonic condition, the individual must either accept the orders of the ruler or rebel. To the extent that the person submits, this choice then subjects him to the continuing hegemony of the rulers of the State. Contrasting the contractual and the hegemonic, Mises states:

> In the frame of a contractual society the individual members exchange definite quantities of goods and services of a definite quality. In choosing subjection in a hegemonic body a man neither gives nor receives anything that is definite. He integrates himself into a system in which he has to render indefinite services and will receive what the director is willing to assign to him. He is at the mercy of the director. The director alone is free to choose. Whether the director is an individual or an organized group of individuals, a directorate, and whether the director is a selfish maniacal tyrant or a benevolent paternal despot is of no relevance for the structure of the whole system.[17]

Mises goes on to contrast the system of contractual coordination that is responsible for much of the achievements of Western civilization with the hegemonic system embodied in the State, "an apparatus of compulsion and coercion . . . by necessity a hegemonic organization."[18]

The idea that taxation is voluntary seems to be endemic among economists and social scientists, though hardly so among the general public.[19] But if an individual refuses to pay his assigned tax, coercion will be wielded against him, and if he resists the confiscation of his property he will be shot or jailed. Failure to pay taxes subjects one to civil and criminal penalties. There should be little need to pursue the matter beyond this, were not economists determined to deny this

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[16]Mises, *Human Action*, p. 196.

[17]Ibid., p. 197.

[18]Ibid., p. 198. this is not to imply that Mises believed that the State could or should be abolished; instead, he believed that the world should be *preponderantly* a product of contractual relations. (Italics mine.)

[19]We speak here of "voluntary" in the nontrivial sense that distinguishes it from the "involuntary" or "coerced" payment to thieves.

patently obvious fact. As Joseph Schumpeter trenchantly declared: "The theory which construes taxes on the analogy of club dues or of the purchases of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind."[20]

But if taxation is coercive and a system of organized theft, then any "services" that the government may supply to its subjects are beside the point, for they do not establish the government as voluntary or as part of the market any more than a criminal band's providing the "service" of defending its victims from competing bands establishes that *its* services are voluntarily paid for. These services are *not* voluntarily paid for by the taxpayers, and we therefore cannot say that the taxes measure or reflect any sort of benefit. In the case of voluntary purchase on the market, as we have seen, the consumer demonstrates by his purchase that he values the good or service he buys more than the price he pays; but in paying taxes he demonstrates no such thing—only the desire not to be the recipient of further violence by the State. We have no idea how much the taxpayers would value these services, if indeed they valued them at all. For example, suppose that the government levies a tax of X dollars on A, B, C, and so on, for police protection—for protection, that is, against irregular, competing looters and not against *itself*. The fact that A is forced to pay $1,000 is no indication that $1,000 in any sense gauges the value to A of police protection. It is possible that he values it very little, and would value it less if he could turn to competing defense agencies. Moreover, A may be a pacifist; so he may consider the State's police protection a net harm rather than a benefit. But one thing we do know: If these payments to government were voluntary, we can be sure that they would be substantially less than present total tax revenue. Why? Because if people were willing to pay voluntarily, then there would be no need for the apparatus of coercion so intimately wrapped up in taxation.

A second important point is that, in contrast to the market, where consumers pay for received benefits (or, in nonprofit organizations,

[20]In the preceding sentence, Schumpeter wrote: "The state has been living on a revenue which was being produced in the private sphere for private purposes and had to be deflected from these purposes by political force." Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper and Bros., 1942), p. 198*n*.

where members pay for psychic benefits), the State, like the robber, creates a total disjunction between benefit and payment. The taxpayer pays; the benefits are received, first and foremost, by the government itself, and secondarily, by those who receive the largess of government expenditures.

But if, under coercive taxation, tax payments far exceed benefits to the victim, *and if* benefits accrue to the government itself and to the recipients of its expenditures at the expense of taxpayers, then it should be quite clear that it is impossible for taxes ever to be neutral to the market. Taxation, whatever its size or incidence, must distort market processes, *must* alter the allocation and distribution of assets, incomes, and resources.

## The Alleged Voluntariness of Taxation

Despite the fact that government and taxation are patently coercive, economists have devoted considerable energy, in numerous ways, to maintaining the contrary. If government and taxation were truly voluntary, then taxation would be akin to a market payment, and government could be deemed a part of, and therefore neutral to, the market.

By lumping government along with private expenditures as a gauge of the output of the economy, the conventional national income statisticians are implicitly assuming that government is neutral to the market because government provides those "services" that "society" desires it to supply. Government "output" is equated to the salaries paid to the bureaucracy. By employing the seemingly precise method of segregating *some* government expenses as mere "transfer payments"—the taxing of Peter to pay Paul—rather than productive purchases of goods and services, the national income statisticians are in reality making an unsupportable ideological judgment. For in what sense does the hiring of bureaucrats, or the purchasing of paper clips, add to the production of the economy and therefore become somehow voluntary, while transfer payments are frankly taxing one group to subsidize another? As we shall see further below, *all* taxation necessarily involves taking from one group to subsidize another; therefore all government expenditures, taken together, constitute one giant transfer payment.

Even if one does not go that far, it is a rare person who would not concede that at least 50 percent of government expenditures are

sheer waste, which would mean that they should not form part of the estimated national product at all. Despite his recognition of this fact, as well as the shakiness of ranking government expenses along with market expenditures, Sir John Hicks finally sees no alternative. He puts it this way:

> I can see no alternative but to assume that the public services are worth to society in general at least what they cost. . . . One may feel considerable qualms about such an assumption—it is obvious that the government spends far too much on this, far too little on that: but if we accept the actual choices of the individual consumer as reflecting his preferences . . . then I do not see that we have any choice but to accept the actual choices of the government, even if they are expressed through a Nero or a Robespierre, as representing the actual wants of society.[21]

Elsewhere, Hicks explains that in constructing national product figures, "the social accountant . . . must work upon some convention which is independent of his individual judgment."[22] It is remarkable that Hicks can find security from the shoals of individual judgment in assuming that Nero or Robespierre embody "the actual wants of society." Can he really believe that this fictive "society" and its head of State adequately represent the preferences of individual citizens?

### *Collective Goods*

More intellectually respectable is the contention that *insofar* as government supplies society with "collective goods" or "public goods," it is supplying a necessary service and is in a sense voluntary and neutral to the market. Collective goods are goods that allegedly cannot be supplied on the private market because they are indivisible and therefore cannot be allocated by having individual consumers pay for their own portions of the product. No consumer can be excluded from receiving the good. Like the sun, collective goods shine on all alike, and none can be made to pay for the service. Professor Buchanan, sympathetic to the idea of an "ideally neutral fiscal system," defines it as one that "uniquely aims at providing the social group with some

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[21]John R. Hicks, "The Valuation of the Social Income," *Economica* (May 1940), cited in Alex Rubner, *Three Sacred Cows of Economics* (New York: Barnes and Noble, 1970), p. 54.

[22]Hicks to Rubner, Sept 28, 1966. In Rubner, *Sacred Cows*, p. 54*n*.

'optimal' or 'efficient' quantity of collective goods and services." Then, if "the fiscal system is conceived as the means through which collective goods and services are provided to members of the society without any subsidiary or supplementary social purposes," we have, says Buchanan, an "analogy with the market economy." The fiscal system is then "ideally neutral" to the market economy.[23]

In the first place, even if there were such things as collective goods, government supply would establish neither its voluntarism nor its neutrality. Even if there were no other way to supply these services, taxation to provide them is *still* compulsory. And since it is coercive, there is no standard, as there is on the market, to decide *how much* of these services to supply by taxation. And the more the government provides, the less people are allowed to spend on their own private consumption.

Furthermore, if there exists but *one* anarchist in any society, the very existence of the State coercively supplying a collective good constitutes a great psychic harm to that anarchist. The anarchist, therefore, receives not a collective service but an individual harm from the operations of the State. It follows therefore that the good or service cannot be truly collective; its "service" is separable, and distinctly negative, to the anarchists. Hence, the good can neither be truly collective (indivisible, and positive) nor can it be voluntary.[24] No matter how "divisible" the service, furthermore, a collective good

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[23]James M. Buchanan, *The Public Finances*, 3rd ed. (Homewood, Ill.: Richard D. Irwin, 1970), pp. 62–63.

[24]After identifying the essence of government as coercion, and after carefully analyzing each type of government and "political entrepreneurship," Montemartini concludes that "there are no public, or collective needs in the strict sense of the word, as opposed to private needs. It is always real individuals who calculate the advantages of imposing on the community the production of certain specific goods." And these individuals' valuations will differ: "The calculations of economic advantage differ from one associate to another when it comes to determining the needs to be satisfied collectively." Hence, the production of "collective goods" is always coercive: "The collectivization of the satisfaction of some needs always aims at a participation in the costs of economic units which would not voluntarily have so participated." Giovanni Montemartini, "The Fundamental Principles of a Pure Theory of Public Finance," in *Classics in the Theory of Public Finance*, Richard Musgrave and Alan Peacock, eds. (New York: Macmillan, 1958), pp. 150–51.

is not quite like the sum: The more resources the government expends, the greater will be its output. These resources will have to be extracted from other potential products. Take, for example, "defense" or police protection, which is often considered to be provided as a homogeneous lump to everyone. But every good or service in the world, "collective" ones included, are provided, not in lump sum, but in marginal units. Yet strangely, economists, trained to think of marginal units everywhere else, suddenly start referring to defense as a "lump" when discussing government. In reality, however, there is a vast range of "defense" services that the government (or any other defense agency) could supply to its customers. To take two polar extremes, the government could supply one unarmed policeman for an entire country, or it could sink most of the national product into providing an armed bodyguard, replete with tank and flame throwers, for every citizen. The question that must be answered by any defense agency is not whether or not to supply defense, but *how much* defense to supply to *whom*? In the same way, the question confronting a steel company is not whether or not to produce steel, but how much steel of various grades and types to supply.

But this failure to provide rational criteria for amounts and types of collective services is an inherent flaw in any provision by government. The market's price system and profit-and-loss test tell private firms how much of what kind of steel to produce; rational criteria for satisfying consumers most efficiently are inherent in the free market. But government can have no such criteria. Since the consumers of defense do not pay for the service, since taxes do not measure the service, and since the government does not have to worry about losses that can be recouped by further taxation, there are no criteria of how much defense to provide to whom. Decisions are purely arbitrary, as well as coercive. If, on the other hand, defense were provided by private firms on the market, then these firms would, as in the rest of the market, supply efficiently the amounts and types of protection desired by particular customers. Those customers, for example, who desired and were willing to pay for round-the-clock bodyguards would do so; those who felt no need for protection—or pacifists aghast at the very idea—would pay nothing; and there might be a large spectrum of services in between.

More specifically: Only a minority of specific individuals find themselves in actual need of police or judicial protection during any

given period. If A and B are attacked, the police can spring to the aid of these specific persons. It will be objected that even if only a few persons are actually attacked at any one time, no one can determine *who* will be attacked in the future, and so everyone will want to be sure of protection in advance, thus salvaging the notion of a "collective want." But, again, there will be a spectrum of opinion among individuals. Some persons may feel pretty sure that they will not be attacked, and will therefore be willing to opt out of protection, to take their chance rather than pay a protection tax. Others will be confident of their own ability to repulse an attack, or would only patronize another, competing private defense agency. Others may fear an attack so little that the cost of paying protection will not be worth the benefit. On the free market, individuals would be free to choose any or none of these protection-insurance packages.

Even if it be conceded that not all people demand protection, it might still be argued that defense is a "collective good" because no one can be excluded from receiving its benefits. But surely if the inhabitants of a particular block refuse to pay for the police protection, the police may simply exclude that block from its patrols or other services. In the case of judicial protection, the conventional case for a collective good is even weaker. For surely a court, financed by voluntary payment (either by insurance premium or by fee-for-service), can refuse to hear the case of a nonpaying plaintiff. Even in the case of national defense, which seems to be a particularly strong example of a collective good, the pacifist or anarchist receives a harm rather than a good, and exclusion can be practiced in such ways as not rushing troops or planes to defend nonpaying areas, or at the very least not to defend them as rapidly and as diligently as areas that do pay.

Thus defense cannot be a collective good so long as only one pacifist or one anarchist exists in the society, for these persons will receive a harm rather than a benefit when they receive the "service" of coercive defense. And defense is not a collective good because its recipients *can* be excluded and separated.

Professor Kenneth Goldin is one of the very few economists to recognize that defense service is separable and not indivisible. He also points out that increased police service requires increased expense:

> As communities grow, and more residents must be supplied with crime defense, most communities hire more policemen; clearly an increased cost. If more policemen are not hired, then new residents can be served only by decreasing service to others: more streets can be patrolled only if there are fewer patrols at night; more properties can be checked only if each one is checked less thoroughly, and only the more urgent calls can be responded to. Each of these service changes imposes costs on residents. Either they will suffer from more crime, or they will incur the costs of purchasing other types of crime defense. Many types of crime defense are selectively available such as locks, fences, guard dogs, guards, and also alarm companies which respond if the burglar alarm is tripped. And don't overlook private police patrols, which check selected houses on selected streets, as thoroughly and as often as each customer requests, for a fee.[25]

Court services are clearly separable, and private arbitrators are indeed generally more efficient than government courts. Goldin adds:

> To service more persons generally requires more judges and courtrooms. If more facilities are not acquired, additional users will impose costs on others, in the form of longer days for trial and/or less judicial time spent on each case. It is costless to serve additional persons only if they have no disputes.

To some extent, he goes on, even government courts charge fees to users and therefore charge for benefits received, although the fees usually do not vary with the difficulty of the case. And "private arbitrators are also available, selectively, to those parties willing to pay a fee. So, although adjudication is a fundamental service in any society, it does not follow that adjudication is a public good."[26]

And even in the case of national defense, Goldin points out,

> there is certainly some variation in protection, especially among cities (regarding protection by missiles), and among Americans who either travel or have property abroad. While the troops may be sent out to protect some Americans or their property from some foreign seizures (such as the Mayaguez), in other cases no action is

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[25]Kenneth D. Goldin, "Equal Access vs. Selective Access: A Critique of Public Goods Theory," *Public Choice* 29 (Spring, 1977): 60.

[26]Ibid., pp. 65–66.

> taken (tuna boats). One of the firmly embedded myths of modern public finance is that it doesn't matter if population increases: The costs of defending the U.S. from external attack will not change. But consider two points. First, the new population must live somewhere. If they cause an increase in the U.S. land area, then either more defenses must be provided, or there will be a decrease in the level of protection to earlier residents and either way the marginal cost of protecting additional persons is positive. . . . Second, even if the new population resides within the existing boundaries, they will generally increase the amount of physical and human wealth which might be coveted by an enemy. That is, foreign attack is (at least partially) an economically motivated action, and is more likely to occur if there is more capital worth coveting.[27]

Not only does total cost of national defense vary with population, but the service of protection against foreign attack can be variable. First, there once existed private armies, and such armies, serving private individuals or groups, still exist today. Goldin mentions the armies of religious groups in contemporary Lebanon, as well as a Central American army owned by Robert Vesco. These armies, as Goldin states, "yield benefits primarily to their owner."[28]

Second, even a collective State army can vary its services to individual citizens:

> A military force also protects people from theft of property and kidnapping by foreigners. Exclusion from this service is relatively easy: The military force simply makes no attempt to stop theft or kidnapping of named persons. These persons would either hire their own guards, or suffer the damages of theft or kidnapping by foreigners. . . . Americans with substantial property abroad or at sea might well prefer to provide their own anti-theft defenses, rather than pay for a communal army which cannot be counted on to protect their property. . . . Contrary to public goods theory, even

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[27]Ibid., pp. 60–61.

[28]Ibid., p. 61. Goldin amusingly adds: "A medieval lord could scarcely be a 'free rider' on a neighboring lord's defense efforts. If he did not have his own defenses, he would probably suffer attacks from his neighbor." Cf. Wicksell: "Side by side with the national army, many countries have voluntary rifle clubs and similar institutions which sometimes constitute no mean military force." Knut Wicksell, "A New Principle of Just Taxation," in *Classics in the Theory of Public Finance*, Musgrave and Peacock, eds., p. 90.

> in this key case of defense from external attack, exclusion is not impossible and the marginal cost of serving additional persons generally is not zero.[29]

Moreover, as Buchanan concedes, a collective defense may be a service to one citizen and be considered a distinctly negative "service" by another:

> The common availability of collective goods or services does not, of course, imply that similar evaluations are placed on these by different persons. The Vietnam War effort demonstrated this point. The services of the plane that bombed North Vietnam in October, 1968, were equally available to all U.S. citizens. But the value placed on these services may have ranged from significantly positive levels . . . to significantly negative levels for those who felt that continued bombing was both immoral and a barrier to peace negotiations.[30]

To Professor Buchanan, the "classic" example of a collective good is the lighthouse. The beams of the lighthouse are indivisible: "If one boat gets all the light beams, all boats may do likewise."[31] Or, as Samuelson has put it, "A businessman could not build it for a profit, since he cannot claim a price from each user."[32] The theory is that it would be virtually impossible for a lighthouse keeper to row out to each boat to demand payment for use of the light. And that hence lighthouses have always been supplied by government.

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[29]Goldin, "Equal Access vs. Selective Access," pp. 61–62.

[30]Buchanan, *Public Finances*, pp. 25–26. Buchanan errs, however, in claiming that "few persons" would place a negative value on internal law and order. Pacifists would, and how "few" they may be will vary, and their number is unknown in any case. Even the existence of one pacifist negates the very concept of defense as a collective good, just as the existence of one anarchist negates the very concept of a collective good supplied by the State.

[31]Ibid., p. 23.

[32]Paul A. Samuelson, *Economics*, 6th ed. (New York: McGraw-Hill, 1964), p. 159. In his tenth edition, Samuelson, perhaps in an unacknowledged response to Professor Coase's noteworthy article (see below), gives the case away by adding, after "from each user" the words "without great difficulty" (p. 160). For he thereby concedes that lighthouses are not "collective goods."

But, first, the problem has now been eliminated by modern technology. It is now technologically highly feasible for a lighthouse's rays to be available only to that boat that has the proper electronic equipment, and to pay a fee for the use of that equipment. But, apart from this, it turns out, as Ronald Coase has discovered, that from the seventeenth until the early nineteenth centuries, the British lighthouse system was developed and operated by private enterprise. The lighthouse owners hardly bothered about collecting a fee from each boat on the spot. Instead, the owners employed agents at ports who found out what routes each ship entering the port had sailed and therefore what lighthouses the ship had passed and charged them accordingly.[33] Furthermore, additional users of lighthouses will impose higher costs for providing them. More ships will increase the likelihood of congestion in the protected waters and will require more navigational aids.[34]

In his trenchant critique of the offhanded way in which economists, from Mill to Samuelson and Arrow, have wrongly used the lighthouse as an example of a collective good, Coase concludes:

> These references by economists to lighthouses are not the result of their having made a study of lighthouses or having read a detailed study by some other economist. Despite the extensive use of the lighthouse example in the literature, no economist, to my knowledge, has ever made a comprehensive study of lighthouse finance and administration. The lighthouse is simply plucked out of the air to serve as an illustration. . . .
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> This seems to me to be the wrong approach. . . . [G]eneralizations are not likely to be helpful unless they are derived from studies of how such activities are actually carried out within different institutional frameworks. . . .

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[33] The tolls were collected at the ports by agents (who might act for several lighthouses). . . . The toll varied with the lighthouse and ships paid a toll, varying with the size of the vessel, for each lighthouse passed. It was normally a rate per ton (say 1/4d or 1/2d) for each voyage. Later, books were published setting out the lighthouses passed on different voyages and the charges what would be made. (Ronald H. Coase, "The Lighthouse in Economics," *Journal of Law and Economics* 17 [October 1974]: 364–65)

[34] Goldin, "Equal Access vs. Selective Access," p. 62.

> The account in this paper of the British lighthouse system . . . shows that, contrary to the belief of many economists, a lighthouse service can be provided by private enterprise. . . . The lighthouses were built, operated, financed and owned by private individuals, who could sell the lighthouse or dispose of it by bequest. The role of the government was limited to the establishment and enforcement of property rights in the lighthouse. The charges were collected at ports by agents from the lighthouses. The problem of enforcement was no different for them than for other suppliers of goods and services to the shipowner.[35]

The analogous navigational aid for air traffic, the services of the air-control tower, can be and is sold separately to individual consumers. Control towers will distribute radar information, for example, to whoever has radar equipment, but the equipment must be purchased by individual users. And heavier use of airspace or airport runways requires more navigational aids and therefore more expenses to service the users.[36]

Radio and television have been cited as collective goods since servicing another viewer allegedly involves no additional cost. But additional service is far from costless, *and* viewers are separable and excludable; therefore radio and TV fail both tests of a collective good. An increased viewing audience means supplying more, and more varied, programs. And new users must either be supplied with a stronger signal or may require cable or stronger antennas because of the increased congestion. Moreover, consumers are excluded now from television. To watch television programs they must buy sets and then must either pay as they go (various forms of pay TV) or else advertisers must pay, imposing on many viewers the psychic costs of

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[35]Coase, "The Lighthouse in Economics," p. 375. As Goldin remarks, "Lighthouses are a favorite textbook example of public goods, because most economists cannot imagine a method of exclusion. (All this proves is that economists are less imaginative than lighthouse keepers.)" Goldin, "Equal Access vs. Selective Access," p. 62.

[36]Since commercial airports are all owned by (largely municipal) government, the pricing of their runway and other services is scarcely akin to market pricing; generally, landing and takeoff fees are set far too low to clear the market, and the resulting shortage is rationed by increased and dangerous air congestion. See Ross D. Eckert, *Airports and Congestion* (Washington, D.C.: American Enterprise Institute, 1972).

commercials. And public television imposes on its viewers the psychic costs of being subjected to lengthy requests for donations.[37]

Moreover, in a sense the collective goods case for radio and television proves too much. For movies may also be said to be "costless" if additional viewers fill empty seats in a theater. Must movies, too, be nationalized, be supplied only by government, and perhaps be free to all?

Research has also been termed a "collective good"; don't we all enjoy the benefits of the research and inventions of Edison, Faraday, et al., without paying for them? But of course *we do* pay for the fruits of research, and we pay separably. For we must purchase the papers or books of researchers, or pay fees for lectures, demonstrations, or consulting. Those who do not pay such fees are excluded from learning of or absorbing these new ideas. And, of course, the holders of patents and copyrights are able to obtain the income from these inventions or discoveries while excluding other producers.[38]

Again, this argument proves too much. For not only patents and inventions are produced by creators: There is also art, sculpture, music, literature, philosophy. Are we to say that all these products of the human spirit are "collective goods" because we cannot be fully excluded from enjoying the products of Beethoven, Shakespeare, or Vermeer? Must all artists therefore be nationalized?

Another commonly cited example of a collective good is insect control by airplane spraying. It is alleged to be impossible to exclude land underneath from being sprayed, and the marginal cost of adding more land sprayed is zero. But if new residents live in previously uninhabited areas, then extra cost is incurred in servicing them, and the same is true if they are engaged in activities that attract insects. More airplane time and fuel must be used as well as more spray. Furthermore, the airplane *could* often, if it wished, exclude specific parcels of land from its spray. And more important, many of those receiving this "service" have not wanted it and have objected to the spraying as vigorously as the pacifist has protested the use of violence in defense. Indeed, a shift in public attitudes toward chemical sprays has greatly reduced their use in recent years.

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[37]See Goldin, "Equal Access vs. Selective Access," pp. 64–65.

[38]Ibid., pp. 63–64.

But if some people consider a service such as a spray as "bad," how can it be an indivisible, positive collective good?

Moreover, as Goldin points out, individual consumers have another option: to buy their own spray guns and spray their own property. In that case, each individual could choose and pay for the type and amount of spray that he precisely desires.[39]

For many reasons, then, there are no collective goods, and even if there were, as we have already seen, their supply would be coercive if furnished by government and taxation. But there is yet another vital point: For even if a good or service could only be supplied "collectively," why must that collection be compulsory? Why couldn't individuals pool their resources voluntarily, as in club dues, and make voluntary contributions for the supply of the service?[40] Or, as Gustave de Molinari argued, couldn't a government even contract for the supply of collective services with private, competitive, and therefore more efficient firms?[41]

Or, as Spencer Heath urged, on the model of real estate developments, shopping centers, and hotels, couldn't such "collective" or "public" goods as police, fire, roads, sanitation, and so on, be supplied by a large private firm with tenants paying for these services in their rents?[42]

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[39]Ibid., p. 54.

[40]Cf., Melvin W. Reder, "Review of Baumol's *Welfare Economics and the Theory of the State*," *Journal of Political Economy* (December 1953): 539.

[41]Gustave de Molinari, *The Society of Tomorrow* (New York: G.P. Putnam's Sons, 1904), pp. 71–72, 84–86. In earlier years, this Belgian-born nineteenth-century French economist believed that all services now supplied by government could be supplied better and more efficiently by privately competitive firms on the free market. See Gustave de Molinari, *The Production of Security* (New York: Center for Libertarian Studies, May 1977); and David M. Hart, "Gustave de Molinari and the Anti-Etatiste Liberal Tradition" (history, honors thesis, Macquarie University, Australia, 1979).

[42]Spencer Heath, *Citadel, Market and Altar* (Baltimore, Maryland: Science of Society Foundation, 1957). For the most developed work on the Heathian proposal, see Spencer Heath, *The Art of Community* (Menlo Park, Calif.: Institute for Humane Studies, 1970). Disney World is a spectacular example of a successful business firm supplying all of these services out of tourists' fees.

Finally, if we look at human history, we find that every good, without exception, that economists glibly term a "collective good" has actually been successfully supplied by the free market. Not only do private guards and patrols exist, and private lighthouses in the past, but there have been societies, such as medieval Ireland, that supplied a complex network of defense service and insurance—including police, crime insurance, and competitive courts—without a State or taxation. Competing market courts serviced for centuries the vitally important fairs of Champagne in the Middle Ages. Common-law courts were marked by competitive, nongovernmentally appointed judges. Private guards and private arbitrators exist successfully even in our society where the State monopolizes most forms of defense.[43]

It seems clear, then, that voluntary rather than governmental supply of the collective good would be possible in every case; the only objection might be, not that the good—defense, firefighting, or whatever—*could not* be supplied, but that "too little" would be supplied. But that brings us to the second line of argument by the proponents of government.

### *External Benefits*

If forced to retreat from the "strong" concept of collective goods, the advocates of government supply or subsidization of such goods, fall back on a "weak," and therefore more plausible argument. Even though every collective good might be furnishable by private means, "not enough" will be supplied because of the difficulty or impossibility of capturing enough payment from "free riders" who benefit from these services without paying for their benefits. Government supply, or taxation of free riders to subsidize supplies, then becomes required in order to "internalize the external benefits" acquired, but not paid for, by the free riders.[44]

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[43]Thus see Joseph R. Peden, "Property Rights in Celtic Irish Law," *Journal of Libertarian Studies* 1 (Spring, 1977): 81–95; Bruno Leoni, *Freedom and the Law* (Los Angeles: Nash, 1972); and William C. Wooldridge, *Uncle Sam the Monopoly Man* (New Rochelle, N.Y.: Arlington House, 1970).

[44]Gordon Tullock advances the curious argument that revolutions are impossible (or virtually so) because individual revolutionaries work and sacrifice whereas the entire public reaps the benefits; hence the public are free

But this argument generates far more difficulties than it solves. It proves too much in many directions. In the first place, *how much* of the deficient good should be supplied? What criterion can the State have for deciding the optimal amount and for gauging by how much the market provision of the service falls short? Even if free riders benefit from collective service X, in short, taxing them to pay for producing more will deprive them of unspecified amounts of private goods Y, Z, and so on. We *know* from their actions that these private consumers wish to continue to purchase *private* goods Y, Z, and so on, in various amounts. But where is their analogous demonstrated preference for the various collective goods? We *know* that a tax will deprive the free riders of various amounts of their cherished private goods, but we have *no idea* how much benefit they will acquire from the increased provision of the collective good; and so we have no warrant whatever for believing that the benefits will be greater than the imposed costs. The presumption should be quite the reverse. And what of those individuals who dislike the collective goods, pacifists who are morally outraged at defensive violence, environmentalists who worry over a dam destroying snail darters, and so on? In short, what of those persons who find other people's good their "bad"? Far from being free riders receiving external benefits, they are yoked to absorbing psychic harm from the supply of these goods. Taxing them to subsidize more defense, for example, will impose a further twofold injury on these hapless persons: once by taxing them, and second by supplying more of a hated service.

Since the tax-and-subsidy, or government-operation, route abandons the process of the market, there is no way of knowing who

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riders on the efforts of revolutionaries. (Gordon Tullock, "The Paradox of Revolution," *Public Choice* 9 [Fall, 1971]: 89–99). If he were consistent, Professor Tullock should therefore advocate that government tax people and subsidize revolutionaries in order to solve the problem of "underproduction of revolution!" In point of fact, of course, revolutions do take place from time to time, and they occur because much of the public has placed high on their values scales the success of the revolution. In short, a strongly held ideology among the public can overcome the free-rider problem for revolution. People's "interest" is not only job or immediate monetary payment, but also the attainment of such concepts as justice, liberty, and so on, none of which has any place in the economic calculus of the public-choice theorists.

the "negative free riders" are, and how much they will be suffering from an increased tax. We do have a pretty good idea, however, that one or more of these people exists: that there is at least one pacifist, anti-dam environmentalist, anarchist opposed to all government actions, and so on, in every society. But in that case, the free-rider as well as the "stronger" collective-good argument for the neutrality of government falls to the ground.

The young Herbert Spencer, in his great treatise *Social Statics*, declared that an individual should be able to opt out of taxation, to "ignore the State," and to renounce its services.[45] Criticizing his own work a half-century later, Spencer, in his *Autobiography*, employs the free-rider argument. "Mr. Spencer," he charges,

> actually contends that the citizen may properly refuse to pay taxes, if at the same time he surrenders the advantages which State aid and State protection yield him! But how can he surrender them? In whatever way he maintains himself, he must make use of sundry appliances which are indirectly due to governmental organization; and he cannot avoid benefiting by the social order which government maintains. Even if he lives on a moor and makes shoes, he cannot sell his goods or buy the things he wants without using the road to the neighboring town, and profiting by the paving and perhaps the lighting when he gets there. And, though he may say he does not want police guardianship, yet, in keeping down footpads and burglars, the police necessarily protect him, whether he asks them or not. Surely it is manifest . . . that the citizen is so entangled in the organization of his own society that he can neither escape the evils nor relinquish the benefits which come to him from it.[46]

The later Spencer was properly refuted, on his own earlier grounds, by "S.R." "S.R." points out first that on the later Spencer's own grounds, a man at least has the right to refuse to pay for advantages that he can relinquish. "S.R." then quotes from the earlier Spencer's application of his "law of equal freedom":

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[45]Herbert Spencer, *Social Statics* (London: John Chapman, 1851), chap. 19, "The Right to Ignore the State," pp. 206–16.

[46]Herbert Spencer, *An Autobiography* (New York: D. Appleton, 1904), vol. 1, pp. 417–18.

> If every man has freedom to do all that he wills, provided he infringes not the equal freedom of any other man, then he is free to stop connection with the State—to relinquish its protection and to refuse paying toward its support. It is self-evident that in so behaving he in no way trenches upon the liberty of others; for his position is a passive one, and while passive he cannot become an aggressor. . . . He cannot be coerced into a political combination without a breach of the law of equal freedom; he can withdraw from it without committing any such breach; and he therefore has the right to withdraw.

"S.R." then proceeds: "Is a man who refuses to pay for incidental advantages he has not solicited an aggressor? Is it a breach of the law of equal freedom to withdraw from a combination that, in working for itself and pursuing its own benefit, indirectly benefits one who is perfectly willing to forego the blessings of the uninvited beneficence?" "S.R." then points out that Spencer is implicitly modifying his equal freedom formula to say that anyone can do whatever he wishes, provided not only that he does not infringe on anyone else's freedom, but also provided "that no one confers upon him benefits which he cannot wholly surrender while remaining a producer and trader."

"S.R." then tellingly supplies the logical *reductio* of the free-rider argument:

> Has an individual the right to withhold proper contributions from neighbors who, individually or collectively, benefit him by caring for their own interests? If my neighbors hire private watchmen, they benefit me indirectly and incidentally. If my neighbors build fine houses or cultivate gardens, they indirectly minister to my pleasure. Are they entitled to tax me for these benefits because I cannot "surrender" them?[47]

Thus the free-rider argument proves far too much. After all, civilization itself is a process of all of us "free-riding" on the achievements of others. We all free-ride, every day, on the achievements of Edison, Beethoven, or Vermeer. When capital investment increases, and technology improves, the real wages of workers and the standard of living of consumers increase, even though they have contributed

[47]"S.R.," "Spencer as His Own Critic," *Liberty* 14 (June 1904): 2.

nothing to these advances. By simply continuing to work and consume, laborers and consumers receive the benefits of the inventions and investments of others without paying for them. So what must we infer from this? Are we all to wear sackcloth and ashes? If our neighbors are wiser, prettier, or happier, we all benefit in countless ways. So what must we do about it? Must we all be taxed to subsidize their beauty and wisdom?

And if people feel that not enough beauty, wisdom, inventions, police protection, and so on, will be provided by consumer payment and because of free riders, they are perfectly at liberty to subsidize provision of such goods on their own, individually or through societies or foundations. By doing so, the donor will demonstrate that, to him, the expected psychic benefit from his subsidy is worth more than the money he pays.

It will be objected that potential donors will not donate if they are rankled by the spectacle of free riders who stubbornly refuse to donate for the benefits they receive. And, further, that consumers on the market will not be willing to purchase these goods if they know that free riders abound. If we wished to moralize here, we might respond that these persons might be well advised to attend to their own affairs without wallowing in envy at benefits received by others. But, in any case, if the rankling at the existence of free riders is strong enough, these persons are always free to boycott the miscreants, either by not trading with them or by general ostracism.[48]

The consumers or donors can also, if they wish, get around the free-rider problem by making contracts, either singly or in organized fashion, that will pay for the "collective good," but only *on condition* that everyone else, including the potential free riders, pay as well.

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[48]Attacking the late Spencer's argument, in *Man vs. the State*, for taxation for defense based on the free rider, "S.R" points out that Spencer "overlooked the fact that there are several methods of securing cooperation for necessary ends, some manifestly nonaggressive and consonant with the principle of equal freedom. It is, of course, unfair for any man to enjoy the benefits of pace and stability while declining to share the risks, sacrifices, and burdens entailed by actual and probable attacks from within or without; but such an unsocial and mean-spirited individual can be brought to terms by the boycott, material and moral." "S.R.," "Spencer and Political Science," *Liberty* 14 (February 1904): 2.

This form of contract would enable those willing to pay, in effect, to put the choice to the free riders: Either you join in paying or the service will not be provided.[49]

### *Transaction Costs*

It has been objected that the "transaction costs" of identifying the free riders or channeling donations, or organizing boycotts or of making conditional contracts, are "too high," and that therefore those who want these services are justified in turning to the government to force the free riders to pay.

There are several grave fallacies in the transaction costs argument for taxation. In the first place, it ignores the transaction costs of the government process itself. The implication is that government is a costless Mr. Fixit, levitating angelically above the fray and busily correcting "market failures." If private persons have difficulty in identifying free riders, will government be able to limit its taxation to free riders only? What of the external costs of the inevitable taxation beyond the free rider? And, as we have seen, since market and demonstrated preference through individual action is not available to government, there is *no way* that government can either identify the free riders or the "negative free riders," or to discover *how much* benefit each person would derive from the subsidized supply and therefore how much each person should be taxed. There are also the inevitable grave inefficiencies in the political supply of goods and services and in the political process itself that need not be expounded here. At any rate, there is no reason to assume that the transaction costs of turning to government will be lower than those of private operation, and every reason to assume the opposite.

Second, another definitive rebuttal of the transaction-cost argument for government is the impossibility of comparing transaction costs, not simply of private and government action, but at any time and in any situation. For costs, like utilities, are subjective, and therefore nonmeasurable and noncomparable between persons. There is no such thing as social transaction costs or any social costs

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[49] I am indebted to Dr. David Gordon of the Center for Libertarian Studies for pointing this out to me.

whatever.[50] Any government action will impose enormous psychic cost on the anarchist; any private action will do likewise for the dedicated totalitarian. How are we to compare them? If an entity does not and cannot exist, then it is senseless to take as one's goal that it be minimized.

And third, even if transaction costs were measurable and comparable, we must ask: What is so terrible about transaction costs? On what basis are they considered the ultimate evil, so that their minimization must override all other considerations of choice, freedom, or justice?[51] After all, if minimizing these dread costs were truly the be-all and end-all, we could all pledge to obey one dictator, one Brezhnev or Idi Amin, in all things, and then everyone would have the assurance of knowing everyone else's relevant value-scales. Other problems would abound, but at least transaction costs would be forced down to a minimum.

### *Coercion as "Really" Voluntary*

A final fallback argument for the voluntariness of taxation and government asserts that every member of society wishes to pay for the collective goods but will do so only if *everyone* else pays. Therefore the *seeming* coercion of taxation is a fallacy, for everyone voluntarily pays in the serene knowledge that all beneficiaries are paying. In a kind of Hegelian leap, we are all voluntarily and cheerfully forcing ourselves to be free.[52]

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[50]Even Professor Buchanan, one of the founders of public-choice theory, admits the subjectivity and hence the noncomparability of costs. James M. Buchanan, *Cost and Choice: An Inquiry in Economic Theory* (Chicago: Markham, 1969).

[51]If transaction costs are to be absolute and override all other considerations, then the transaction cost theorists are taking the very same position they deride in ethicists: that is, rendering their values absolute, with no trade-off for other values. If transaction-cost economists are to scorn ethicists for ignoring cost-benefit considerations, why are they to be allowed to ignore ethics?

[52]Professors Buchanan and Tullock and the public-choice theorists are the outstanding modern proponents of this theory, which was also enunciated by Professor Baumol. See William J. Baumol, *Welfare Economics and the Theory of the State* (Cambridge, Mass.: Harvard University Press, 1952), and idem, "Economic Theory and the Political Scientist," *World Politics* (January 1954): 275–77.

This argument adds a heavy dose of mysticism to the other collective goods and external benefits arguments. For how do we *know* that everyone is voluntarily paying knowing that everyone else is doing so? There is no evidence, there is no social compact whatever to that effect. Is *all* that they pay supposed to be voluntary, or just some? Are they perhaps in mourning that their payments are not higher? And what of the anarchist and the pacifist and the tax rebel? Is *their* bitter opposition to taxation only a cloak for their cheerful acceptance? On what basis are we supposed to accept this curious doctrine?

There is, in short, no warrant whatever for Baumol's contention that every individual prefers to be coerced into paying for a service rather than have none of it supplied at all. Moreover, this argument ignores the options as discussed above, of conditional contracts to finance the service voluntarily, or of voluntary boycotts of free riders.[53]

A popular argument holds that the fact of democracy establishes the voluntary nature of government. This idea need not detain us here long. As Herbert Spencer pointed out, democracy at best can only reduce the number of people being coerced; it does not eliminate coercion:

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[53]See Rothbard, *Toward a Reconstruction of Utility and Welfare Economics*, pp. 33ff. On collective goods and external benefits, also see Rothbard, *Man, Economy, and State*, vol., 2, pp. 883–90.

Buchanan and public-choice theorists argue that the all-voluntarily-forcing-themselves process actually takes place at the basic "constitutional" level. But again there is no evidence for this whatever. If they have the American Constitution in mind, then they should realize that the Constitution was put across against the wishes of the majority of the public and that the Constitution makers were interested not in "general rules" for the benefit of all, but in pushing through measures—protective tariffs, opening up of export markets, repayment of public debt at far above market price, expanded bank credit for privileged groups, public works—for one set of people at the expense of another. Contrast James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962), with among others, E. James Ferguson, *The Power of the Purse* (Chapel Hill: University of North Carolina, 1961), and Jackson Turner Main, *The Antifederalists* (Chapel Hill: University of North Carolina Press, 1961).

> By no process can coercion be made equitable. . . . The rule of the many by the few we call tyranny: the rule of the few by the many is tyranny also. . . . "You shall do as we will, and not as you will," is in either case the declaration; and if the hundred make it to the ninety-nine, instead of the ninety-nine to the hundred, it is only a fraction less immoral. Or two such parties, whichever fulfills this declaration necessarily breaks the law of equal freedom: the only difference being that by the one it is broken in the persons of the ninety-nine, whilst by the other it is broken in the persons of a hundred. And the merit of the democratic form of government consists solely in this, that it trespasses against the smallest number.[54]

Spencer concludes that "the very existence of majorities and minorities is indicative of an immoral state." For the "enactment of public arrangements by vote," he points out, "implies that the desires of some cannot be satisfied without sacrificing the desires of others . . . implies therefore, organic immorality."[55]

Spencer goes on to point out that the doctrine that men may only be taxed by their own consent implies their right not to pay taxes, to "ignore the State." He then notes the reply of the statists that "this consent is not a specific, but a general one, and that the citizen is understood to have assented to everything his representative may do, when he voted for him." Spencer's rebuttal to this democratic mythos is definitive:

> But suppose he did not vote for him; and on the contrary did all in his power to get elected some one holding opposite views—what then? The reply will probably be that, by taking part in such an election, he tacitly agreed to abide by the decision of the majority. And how if he did not vote at all? Why then he cannot justly complain of any tax, seeing that he made no protest against its imposition. So, curiously enough, it seems that he gave his consent in whatever way he acted—whether he said yes, whether he said no, or whether he remained neuter! A rather awkward doctrine this. Here stands an unfortunate citizen who is asked if he will pay money for a certain preferred advantage; and whether he employs the only means of expressing his refusal or does not employ it, we are told that he practically agrees; if only the number of others who

[54]Spencer, *Social Statics*, p. 210.

[55]Ibid., p. 211.

> agree is greater than the number of those who dissent. And thus we are introduced to the novel principle that A's consent to a thing is not determined by what A says, but by what B may happen to say![56]

### *The Unanimity Principle*

Sensing the problems of coercion by majority rule, social theorists from Calhoun (the "concurrent majority" theory) to Wicksell and Buchanan (the Unanimity Principle) have been trying to arrive at a polity free of this coercion. Although the search for a way out of coercion may be commendable, the seeming voluntariness of the Unanimity Principle suffers from two grave flaws. First, Wicksell and Buchanan apply the Unanimity Principle only to *changes* in the status quo, that is, to *new* acts of taxation and expenditure. But this simply ratifies existing property titles, and assumes that these existing property titles are just and must be maintained. In short, the ratification of changes from the zero point only by unanimous consent, virtually freezes that zero point permanently. But should it be? Suppose that, previous to the installation of the Unanimity Principle, a group of persons, either by their own violent conquest or through State action, had stolen and confiscated the property of another large group and called that property their own. The Unanimity Principle would then prohibit the victims from taking back their property, since such action would have to gain the consent of the robbers. In his classic article on the Unanimity Principle, Knut Wicksell first acknowledged this problem and then brusquely dismissed it. Thus Wicksell first concluded:

> If there are within the existing property and income structure certain titles and privileges of doubtful legality or in open contradiction with modern concepts of law and equity, then society has both the right and the duty to revise the existing property structure. It would obviously be asking too much to expect such revision ever to be carried out if it were to be made dependent upon the agreement of the persons primarily involved.[57]

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[56]Ibid., pp. 211–12.

[57]Knut Wicksell, "A New Principle of Just Taxation," in *Classics in the Theory of Public Finance*, Musgrave and Peacock, eds., p. 109.

But having admitted that, Wicksell then proceeded as if it had not been said, asserting that "no [such] measure should be carried out unless it have the prior unanimous or at any rate overwhelming support of the whole people."[58]

Second, the Unanimity Principle turns out to be something less than unanimous. Pacifists, tax rebels, and anarchists are apparently inconvenient to the goal of achieving unanimity in taxation, so the proponents speak of "relative unanimity" (Buchanan and Tullock), "approximate unanimity" (Wicksell), or "virtual unanimity" (the later Spencer). But these are all oxymorons, comparable to the phrase "only a little pregnant." Unanimity must mean consent by all and nothing less.[59] Anything less is necessarily coercive and not voluntary.[60]

## J.B. Say on Taxation

In contrast to almost all other economists, J.B. Say was astonishingly clear-sighted about the true nature of the State and of taxation. In Say there was no vain, mystical quest for a truly voluntary State or for a benign quasi-business firm supplying services to the grateful public. Say saw clearly that government supplies services to itself and its favorites, that all government spending is therefore consumption spending by the politicians and the bureaucracy, and that that spending is extracted by coercion at the expense of the taxpaying public.

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[58]Ibid.

[59]Thus, "S.R."'s critique of the later Spencer's argument for compulsory military service, compulsory justice, and compulsory taxation, to the effect that there is "virtual unanimity" behind these forms of State action, pointed out: "The word virtual is fatal. The question is evaded, not answered. Has the one man, or the insignificant group of men, that refuses to support the State, even in the simplest of its functions, the right to stand alone, to ignore it? Spencer never refuted his own early demonstration of this right." "S.R," "Spencer and Political Science," p. 2.

[60]Here we might note the curious position of Laffer-Wanniski that the tax rate that maximized government revenue along the "Laffer curve" is, for some obscure reason, the *point at which the electorate desires to be taxed*. (Italics Wanniski's.) Jude Wanniski, "Taxes, Revenues, and the 'Laffer Curve'" in *The Economics of the Tax Revolt*, Arthur Laffer and Jan Seymour (New York: Harcourt Brace Jovanovich, 1979), p. 8.

As Say points out: "The government exacts from a taxpayer the payment of a given tax in the shape of money. To meet this demand, the taxpayer exchanges part of the products at his disposal for coin, which he pays to the tax-gatherers." Eventually, the government spends the money on its own needs, and so "in the end . . . this value is consumed; and then the portion of wealth, which passes from the hands of the taxpayer into those of the tax-gatherer, is destroyed and annihilated." Were it not for taxes, the taxpayer would have spent his money on his own consumption. As it is, "The state . . . enjoys the satisfaction resulting from the consumption."[61]

Say goes on to attack the "prevalent notion, that the values, paid by the community for the public service, return to it again . . . , that what government and its agents receive, is refunded again by their expenditures." Say is indignant:

> This is a gross fallacy; but one that has been productive of infinite mischief, inasmuch as it has been the pretext for a great deal of shameless waste and dilapidation. The value paid to government by the tax-payer is given without equivalent or return: it is expended by the government in the purchase of personal service, of objects of consumption.[62]

At this point Say revealingly quotes with approval Robert Hamilton's likening of government to a robber in refuting the argument that taxation is harmless because the money is recirculated into the economy by the State. Hamilton compares this impudence to the "forcible entry of a robber into a merchant's house, who should take away his money, and tell him he did him no injury, for the money, or part of it, would be employed in purchasing the commodities he dealt in, upon which he would receive a profit." Say then adds "that the encouragement afforded by the public expenditure is precisely analogous."[63]

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[61]Jean-Baptiste Say, *A Treatise on Political Economy*, 6th ed. (Philadelphia: Claxton, Remsen and Haffelfinger, 1880), pp. 412–13.

[62]Ibid., p. 413.

[63]Ibid., p. 413*n*. Say likens government to a robber at another point. He states that government's claim to a right over individual property, which it makes through taxation, is pure usurpation. The government is no more the proper owner of its claimed property than a thief over the property he has robbed. Ibid., p. 414*n*.

Say bitterly goes on to denounce the "false and dangerous conclusion" of writers who claim that public consumption increases general wealth. "If such principles were to be found only in books," Say went on, "and had never crept into practice, one might suffer them without care or regret to swell the monstrous heap of printed absurdity." But unfortunately they have been put into "practice by the agents of public authority, who can enforce error and absurdity at point of the bayonet or mouth of the cannon.[64] Once again, Say sees the uniqueness of government as the naked exercise of force and coercion.

Taxation, then, is the coercive imposition of a burden on members of the public for the benefit of consumption by the ruling class, by those in command of the government. Say writes:

> Taxation is the transfer of a portion of the national products from the hands of individuals to those of the government, for the purpose of meeting the public consumption of expenditure. . . . It is virtually a burthen imposed upon individuals, either in a separate or corporate character, by the ruling power . . . for the purpose of supplying the consumption it may think proper to make at their expense; in short, an impost, in the literal sense.[65]

Thus Say is not impressed with the notion, properly ridiculed by Schumpeter, that all of society somehow voluntarily pay their taxes for the general benefit; instead, taxes are a burden coercively imposed upon society by the "ruling power." Neither is Say impressed if the taxes are voted by the legislature: For "what avails it . . . that taxation is imposed by consent of the people or their representatives, if there exists in the state a power, that by its acts can leave the people no alternative but consent?"

Taxation, Say clearly pointed out, cripples rather than stimulates production, for taxation robs people of resources that they would rather use in a different way:

> Taxation deprives the producer of a product, which he would otherwise have the option of deriving a personal gratification from, if consumed . . . or of turning to profit, if he preferred to devote it to

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[64]Ibid., pp. 414–15.

[65]Ibid., p. 446.

> any useful employment. . . . [T]herefore, the subtraction of a product must needs diminish, instead of augmenting, productive power.[66]

Say continues with a devastating critique of the argument that taxation is useful in stimulating people's exertions and the development of industry. But first, industry is looted to satisfy the demands of the State, and hence productive capital is crippled:

> Mere exertion cannot alone produce, there must be capital for it to work upon and capital is but an accumulation of the very products, that taxation takes from the subject: . . . in the second place, it is evident, that the values, which industry creates expressly to satisfy the demands of taxation, are no increase of wealth; for they are seized on and devoured by taxation.

As for the argument that taxes stimulate exertions:

> To use the expedient of taxation as a stimulative to increased production, is to redouble the exertions of the community, for the sole purpose of multiplying its privations, rather than its enjoyments. For, if increased taxation be applied to the support of a complex, overgrown, and ostentatious internal administration, or of a superfluous and disproportionate military establishment, that may act as a drain of individual wealth, and of the flower of the national youth, and an aggressor upon the peace and happiness of domestic life, will not this be paying as dearly for a grievous public nuisance, as if it were a benefit of the first magnitude?[67]

Say is also properly critical of Ricardo for maintaining that the suppression of one branch of private industry by taxation will always be compensated by a diversion of capital to some other industry. Say rebuts that:

> I answer, that whenever taxation diverts capital from one mode of employment to another, it annihilates the profits of all who are thrown out of employ by the change, and diminishes those of the rest of the community: for industry may be presumed to have chosen the most profitable channel. I will go further, and say, that a forcible diversion of the current of production annihilates many additional sources of profit to industry. Besides, it makes a vast

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[66]Ibid., p. 447.

[67]Ibid., pp. 447, 447*n*–448*n*.

> difference to the public prosperity, whether the individual or the state be the customer. . . . [In the latter case] wealth and production decline in consequence, and prosperity vanishes, leaving behind the pressure of unremitting taxation.[68]

Say concludes with a scornful attack on the very idea that taxation and government spending add to national wealth:

> It is a glaring absurdity to pretend that taxation contributes to national wealth, by engrossing part of the national produce, and enriches the nation by consuming part of its wealth. Indeed, it would be trifling with my reader's time, to notice such a fallacy, did not most governments act upon this principle, and had not well-intentioned and scientific writers endeavored to support and establish it.[69]

Say's basic recommendation on the tax question was, in consequence, simple, trenchant, and clear-cut: "The best scheme of finance is, to spend as little as possible; and the best tax is always the lightest."[70] In short, that government is best that spends and taxes least. But then, paraphrasing Thoreau's and Benjamin R. Tucker's logical extension of the similar conclusion of Jefferson: May we not say that that government is best that spends and taxes not at all?[71]

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[68]Ibid., p. 452*n*. In a charming aside, Say chides Ricardo for erring because of his penchant for introducing "the unbending maxims of geometrical demonstration." For, "in the science of political economy, there is no method less worthy of reliance."

[69]Ibid., p. 447.

[70]Ibid., p. 449. Here we may note with amusement Frédéric Bastiat's reaction to these passages of Say. In the light of Bastiat's reputation as a "laissez-faire extremist" in contrast to Say's "moderation," we might note that Bastiat was shocked at the extremism of Say's views: Doesn't the State supply some services to the public? Frédéric Bastiat, *Economic Harmonies* (Princeton, N.J.: D. Van Nostrand, 1964), p. 567.

[71]In a famous passage, Thoreau wrote: "I heartily accept the motto—'That government is best which governs least,' and I should like to see it acted up to more rapidly and systematically. Carried out, it amounts to this, which also I believe—'that government is best which governs not at all.'" Or, as Tucker concluded succinctly: "That which governs least is no government at all." Henry D. Thoreau, "Civil Disobedience" [1849], in *Walden and Other Writings* (New York: Modern Library, 1937), p. 635; Benjamin R. Tucker, *Instead of a Book* (New York: B.R. Tucker, 1893), p. 14.

## The Neutral Tax

Any quest for a nonredistributive neutral tax, such as free-market economists indulge in, must succeed in providing criteria for two basic questions about taxes: (a) *how much* taxes should be paid? and (b) *who* should pay them? The free market answers questions of "who" and "how much" very easily for its goods and services. But free-market economists have been singularly unsuccessful in providing either of these criteria for taxation.[72] Thus the answer of *laissez-faire* economists to the former question—that taxation should be limited strictly to protection or defense—founders, not only on the coercive nature of the payment, but also on the nonhomogeneity of the defense service. Defense, as we have seen above, is not a homogeneous lump but a good available in different quantities and qualities, in marginal units. Since the free market has been abandoned in this area, there is no way to arrive at any rational criteria for the optimal total amount or distribution of government defense, or of any other good or service.

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[72]Thus Ludwig von Mises, by far the most thoughtful and systematic of free-market economists, devotes only a few unsatisfactory paragraphs to the subject of a neutral tax, or indeed to taxation in general. While conceding the impossibility of a neutral tax in the real world, he maintains without demonstration that it *would* be possible in a world of general equilibrium. And, despite its conceded impossibility, he seems to advocate pursuing the neutral tax as an ideal. (He also does not explain why everyone's income would be equal in general equilibrium.) Apart from this, Mises maintains that taxes, despite "directly curtail[ing] the taxpayer's satisfaction," are "the price he pays for the services which government renders to . . . each of its members." He warns that taxes should remain "low," but the only criterion offered for this lowness is that they "do not exceed the amount required for securing the smooth operation of the government apparatus"; in that case, "they are necessary costs and repay themselves." We may here reiterate all the questions we've discussed above, emphasizing such problems as: How much service? To which members? How about pacifists? Who pays the necessary costs and who gets repaid and then some? And *what* exactly is the "smooth operation of the government apparatus," and should that be the overriding desideratum? Mises, *Human Action*, pp. 730–31, 733–34, 738.

### *Taxpayers and Tax-Consumers*

It might be claimed that neutral taxation could be achieved in one way, if in no other: if the precise amounts that each individual paid in taxes were returned to him in government expenditure. Thus if A paid $1,000 in taxes in a certain year, B paid $500, and C $300, and so on, then A would receive $1,000, B $500, and so on. It might be thought that such a taxation system would be at best absurd; for why construct an elaborate machinery that would simply take and then give back the same amounts to each person? Why then have taxation at all? But there is a grave flaw even in this attempt at a neutral tax: neglect of the bureaucratic handling charge.

For even if such a precisely equal tax-and-payment mechanism were constructed, there would have to be salaries paid to the bureaucracy administering the system (and to the politicians ruling the administrators). But these bureaucrats, then, would, in contrast to the rest of society, be net tax-receivers, and hence by at least the amount and dispensation of their salaries, the fiscal system could not be neutral to the market economy. For even if A, B, C, and so on, paid and received the equivalent amounts, bureaucrats $B_1$, $B_2$, $B_3$, and so on, would be net tax-recipients, and in essence, would be paying no taxes at all. Their net incomes functioning in the bureaucracy will necessarily have to be subtracted from the net incomes of other members of society. And therefore the very existence and operation of government, as John C. Calhoun brilliantly pointed out, establishes *at the very least* a class struggle between the net tax-recipients and the net taxpayers. Calhoun's analysis is worth quoting at length:

> So deeply seated, indeed, is this tendency to conflict between the different interests or portions of the community that it would result from the action of the government itself, even though it were possible to find a community where the people were all of the same pursuits, placed in the same condition of life, and in every respect so situated as to be without inequality of condition or diversity of interests. The advantages of possessing the control of the powers of the government, and thereby of its honors and emoluments, are, of themselves, exclusive of all other considerations, ample to divide even such a community into two great hostile parties. . . . And what makes this evil remediless through the right of suffrage of itself . . . is the fact that, as far as the honors and emoluments of the government and its fiscal action are concerned, it is impossible to equalize it. The reason is obvious. Its honors and

emoluments, however great, can fall to the lot of but a few, compared to the entire number of the community and the multitude who will seek to participate in them. But without this there is a reason which renders it impossible to equalize the action of the government so far as its fiscal operation extends. . . .

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 take 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. Taxation may, indeed, be made equal, regarded separately from disbursement. Even this is no easy task; but the two united cannot possibly be made equal.

Such being the case, it must necessarily follow that some one portion of the community must pay in taxes more than it receives back in disbursements, while another receives in disbursements more than it pays in taxes. It is, then, manifest, taking the whole process together, that taxes must be, in effect, bounties to that portion of the community which receives more in disbursements than it pays in taxes, while to the other which pays in taxes more than it receives in disbursements they are taxes in reality—burdens instead of bounties. This consequence is unavoidable. It results from the nature of the process, by the taxes ever so equally laid. . . .

Nor would it be less a bounty to the portion of the community which received back in disbursements more than it paid in taxes because received as salaries for official services, or payments to persons employed in executing the works required by the government, or furnishing it with its various supplies, or any other description of public employment—instead of being bestowed gratuitously. It is the disbursements which give additional and, usually, very profitable and honorable employments to the portion of the community where they are made . . . and hence, to the extent that the disbursements exceed the taxes, it may be fairly regarded as a bounty.

> The very reverse is the case in reference to the portion which pays in taxes more than it receives in disbursements. With them profitable employments are diminished to the same extent, and population and wealth correspondingly decreased.
>
> The necessary result, then, of the unequal fiscal action of the government is to divide the community into two great classes: one consisting of those who, in reality, pay the taxes and, of course, bear exclusively the burden of supporting the government; and the other, of those who are the recipients of their proceeds through disbursements, and who are, in fact, supported by the government; or in fewer words, to divide it into taxpayers and tax-consumers.
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> But the effect of this is to place them in antagonistic relations in reference to the fiscal action of the government and the entire course of policy therewith connected. For the greater the taxes and disbursements, the greater the gain of the one and the loss of the other, and vice versa; and consequently, the more the policy of the government is calculated to increase taxes and disbursements, the more it will be favored by the one and opposed by the other.
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> The effect, then, of every increase is to enrich and strengthen the one, and impoverish and weaken the other.[73]

Thus if a bureaucrat receives an income of $30,000 per year, and pays $10,000 to the government in taxes, he is in reality not paying taxes at all. His tax payment is a bookkeeping fiction; in reality, he is simply a net tax-consumer to the tune of $20,000.

Calhoun has thus shown that the very existence of taxation creates at least two conflicting classes: the ruling and the ruled, and that the ruling class are the net tax-consumers and the ruled the net taxpayers. The ruling classes comprise the full-time politicians and bureaucrats receiving government salaries, as well as the private sellers of goods and services to the governments or recipients of outright government subsidy. There is hence no way for government or for taxation to be neutral. Moreover, the greater the amount and degree of taxation/expenditures by government, the more important will be this unneutrality, this diversion of output and income from producers on the market to the State and the receivers of its largess. The greater the extent of government operation, therefore, the greater the class conflict in the society.

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[73]John C. Calhoun, *A Disquisition on Government* (New York: Liberal arts Press, 1953), pp. 14–18.

### *Proportional Taxation*

Setting aside for a moment the problem of inherent nonneutrality stemming from the existence of taxation and expenditures, let us examine further the specific types or forms of taxes. Is there any form that might be called neutral to the market? Many economists have assumed that proportional taxation for each taxpayer (whether on incomes, property, or intangible "sacrifice") will leave the distribution of income or wealth the same as before, and therefore be neutral to the market. Thus to Edwin Cannan proportional property taxation serves as a "sufficiently accurate standard" of neutrality, so that "the distribution of wealth between individuals" is the same as "it would be in the absence of State action."[74] To Blum and Kalven, proportional sacrifice, presuming this intangible could be measured, has "the virtue . . . that it remains neutral as to the relative distribution of satisfactions among taxpayers. Under it they are all equally 'worse off' after taxes."[75]

At first blush, proportionality appears to leave market distribution the same. If, for example, a tax of 10 percent is levied on all incomes, is not the distribution of incomes left the same (setting aside the above insoluble problem of net tax-consumers)? It is true that if A earns $30,000 a year, B earns $20,000, and C earns $10,000, and each pays 10 percent, the relative proportions of their income after taxes will remain the same as before ($27,000, $18,000, and $9,000). But this question misconceives the very idea of the neutral tax. The point of a tax neutral to the market is not to leave the income distribution the same as if a tax had not been imposed. The point of a neutral tax is to affect the income "distribution" and all other aspects of the economy in the same way as if the tax were a free-market price. Only if a tax has the effect of a surrogate free-market price, only if, in a profound sense, it is *part of the market*, could it be neutral to that market. And it should be evident that no free-market price leaves income distribution the same. If every market price

[74]Edwin Cannan, "Minutes of Royal Commission on Local Taxation," 1899," in *Readings in the Economics of Taxation*, Richard Musgrave and Carl Shoup, eds. (Homewood, Ill.: Irwin, 1959), pp. 182–83.

[75]Walter Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1953), p. 44.

were proportional to the income of the purchaser, if David Rockefeller had to pay $1,000,000 for a box of Wheaties, then there would be no point in having a higher income, and we would have an extraordinarily complex and unworkable form of compulsory equality of incomes.

The market does not form prices proportional to incomes; the market is characterized by uniform pricing, by a strong tendency toward the same price for the same good or service regardless of the income or personality of the buyer.[76]

### *Taxation and Benefits*

If the market charges all consumers the same price for a particular service, it would seem that some form of equal (rather than equiproportional) taxation might be neutral to the market. One time-honored criterion attempting to arrive at such neutrality is the "benefit" principle: that each should pay taxes in accordance with the benefits he receives from the State. Those receiving the same benefits would pay the same amount of tax. There are many grave problems with this approach, however. First, in contrast to the marketplace, there is no way whatever for an external observer to gauge anyone's benefits as derived from government. Since "benefits" are subjective, we cannot measure anyone's benefit on the market either, but we *can* conclude, from a person's voluntary purchase, that his (expected) benefit was greater than the value to him of the money given up in exchange. If I buy a newspaper for 25 cents, we can conclude that my expected benefit is greater than a quarter. But since taxes are compulsory and not voluntary, we can conclude nothing about the alleged benefits that are paid for with them. Suppose, in analogy, that I am forced at gunpoint to contribute 25 cents for a newspaper and that that newspaper is then forcibly hurled at my door. We would be able to conclude nothing about my alleged benefit from the newspaper. Not only might I be willing to pay no more than 5 cents for the paper, or even nothing on some days, I might positively detest the newspaper and would demand payment to accept it. From the fact of coercion there is no way of telling. Except that we can conclude that many people are not getting 25 cents'

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[76]A similar critique could be leveled against any form of proportional tax, for example, on sales or property.

worth from the paper or indeed are positively suffering from this coerced "exchange." Otherwise, why the need to exercise coercion? Which is all that we can conclude about the "benefits" of taxation.[77]

To Adam Smith, the benefit principle dictated proportional income taxation: "The subjects of every state ought to contribute toward the support of government, as nearly as possible . . . in proportion to the revenue which they respectively enjoy under protection of the state."[78]

Other writers have even used the benefit principle to justify progressive taxation. Yet there is no warrant whatever for assuming equi-, or even more than, proportional benefit from government. In one model the alleged benefit from government is to be simply deduced from one's income, and it is claimed that this indicates a proportionately greater "benefit from society." But there are many flaws with this approach. For first, since everyone benefits from participating in society, the fact that A earns more than B must be attributed to individual differences in ability or productivity rather than to the benefits of society. And second, "society"—the pattern of voluntary exchanges of goods and services—is most emphatically not identical to the State, the coercive extractor of taxation.

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[77]In contrast to benefit theory, which naively assumes that people "purchase" government services in much the same way as they purchase goods and services on the market, at least sacrifice theory assumes in the words of Blum and Kalven, "that the taxes are a necessary evil falling up on a distribution of money, and therefore upon a distribution of satisfactions, which is otherwise acceptable." *Uneasy Case for Progressive Taxation*, p. 44. The basic problem with sacrifice theory is that it doesn't explain why people must bear the burdens or sacrifices of taxation, why that is, we must turn from talk of benefits and free choice on the market to talk to burden and sacrifice in the sphere of government.

[78]Adam Smith, *The Wealth of Nations* (New York: Modern Library, 1937), p. 777. Smith added immediately that "the expense of government to the individuals of a great nation, is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute to their respective interest in the estate." Presumably, however, these tenants also get benefits from the estate greater than their pro-rata expenses, and if they do not, or even if they do, they can sell their share and leave—an option not available to the taxpayer.

If, indeed, we are to tax people in accordance with their benefit from government, we would have to tax all the net tax-consumers to the amount of their subsidies. We would have to tax 100 percent of the salaries of bureaucrats, of the incomes of welfare recipients and of defense contractors, and so on. We would then have our ideal model of the neutral tax where all recipients of government funds would systematically repay them to the taxpayers—an absurd if rather charming state of affairs. If we leave subsidies to concentrate only on supposedly common services such as police protection, then we would have to conclude that the poor benefit far more from police protection than the wealthy, since the wealthy could far better afford to pay for their own protection. We would therefore have to conclude, not that the rich benefit as much as or more than the poor, but far less. We would have to conclude that the poor and the infirm, far more in need of protection than the rich, should be taxed far more heavily than the rich and the able-bodied.[79]

Moreover, the market is misconstrued by the benefit principle. For on the market people do not pay in accordance with benefits received. The chess addict and the indifferent players pay the same price for the same chess set, and the opera enthusiast and the novice pay the same price for the same ticket. On the market, people tend to pay the same price for the same good, regardless of benefit. The poor and the weak might be the most eager for protection, but, in contrast to the benefit principle, they would not pay more for the same degree of protection on the market. And finally, everyone on the market enjoys a net benefit from exchange. If the entire benefit were taxed away (assuming this subjective concept could be measured), then this

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[79]Mill put the case very well: "If we wanted to estimate the degrees of benefit from the protection of government we should have to consider who would suffer most if that protection were withdrawn: to which question if any answer could be made, it must be, that those would suffer most who were weakest in mind or body, either by nature or by position. Indeed, such persons would almost infallibly be slaves. If there were any justice, therefore, in the theory of justice now under consideration, those who are least capable of helping or defending themselves, being those to whom the protection of government is the most indispensable, ought to pay the greatest share of its price." John Stuart Mill, *Principles of Political Economy* (New York: D. Appleton, 1901), vol. 2, pp. 398.

practice would totally violate market principles, where net benefits from exchange are always maintained.

### *The Equal Tax*

If the market means having everyone pay the same price for the same service, perhaps then each person should pay the same tax, equal in absolute amount? The equal tax, or "poll tax," is surely a far closer approximation to neutral taxation than any of the more common forms of taxation. It would indeed preserve the market principle of same price for same service. It would also be particularly appropriate for a democratic polity, where one person, one vote prevails, or for a regime that attempts to adhere to the principle of "equality before the law."[80]

But even the equal tax cannot be said to be neutral to the market. In the first place, it is impossible for observers outside the market, such as government, to gauge what service is "equal" to another service. Equality of service is not technological identity but similarity in the minds of the consumers. Only the free market, then, can determine different qualities or degrees of a service. Second, and even more important, there is no indication that for a particular taxpayer, the government is supplying a "service" at all. Since the tax is compulsory, it may well be that the "service" has zero or even negative value for individual taxpayers. Thus, a pacifist, philosophically opposed to any use of violence, would not consider a tax levied for his and others' police protection to be a positive service; instead, he finds that he is being compelled, against his will, to pay for the provision of a "service" that he detests. In short, equal pricing on the market reflects demands by consumers who are voluntarily paying the price, who, in short, believe that they are gaining more from the good or service than they are giving up in exchange. But taxation is

[80]In recent years, the poll tax was used to designate a voting requirement, in effect a tax on voting, in the southern states. But originally, the poll tax was simply an equal tax per head, and the payment for voting was simply one method of enforcing the tax. On poll taxes, see Merlin H. Hunter and Harry K. Allen, *Principles of Public Finance* (New York: Harper and Bros., 1940), pp. 265–70. Many early poll taxes were graduated rather than uniform. C.F. Bastable, *Public Finance* (London: Macmillan, 1895), pp. 433–34.

imposed on all people, regardless of whether they would be willing to pay such a price (the equal tax) voluntarily, or indeed whether they would voluntarily purchase any of this service at all.

The poll tax works particular hardship on those who would not ordinarily be participating in the market economy. Hence it (as well as the income tax) is payable in money and has been used as a fearsome whip to force natives in undeveloped countries out of subsistence or barter production and into working for money wages. Working for capitalists becomes the only way these natives can pay the tax. Thus Sir Percy Girouard, the British governor of Kenya, freely admitted, in the early twentieth century, that taxation was levied on the native to force him to go to work for British employers. The hut tax "is the only method," opined Sir Percy, "of compelling the native to leave his reserve for the purpose of seeking work. Only in this way can the cost of living be increased for the native."[81] In the Congo Free State, the problem in that Belgian colony, as Parker Moon put it, was: "Would the natives willingly go out into the jungle to collect rubber and tusks for the State?" For, "little appreciating the dignity of labor, the Congo negroes evinced a marked distaste for the task which their humane sovereign expected them to perform. Accordingly, another civilized innovation was introduced—taxes."[82] Moon illuminates the relationship between taxation and forced labor in colonial countries:

> In tropical Africa . . . the problem is how to make the natives work at all, for Europeans. Actual slavery is everywhere condemned, and vanishing. . . . Compulsory labor, once the fashion in Central

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[81]Cited in Parker T. Moon, *Imperialism and World Politics* (New York: Macmillan, 1930), p. 132. In South West Africa, the British accomplished the same purpose with a dog tax, levied per native dog.

> Many of the natives, of course, were too poor to pay any such tax, and consequently in four months over one hundreds members of the Bondelzwarts tribe along were condemned, for nonpayment of the tax, to pay a fine of two pounds or spend two weeks in jail. To obtain the money for tax and fines, the natives would have to work for white ranchers and mine-owners. (Ibid., p. 504)

[82]Ibid., p. 86.

> Africa, is falling more and more under censure, though it is still utilized by governments when they need natives for railroad or road construction, or other public works. . . .
>
> Taxation is a favorite method of stimulating native industry. In many African colonies hut and poll taxes are imposed, ranging from fifty cents to several dollars per capita. The amount seems small enough, by our standards, but to the negro without money it is a large sum. He can earn it by working on a plantation or in a mine, for white employers, at wages that vary from five cents a day, or less, in Congo, Northern Rhodesia, and other regions, to six or seven cents in Kenya, perhaps twenty cents in the interior of Nigeria, and fifty cents or more in South Africa. At such wages it takes a native months to save enough to pay the tax for his family.[83]

## Conclusion

Free-market economists have successfully extended their critical analyses of government to all areas of State operation and intervention—all except one. Taxation, the heart and soul of government, has escaped unscathed. Free-market economists have either avoided the topic of taxation altogether or have provided concepts that, while claiming to help limit government, have in reality offered apologies for the extension of State power. The view that income taxes are "better" than excise taxes; the call for proportional or degressive income taxation; the Friedman negative income tax; the Buchanan-Tullock Unanimity Principle; and the collective-goods, external-benefits, and transaction costs arguments for government and taxation, have all served to place the *imprimatur* of economics on the status quo or on extensions of government rather than to limit or roll back State power. All this has followed the course traced by Bertrand de Jouvenel three decades ago: From the idea of divine right down to modern times concepts originally meant to limit State power have been turned by the State and its advocates into rationales for its further extension.[84]

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[83]Ibid., p. 563.

[84]Bertrand de Jouvenel, *On Power: The Nature History of Its Growth* (New York: Viking Press, 1949).

Much the same thing has happened to the noble concept of neutral taxation. The idea that taxation, and therefore government's fiscal operation, should be neutral to the market—should not disturb the operations of the market nor divert it from its free course—is a noble but impossible one. As we have seen here, taxation can never be neutral to the market, and the impossibility of this dream is rooted in the very nature of taxation and government. Neutral taxation is merely a chimera. It is perhaps because of this impossibility that this concept, in the hands of the modern public-choice theorists and others, has so quickly become yet another device for ratifying the status quo of State power.

We are forced, then, to the realization of crucial points from which free-market economists seem to have been fleeing as from the very plague. That neutral taxation is an oxymoron; that the free market and taxation are inherently incompatible; and therefore either the goal of neutrality must be forsaken, or else we must abandon the institution of taxation itself.

# 25

# The Myth of Tax "Reform"

Everyone will agree that the American tax system is a mess. Taxes are far too high, and the patchwork system is so complicated that even IRS officials don't understand it. Hence the evident need for some sort of dramatic, even drastic, reform. As often happens, a group of dedicated and determined reformers has arisen to satisfy that need. But before we embrace this new gospel, we should heed the old maxim about jumping from the frying pan into the fire, and also remember the warning of the great H.L. Mencken, who defined "reform" as "Mainly a conspiracy of prehensile charlatans to mulct the American taxpayer." And we should also bear in mind that all acts of government, however worthy they may seem, have a way of winding up solving no problems and only making matters worse.

Working within current tax realities, the reformers' plans are varied and change nearly daily, as they meet conflicting political pressures. But whether they be Kemp-Kasten, Bradley-Gephardt, the Treasury plan of fall, 1984 (Regan, or Reagan I), or the final Reagan plan of spring, 1985 (Reagan II), there is one common and seemingly simple goal: that every person or group should pay the same proportional tax on their net income, and that all deductions, exemptions, and shelters be abolished in the name of this uniform proportional tax (a "flat tax with no exemptions").

The flat tax reformers have much in common with militant ideologues that we have become all too familiar with in the twentieth century. In the first place, they are egalitarians in this case, assuming

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it to be sinful or at least grossly "unfair" for any person or group to escape the scythe of the great uniform tax. Second, and along with this egalitarianism, they assume in brusque and lordly fashion that they alone represent and embody the "general interest," and that all objections to a uniform flat tax may be quickly dismissed as the self-interested croakings of the "special interests." It doesn't seem to matter if the "special interests" encompass most of the American populace; they must be unceremoniously swept aside to achieve the flat tax paradise. The fact that most of the impetus for this and other reforms comes from academic economists puts the icing on the flat tax cake. Academic idealists have always been accustomed to sweeping aside everyone else's interests and concerns as petty and "special," while they speak automatically for the larger interests of mankind. At best, the reformers cavalierly overlook the enormous amount of harm and pain they will inflict in the course of their grandiose reform.

One example: the flat tax would impose an enormous amount of harm and damage on every American homeowner. In their wisdom, the flat taxers have decided that deduction of interest payments on your mortgage is a "subsidy" granted by the tax system, and that your true net income would permit no such deduction. They have also concluded that the unwitting homeowner also enjoys another "subsidy" from the government: failure to tax his "imputed rent"; that is, the amount that he would have had to pay in rent if he had been renting the house instead of owning it. One of the many problems with the latter proposal is that the poor homeowner is never able to pay his "imputed" taxes; no, his taxes would have to be paid in cold cash, even though his income is "psychic" and not earned in money. But we press on. A third body blow to the homeowner would be the flat taxer's insistence on eliminating federal tax deductions for state and local taxes, most of which are property taxes on one's home. Thus, we have a three-fold tax increase inflicted on the homeowner, and the effect of this one-two-three punch would be a permanent lowering of the market value of one's home, which consists of the present value of expected future returns from the house.

These are but a few of the many grave consequences and damages that would flow from the reformers' measures. But the reformers literally do not care; no pains (almost invariably suffered by others) must be permitted to block or delay the speedy achievement of

their Utopia. Any alterations are only grudging concessions to the fierce resistance of the "special interests" to the advent of the flat taxers' New Jerusalem. Thus, the Regan plan of fall, 1984 (Reagan I), proposed to increase drastically the capital gains tax, toward the ideal of raising it to the precise level of the income tax, and also suggested a sharp lowering of oil depletion allowances. Great resistance was offered to the plan by risky venture capitalists, who would be particularly crushed by a high capital gains tax, and by the similarly damaged oil interests, always considered sinister in the popular imagination. As a result, the reformers were forced to abandon these two aspects of their Grand Plan in Reagan II. But in the long run, these forced retreats are not important; their goal—a uniform across-the-board flat tax—always remains the same.

But why is this plan so grand? So vitally important that our pain and hardships should be treated as nothing? Here the reformers offer little argument. Basically, their reasons boil down to two: their tax system would be simple (you could calculate your tax on a postcard), and above all, it would be fair.

## The Argument for Simplicity

Making out your taxes, the reformers claim, would be simplicity itself. No more back-breaking work trying to figure out what's going on, no more hiring tax lawyers or accountants. But the sweet simplicity of the argument can be disposed of very quickly. In the first place, anyone who wants simplicity can have it now, by using the short E-Z form, and two-thirds of Americans do so at the present time. So then the question to ask is: why do one-third of us choose complexity by spending many painful hours over the complex form, and why do we hire expensive lawyers and accountants to aid us? Surely, not because we love complexity and expense for their own sakes, but because we believe that there are things in life worse than complexity, and one of them is paying more taxes! We are willing to suffer some complexity in order to lower some of our monstrous tax burden. And by eliminating our deductions, exemptions, shelters, and so on, the reformers are imposing compulsory simplicity against our wishes. They are truly what the great nineteenth century Swiss historian Jacob Burckhardt said of the statist intellectuals of his day, "terrible simplifiers."

But the joke is on us, for the reformers' system would really in no way be simple. We would still have to go through a complex and

murky maze. For the key to the flat taxers is that the uniform proportionate tax is to be levied on all net income. But what is net income? The answers are far from simple, and good arguments can be found on either side. The interesting and crucial fact is that, on each of these arguments, the flat taxers invariably come down against the harried taxpayer, and in favor of bringing ever more of our income and assets into the greedy maw of the taxing Leviathan State.

Thus, are "capital gains" income? The reformers say yes, and call for taxing it to the same extent as ordinary income. Western Europe has not gone down the economic drain partly because its capital gains taxes have always been far lower than its income taxes, but this fact does not and cannot count in the harsh calculus of our reformers. Should capital gains be taxed as they accrue on our books or only as they are realized in cash? Once again, the reformers opt for accrual, grabbing our assets at an earlier date, and heedless of our problem of paying taxes in money while our "gains" have only accrued in our psyche or on paper. Are the losses in our tax shelters phony, or should they be treated as real losses to write off our income? The reformers insist that they are phony, and that therefore they must be disregarded when our taxes are estimated. But who is to say so? Who is to say that if I buy a horse farm in Virginia, and suffer losses, that these are losses I welcome in order to reduce my taxes? Who is equipped to look into my heart and mind and find out if these losses are "genuine" or not? And since when has the IRS acquired occult powers, along with the rest of its totalitarian armamentarium?

And what about the cherished American institution of the three-martini lunch? Reformers from Carter to Reagan have tried to crush that lunch, and to claim that these are not genuine or worthy business expenses. Net income is arrived at by deducting costs from gross income. But is the three-martini lunch a "genuine" cost of business, or is it a sneaky way of earning income that is not subject to tax? Who knows? Who knows how much genuine business, if any, is conducted at such lunches? Once again, the reformers know! And they know that such deductions can be swept away.

And there is the problem of the corporation. Corporations are entities. Should their income be taxed at the same rate as personal income? Economists have come to recognize that there is no living thing called a corporation. A corporate income tax is a double tax

upon stockholders, first as a "corporation," and next upon their personal income. But while economists have been increasingly calling for abolition of the corporate tax, the reformers have in their wisdom decided that since all entities' income must be taxed uniformly, the corporate income tax must be included and even raised if necessary to be taxed at the same rate.

None of these arguments is simple, but it's instructive that in each and every case, the reformers have come down fiercely on the side of including all these incomes or assets in the taxation category. Their bias in favor of tax, tax, and more tax should be clear by now.

## The Argument for Fairness

The major argument of the flat taxers is that it is "fairness" that demands a swift forced march toward their ideal. "Fairness" is worth almost any cost. But it is strange that this ethical argument comes from a profession (academic economists) who have made a career of loudly proclaiming that all of their doctrines are "value-free science" that have nothing to do with ethics. So when did they become expert ethicists? Indeed, the fairness argument is generally and blithely assumed to be true, after which the reformers can gleefully denounce every resister to higher or broader taxes as embodiments of sinister "special" interests.

One argument holds that fairness demands that everyone pay his or her equal share of the "services" of government. Let us set aside for a moment the surely important point that these "services" are often dubious, are inordinately expensive, and sometimes mean that the taxpayer is forced to pay for his own surveillance and oppression. Since when does "fairness" demand that everyone pay the same proportion of his income for a good or service? Mixed in with the argument for fairness is the view that government should do nothing to penalize one industry or occupation, or subsidize another. This neutral-to-the-market argument puts the flat taxers in the guise of militant adherents of free enterprise This sounds admirable but why does it imply that everyone should pay the same proportion of his income? When David Rockefeller and I buy a loaf of Wonder Bread at the supermarket each of us pays the same price; no one is there to inspect our annual incomes and levy a proportionate fine. No one forces Rockefeller to pay $1,000 for a loaf of Wonder Bread, just because his income is a thousand times that of the next man. The

free market tends toward uniform and equal pricing for each product; one price for everyone whatever that person's race, creed, class, color, or income. Why should it suddenly be different for taxes? In short, a quiet but highly important change has here been made in the concept of "equal," from equal and uniform price for all on the free market, to equal proportion to income in the hands of the flat taxers.

## "Subsidy" True and False

At the heart of the fairness and neutral-to-the-market assumptions of the flat taxers is their express desire to eliminate subsidies, which are assumed to be both evil and non-neutral to the free market. The problem here is an equivocation on the term "subsidy." It's certainly true that our tax and budget system is riddled with subsidies, properly defined as taxing one group of people to line the pockets of another, or robbing Peter to pay Paul. If you or I are taxed to subsidize tobacco growers, or highway builders, or contractors, or welfare recipients, then these are indeed subsidies, cases where productive people are being robbed by the government to support groups who function, in effect, as parasites upon the producers. These are subsidies that should be eliminated forthwith. But what about, say, deductions for payment of interest on mortgages, tax credits for investment, or deductions for payment of state and local taxes? In what sense are they "subsidies"? Instead, what is really happening here is that some people—homeowners, investors, or state and local taxpayers—are graciously allowed by the government to keep more of their own money than they would have otherwise. I submit that being allowed to keep more of your hard-earned money is not a subsidy in any true sense; it simply means that you are being fleeced less intensely than you would have been. If a robber assaults you on the highway, and is about to run off with all of your funds, and you persuade him to let you keep some bus fare, is he "subsidizing" you? Surely not. Being allowed to keep your own money can scarcely be called a subsidy.

We are now able to see through two very different senses of the concept of "special interest." It is all too true that the tobacco planter or the highway contractor who eagerly demands government funds are special interests aggressively dedicated to fleecing the taxpayer. But the investor, or the homeowner, or the venture capitalist, or whatever, who lobbies to be able to keep more of his own money is a

"special interest" in a very different sense. They are resisters properly dedicated to defending their own rights and assets against government assault. "Special" they might be, but they are, whether they know it or not, engaged in the noble effort of defending the rights and the freedoms of all of us against assault and depredation.

By focusing on defenders of their property and rights as alleged subsidy-seekers, the flat taxers are engaging in a strategy of "divide and conquer." The reformers have taken a growing movement of rebellion, resentment, and call for lower taxes and split the taxpayer forces by encouraging one set of us to seek out and persecute the other set. The flat taxers have managed to shift the focus of discussion from "lower taxes for all" to the proposition: "If you want your taxes to be lower, seek out and confiscate the assets of those bad people whose taxes are 'unfairly' low." The focus becomes raising the other guy's taxes instead of lowering yours and everyone else's. This clever ploy of the high taxers unfortunately seems to be working.

The flat taxers like to proclaim their plan to be "revenue-neutral," that is, the overall tax burden will not change. The lowering of some taxes on upper income groups, then, must be offset by "broadening the base," or by extending the tax burden to more people and sources of income. But who is to guarantee that once the base is broadened, and more income sources are brought under government's sway, it will not follow its natural proclivities and once again raise taxes for everyone?

## What Is a Loophole?

It is ironic that the slogan "close the loopholes," which used to be a hallmark of left-liberalism, has now been adopted by the Reagan administration and by the flat taxers. The great free-market economist Ludwig von Mises once rose up in a conference on taxation that devoted much energy to the closing of tax loopholes, and asked the crucial question: "What is a loophole?" He answered that the assumption of the loophole theorists seemed to be that all of everyone's income really belongs to the government, and that if the government fails to tax all of it away, it is thereby leaving a "loophole" that must be closed. The same charge applies to the deductions, exemptions, credits, and all the other loopholes out of a flat tax so condemned by our tax reformers.

Let us now consider the vexed question of ending deductibility of state and local taxes—a vital point to our reformers—because ending deductibility will provide a huge bonanza for our federal tax collectors. The flat taxers argue that by allowing deductions, the citizens of low-tax cities and states are "subsidizing" the citizens of high-tax states, and that an end to deductions will put all regions on a plane of fairness and uniformity. Governor Mario Cuomo, on behalf of the notoriously tax-oppressed citizens of New York, accepted the charge of subsidy, and then eloquently threw it back to the critics of New York, asking, in effect, "What's wrong with a subsidy? Are you against the citizens of New York subsidizing tobacco farmers in North Carolina, or subsidizing highway contractors in Iowa?" As a rare consistent supporter of left-liberalism, Cuomo was able to reveal the hypocrisy of those whose attacks on subsidies habitually suffer from a convenient double (or triple) standard. Being a left-liberal, Cuomo was not equipped to go one step further—to step outside the mammoth subsidy system and ask the crucial question: Are Iowans really subsidizing New Yorkers under deductibility? Or are the oppressed and cruelly taxed New Yorkers being spared from being doubly taxed on their own income? The average New Yorker is not responsible for his high taxation; he suffers unwillingly under the highest sales, income, and property taxes in the country. Why should he suffer more than the average Iowan? What is so "fair" about that?

The Reagan administration supporters of ending deductibility offer a pragmatic or strategic argument in reply. If you tax New Yorkers higher up by eliminating deductions, then they will rise up and roll back New York state and city taxes to the lower Iowan level.

This is the old the-worse-the-better argument that unfortunately, in addition to being strategic rather than moral, never seems to work. One of the main arguments for bringing in the income tax in the early twentieth century was that now, in contrast to the indirect tariff, everyone would directly feel such a tax, and therefore the public would rise up to keep taxes low. Obviously it didn't work that way. Instead, we kept and increased tariffs, and we exploited a new tax source and raised it to gigantic and crippling proportions.

## "Fairness": Equal Slavery

One dramatic way of looking at our tax system in relation to the question of subsidy or fairness is to assume for a moment that this is

1850, and that the question arises in the North as to what should be done with slaves who had managed to escape from the South. Let us assume that both sides of a growing debate are ardently in favor of freedom and are opposed to slavery. Group A hails the slaves' escape and advocates setting them free. But Group B argues as follows: "We are, of course, just as ardent a champion of slave freedom as the people of Group A. But we believe it is unfair for one group of slaves to escape, while the remainder of their brothers and sisters remain in slavery. Therefore, we hold that these escapees should be shipped back into slavery until such time as all the slaves can be freed together and simultaneously."

What would we think of such an argument? To call it specious would be a kindly understatement. But I submit that believers in the free market are arguing in precisely the same way when they say that all taxes must be uniform, and that all specific tax deductions or exemptions must be canceled until such time as everyone's taxes can be reduced uniformly. In both cases, the egalitarians are arguing not for equal freedom but for equal slavery or equal robbery in the name of "fairness." In both cases, the rebuttal holds that the enslavement or plunder of one group can in no way justify the enslavement or plunder of another, be it in the name of fairness, equity, or whatever.

## The Argument for Misallocation of Resources

The most sophisticated argument of the flat tax reformers is that deductions, exemptions, and loopholes distort the allocation of resources from what it would be on the free market, and therefore should be abolished. This is an integral part of the neutrality-to-the-market argument, and is particularly insidious, because it makes the reformers appear to be knowledgeable and dedicated adherents of the free market. Let us take, for example, two credits or deductions: an investment tax credit, and an energy credit. The reformers argue that the result of the "subsidy" of tax credits is that more resources are now going into investment or energy, and less are going into other areas, than would on the free market, and that therefore these credits should be eliminated.

It is true that more resources are now going into investment, energy, and a slew of other areas, than would have in a purely free market system. But the reformers leave out a crucial point: what is the alternative? If investment, energy, or other credits or deductions

are abolished, resources will not automatically go into more productive areas; instead, they go into government, via higher taxes. In short, the alternatives to energy credits are not merely Energy or All Other Consumption and Investment. They are threefold: Energy, Other Forms of Expenditure, and Government. And a higher tax will simply be wasted, thrown down the rathole of unproductive and profligate government spending. In short, there is no waste—no misallocation—like government; anything else would be an improvement.

## The Way Out of the Mess

The policy conclusions that flow from our analysis are diametrically opposed to those of the flat taxers. In looking at the history of reform and at the arguments of the flat taxers, one can almost sympathize with Richard L. Doernberg, professor of law at Emory University, who throws up his hands and concludes that "We have a lousy system; let's leave it alone or it will get worse." Doernberg urges that the current tax code, as bad as it is, should remain precisely the way it is forever, so that at least people will know the score and be able to plan around its provisions.

But we can do better than that. We have to look differently at taxation. We have to stop looking at taxes as a mighty system for achieving social goals, which merely needs to be made "fair" and rational in order to usher in Utopia. We have to start looking at taxation as a vast system of robbery and oppression, by which some people are enabled to live coercively and parasitically at the expense of others. We must realize that from the point of view of justice or of economic prosperity, the less people are taxed, the better. That is why we should rejoice at every new loophole, new credit, new manifestation of the "underground" economy. The Soviet Union can produce or work only to the extent that individuals are able to avoid the myriad of controls, taxes, and regulations. The same is true of most Third World countries, and the same is increasingly true of us. Every economic activity that escapes taxes and controls is not only a blow for freedom and property rights; it is also one more instance of a free flow of productive energy getting out from under parasitic repression.

That is why we should welcome every new loophole, shelter, credit, or exemption, and work, not to shut them down but to expand them to include everyone else, including ourselves.

If, then, the standard for proper reform is to lower any and all taxes as much as possible, how might government services be supplied? To answer we must take a very hard look at government services. Are they "services," or are they embodiments of repression? Or are they "services," at best, that no one really wants? And if they are genuine services, wouldn't they be supplied more efficiently, as well as voluntarily, by private enterprise? And if our friends the tax reformers are so all-fired concerned about the free market, shouldn't they answer this question: Why not put your emphasis on privatizing and thereby drastically lowering/eliminating government services? Wouldn't that be really neutral to, and consistent with, the free market? How do we explain the fact that if we go back to the earlier years of our nation, the level of government spending and taxation—even adjusted for inflation and population growth—was enormously less, on every level of jurisdiction, than it is today? And yet the Republic survived, and even flourished.

We must, in short, get past the tax reformers' favorite ploy of revenue neutrality. Why must total revenue remain the same? Instead, it should be lowered drastically, and as much as possible.

We now return to the old question of "fairness": if there are any taxes or government spending left after our drastic cuts, how should the remaining taxes be levied? Here we reopen the point that fairness is the closest possible approximation to neutrality toward the free market. One method would be user fees, so that only direct users would pay for a service and there would be no extra coercion on non-users. For the rest, we should look at the free-market system of one price for a good or service. We might then suggest a system not of equal proportional income tax, but of equal tax, period. This is the age-old system of the "head tax," in which every citizen pays an equal amount each year to the government in payment for whatever services may have been conferred upon him from governments' existence during that year. The abolition of the income tax would mean the end of snooping and surveillance by the IRS as well as the elimination of vast economic distortions and oppression caused by the system; the end of sales and property taxes would also be a great boon to the freedom and prosperity of Americans.

We would then and only then have a tax system that truly, and at long last, fulfilled the proclaimed goals of our flat tax reformers. For here would be a system that would be truly simple, truly fair, and

genuinely neutral to the free market. Short of that goal, we could settle temporarily for former Congressman Ron Paul's (R-TX) interesting variant of the flat tax proposal: reducing all income tax rates to 10 percent, while at the same time keeping all existing deductions, credits, and exemptions. The principle should be clear: to support all reductions in taxes, whether they be by lower rates or widening of exemption and deductions; and to oppose all rate increases or exemption decreases. In short, to seek in every instance to remove the blight of taxation as much as possible. Here is one reform, at least, that could not fall under Mencken's definition of a plot to injure the American taxpayer.

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# The Consumption Tax: A Critique

## The Alleged Superiority of the Income Tax

Orthodox neoclassical economics has long maintained that, from the point of view of the taxed themselves, an income tax is "better than" an excise tax on a particular form of consumption, since, in addition to the total revenue extracted, which is assumed to be the same in both cases, the excise tax weights the levy heavily against a particular consumer good. In addition to the total amount levied, therefore, an excise tax skews and distorts spending and resources away from the consumers' preferred consumption patterns. Indifference curves are trotted out with a flourish to lend the scientific patina of geometry to this demonstration.

As in many other cases when economists rush to judge various courses of action as "good," "superior" or "optimal," however, the *ceteris paribus* assumptions underlying such judgments—in this case, for example, that total revenue remains the same—do not always hold up in real life. Thus, it is certainly possible, for political or other reasons, that one particular form of tax is not likely to result in the same total revenue as another. The nature of a particular tax might lead to less or more revenue than another tax. Suppose, for example, that all present taxes are abolished and that the same total is to be raised from a new capitation, or head, tax, which requires that every inhabitant of the United States pay an equal amount to the support of federal, state, and local government. This would mean that the existing total government revenue of the United States, which we estimate at 1 trillion, 380 million dollars—and here exact figures are

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not important—would have to be divided between an approximate total of 243 million people. Which would mean that every man, woman, and child in America would be required to pay to government each and every year, $5,680. Somehow, I don't believe that anything like this large a sum could be collectible by the authorities, no matter how many enforcement powers are granted the IRS. A clear example where the ceteris paribus assumption flagrantly breaks down.

But a more important, if less dramatic, example is nearer at hand. Before World War II, Internal Revenue collected the full amount, in one lump sum, from every taxpayer, on March 15 of each year. (A month's extension was later granted to the long-suffering taxpayers.) During World War II, in order to permit an easier and far smoother collection of the far higher tax rates for financing the war effort, the federal government instituted a plan conceived by the ubiquitous Beardsley Ruml of R.H. Macy & Co., and technically implemented by a bright young economist at the Treasury Department, Milton Friedman. This plan, as all of us know only too well, coerced every employer into the unpaid labor of withholding the tax each month from the employee's paycheck and delivering it to the Treasury. As a result, there was no longer a need for the taxpayer to cough up the total amount in a lump sum each year. We were assured by one and all, at the time, that this new withholding tax was strictly limited to the wartime emergency, and would disappear at the arrival of peace. The rest, alas, is history. But the point is that no one can seriously maintain that an income tax deprived of withholding power, could be collected at its present high levels.

One reason, therefore, that an economist cannot claim that the income tax, or any other tax, is better from the point of view of the taxed person, is that total revenue collected is often a function of the type of tax imposed. And it would seem, that from the point of view of the taxed person, the less extracted from him the better. Even indifference curve analysis would have to confirm that conclusion. If someone wishes to claim that a taxed person is disappointed at how little tax he is asked to pay, that person is always free to make up the alleged deficiency by making a voluntary gift to the bewildered but happy taxing authorities.[1]

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[1]In 1619, Father Pedro Fernandez Navarrete, "Canonist Chaplain and Secretary of his High Majesty," published a book of advice to the Spanish

A second insuperable problem with an economist's recommending any form of tax from the alleged point of view of the taxee, is that the taxpayer may well have particular subjective evaluations of the form of tax, apart from the total amount levied. Even if the total revenue extracted from him is the same for tax A and tax B, he may have very different subjective evaluations of the two taxing processes. Let us return, for example, to our case of the income as compared to an excise tax. Income taxes are collected in the course of a coercive and even brutal examination of virtually every aspect of every taxpayer's life by the all-seeing, all-powerful Internal Revenue Service. Each taxpayer furthermore is obliged by law to keep accurate records of his income and deductions and then, painstakingly and truthfully, to fill out and submit the very forms that will tend to incriminate him into tax liability. An excise tax, say on whiskey or on movie admissions will intrude directly on no one's life and income, but only into the sales of the movie theater or liquor store. I venture to judge that, in evaluating the "superiority" or "inferiority" of different modes of taxation, even the most determined imbiber or moviegoer would cheerfully pay far higher prices for whiskey or movies than neoclassical economists contemplate, in order to avoid the long arm of the IRS.[2]

## The Forms of Consumption Tax

In recent years, the old idea of a consumption tax in contrast to an income tax has been put forward by many economists, particularly by allegedly pro-free market conservatives. Before turning to a critique of the consumption tax as a substitute for the income tax, it should be noted that current proposals for a consumption tax would

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monarch. Sternly advising a drastic cut in taxation and government spending, Father Navarrete recommended that, in the case of sudden emergencies, the king rely solely on soliciting voluntary donations. Alejandro Antonio Chafuen, *Christians for Freedom: Late Scholastic Economics* (San Francisco: Ignatius Press, 1986), p. 68.

[2]It is particularly poignant, on or near any April 15, to contemplate the dictum of Father Navarrete, that "the only agreeable country is the one where no one is afraid of tax collectors," ibid., p. 73. Also see Murray N. Rothbard "Review of A. Chafuen, *Christians for Freedom: Late Scholastic Economics*," *International Philosophical Quarterly* 28 (March 1988): 112–14.

deprive taxpayers of the psychic joy of eradicating the IRS. For while the discussion is often couched in either-or terms, the various proposals really amount to adding a new consumption tax on top of the current massive armamentarium of taxing power; in short, seeing that income tax levels may have reached their political limits for the time being, our tax consultants and theoreticians are suggesting a shining new tax weapon for the government to wield. Or, in the immortal words of that exemplary economic czar and servant of absolutism, Jean-Baptiste Colbert, the task of the taxing authorities is to "so pluck the goose as to obtain the largest amount of feathers with the least amount of hissing." We the taxpayers, of course, are the geese.

But let us put the best face on the consumption tax proposal, and deal with it as a complete replacement of the income tax by a consumption tax, with total revenue remaining the same. Our first point is that one venerable form of consumption tax not only retains existing IRS despotism, but makes it even worse. This is the consumption tax first prominently proposed by Irving Fisher.[3] The Fisher tax would retain the IRS, as well as the requirement that everyone keep detailed and faithful records and truthfully estimate his own taxes. But it would add something else. In addition to reporting one's income and deductions, everyone would be required to report his additions to or subtractions from capital assets (including cash) over the year. Then, everyone would pay the designated tax rate on his income minus his addition to capital assets, or net consumption. Or, contrarily, if he spent more than he earned over the year, he would pay a tax on his income plus his reduction of capital assets, again equalling his net consumption. Whatever the other merits or demerits of the Fisherine tax, it would add to IRS power over every individual, since the state of his capital assets, including his stock of cash, would now be examined with the same care as his income.

A second proposed consumption tax, the VAT, or value-added tax, imposes a curious hierarchical tax on the "value added" by each firm and business. Here, instead of every individual, every business

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[3]See, for example, Irving and Herbert N. Fisher, *Constructive Income Taxation* (New York: Harper, 1942).

firm would be subjected to intense bureaucratic scrutiny, for each firm would be obliged to report its income and its expenditures, paying a designated tax on the net income. This would tend to distort the structure of business. For one thing, there would be an incentive for uneconomic vertical integration, since the fewer the number of times a sale takes place, the fewer the imposed taxes. Also, as has been happening in European countries with experience of the VAT, a flourishing industry may arise in issuing phony vouchers, so that businesses can overinflate their alleged expenditures, and reduce their reported value added. Surely a sales tax, other things being equal, is manifestly both simpler, less distorting of resources, and enormously less bureaucratic and despotic than the VAT. Indeed the VAT seems to have no clear advantage over the sales tax, except of course, if multiplying bureaucracy and bureaucratic power is considered a benefit.

The third type of consumption tax is the familiar percentage tax on retail sales. Of the various forms of consumption tax, the sales tax surely has the great advantage, for most of us, of eliminating the despotic power of the government over the life of every individual, as in the income tax, or over each business firm, as in the VAT. It would not distort the production structure as would the VAT, and it would not skew individual preferences as would specific excise taxes.

Let us now consider the merits or demerits of a consumption as against an income tax, setting aside the question of bureaucratic power. It should first be noted that the consumption tax and the income tax each carry distinct philosophical implications. The income tax rests necessarily on the ability-to-pay principle, namely the principle that if a goose has more feathers it is more ripe for the plucking. The ability-to-pay principle is precisely the creed of the highwayman of taking where the taking is good, of extracting as much as the victims can bear. The ability-to-pay principle is the philosophical embodiment of the memorable answer of Willie Sutton when he was asked, perhaps by a psychological social worker, why he robbed banks. "Because," answered Willie, "that's where the money is."

The consumption tax, on the other hand, can only be regarded as a payment for permission to live. It implies that a man will not be allowed to advance or even sustain his own life, unless he pays, off the top, a fee to the State for permission to do so. The consumption

tax does not strike me, in its philosophical implications, as one whit more noble, or less presumptuous, than the income tax.

## Proportionality And Progressivity: Who? Whom?

One of the suggested virtues of the consumption tax advanced by conservatives is that, while the income tax can be and generally is progressive, the consumption tax is virtually automatically proportional. It is also claimed that progressive taxation is tantamount to theft, with the poor robbing the rich, whereas proportionality is the fair and ideal tax. In the first place, however, the Fisher-type consumption tax could well be every bit as progressive as the income tax. Even the sales tax is scarcely free from progressivity. For most sales taxes in practice exempt such products as food, exemptions that distort individual market preferences and also introduce progressivity of taxation.

But is progressivity really the problem? Let us take two individuals, one who makes $10,000 a year and another who makes $100,000. Let us posit two alternative tax systems: one proportional, the other steeply progressive. In the progressive tax system, income tax rates range from 1 percent for the $10,000 a year man, to 15 percent for the man with the higher income. In the succeeding proportional system, let us assume, everyone, regardless of income, pays the same 30 percent of his income. In the progressive system, the low-income man pays $100 a year in taxes, and the wealthier pays $15,000, whereas in the allegedly fairer proportional system, the poorer man pays $3,000 instead of $100, while the wealthier pays $30,000 instead of $15,000. It is, however, small consolation to the higher-income person that the poorer man is paying the same percentage of income in tax as he, for the wealthier person is being mulcted far more than before. It is unconvincing, therefore, to the richer man to be told that he is now no longer being "robbed" by the poor, since he is losing far more than before. If it is objected that the total level of taxation is far higher under our posited proportional than progressive system, we reply that that is precisely the point. For what the higher income person is really objecting to is not the mythical robbery inflicted upon him by "the poor"; his problem is the very real amount being extracted from him by the State. The wealthier man's real complaint, then, is not how badly he is being treated relative to someone else, but how much money is being extracted from his own hard-earned assets. We sub-

mit that progressivity of taxes is a red herring; that the real problem and proper focus should be on the amount that any given individual is obliged to surrender to the State.[4]

The State, of course, spends the money it receives on various groups, and those who claim that progressive taxation mulcts the rich on behalf of the poor argue by comparing the income status of the taxpayers with those on the receiving end of the State's largess. Similarly, the Chicago School claims that the tax system is a process by which the middle class exploits both the rich and the poor, while the New Left insists that taxes are a process by which the rich exploit the poor. All of these attempts misfire by unjustifiably bracketing as one class the payers to, and recipients from, the State. Those who pay taxes to the State, be they wealthy, middle class or poor, are certainly on net, a different set of people than those wealthy, middle-class, or poor, who receive money from State coffers, which notably includes politicians and bureaucrats as well as those who receive favors from these members of the State apparatus. It makes no sense to lump these groups together. It makes far more sense to realize that the process of tax-and-expenditures creates two and only two separate, distinct, antagonistic social classes, what Calhoun brilliantly identified as the (net) taxpayers and the (net) tax-consumers, those who pay taxes and those who live off them. I submit that, looked at in this perspective, it also becomes particularly important to minimize the burdens which the State and its privileged tax-consumers place on the productivity of the taxpayers.[5]

## THE PROBLEM OF TAXING SAVINGS

The major argument for replacing an income by a consumption tax is that savings would no longer be taxed. A consumption tax, its advocates assert, would tax consumption and not savings. The fact

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[4]For a fuller treatment, and a discussion of who is being robbed by whom, see Murray N. Rothbard, *Power and Market: Government and the Economy*, 2nd ed. (Kansas City: Sheed Andrews and McMeel, 1977), pp. 120–21.

[5]See Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economic Principles*, 2nd. ed. (Los Angeles: Nash, 1970), vol. 2, pp. 791–92; idem, *Power and Market*, pp. 84–88, 14–16. Cf. John C. Calhoun, *A Disquisition on Government* (New York: Liberals Arts Press, 1953), pp. 16–18.

that this argument is generally advanced by free-market economists, in our day mainly by the supply-siders, strikes one immediately as rather peculiar. For individuals on the free market, after all, each decide their own allocation of income to consumption or to savings. This proportion of consumption to savings, as Austrian economics teaches us, is determined by each individual's rate of time preference, the degree by which he prefers present to future goods. For each person is continually allocating his income between consumption now, as against saving to invest in goods that will bring an income in the future. And each person decides the allocation on the basis of his time preference. To say, therefore, that only consumption should be taxed and not savings, is to challenge the voluntary preferences and choices of individuals on the free market, and to say that they are saving far too little and consuming too much, and therefore that taxes on savings should be removed and all the burdens placed on present as compared to future consumption. But to do that is to challenge free-market expressions of time preference, and to advocate government coercion to forcibly alter the expression of those preferences, so as to coerce a higher saving to consumption ratio than desired by free individuals.

We must, then, ask: by what standards do the supply-siders and other advocates of consumption taxes decide why and to what extent savings are too low and consumption too high? What are their criteria of "too low" or "too much," on which they base their proposed coercion over individual choice? And what is more, by what right do they call themselves advocates of the "free-market" when they propose to dictate choices in such a vital realm as the proportion between present and future consumption?

Supply-siders consider themselves heirs of Adam Smith, and in one sense they are right. For Smith, too, driven in his case by a deep-seated Calvinist hostility to luxurious consumption, sought to use government to raise the social proportion of investment to consumption beyond the desires of the free market. One method he advocated was high taxes on luxurious consumption; another was usury laws, to drive interest rates below the free market level, and thereby coercively channel or ration savings and credit into the hands of sober, industrious prime business borrowers, and out of the hands of "projectors" and "prodigal" consumers who would be willing to pay high interest charges. Indeed, through the device of the ghostly Impartial Spectator, who, in contrast to real human beings, is

indifferent to the time at which he will receive goods, Smith virtually held a zero rate of time preference to be the ideal.[6]

The only coherent argument offered by advocates of consumption against income taxation is that of Irving Fisher, based on suggestions in John Stuart Mill.[7] Fisher argued that, since the goal of all production is consumption, and since all capital goods are only way-stations on the way to consumption, the only genuine income is consumption spending. The conclusion is quickly drawn that therefore only consumption income, not what is generally called "income," should be subject to tax.

More specifically, savings and consumption, it is alleged, are not really symmetrical. All saving is directed toward enjoying more consumption in the future. Potential present consumption is foregone in return for an expected increase in future consumption. The argument concludes that therefore any return on investment can only be considered a "double-counting" of income, in the same way that a repeated counting of the gross sales of, say, a case of Wheaties from manufacturer to jobber to wholesaler to retailer as part of net income or product would be a multiple counting of the same good.

This reasoning is correct as far as it goes in explaining the consumption-savings process, and is quite helpful in leveling a critique of conventional national income or product statistics. For these statistics carefully leave out all double or multiple counting in order to arrive at total net product, yet they arbitrarily include in total net income, investment in all capital goods lasting longer than one year—a clear example itself of double counting. Thus, the current practice absurdly excludes from net income a merchant's investment in inventory lasting eleven months before sale, but includes in net income investment in inventory lasting for thirteen months. The cogent conclusion is that an estimate of social or national income should include only consumer spending.[8]

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[6]See the illuminating article by Roger W. Garrison, "West's 'Cantillon and Adam Smith': A Comment," *Journal of Libertarian Studies* 7 (Fall, 1985): 291–92.

[7]See Rothbard, *Power and Market*, pp. 98–100.

[8]We omit here the fascinating question of how government's activities should be treated in national income statistics. See Rothbard, *Man, Economy, and State*, vol. 2, pp. 815–20; idem, *Power and Market*, pp. 199–201;

Despite the many virtues of the Fisher analysis, however, it is impermissible to leap to the conclusion that only consumption should be taxed rather than income. It is true that savings leads to a greater supply of consumer goods in the future. But this fact is known to all persons; that is precisely why people save. The market, in short, knows all about the productive power of savings for the future, and allocates its expenditures accordingly. Yet even though people know that savings will yield them more future consumption, why don't they save all their current income? Clearly, because of their time preferences for present as against future consumption. These time preferences govern people's allocation between present and future. Every individual, given his money "income"—defined in conventional terms—and his value scales, will allocate that income in the most desired proportion between consumption and investment. Any other allocation of such income, any different proportions, would therefore satisfy his wants and desires to a lesser extent and lower his position on his value scale. It is therefore incorrect to say that an income tax levies an extra burden on savings and investment; it penalizes an individual's entire standard of living, present and future. An income tax does not penalize saving *per se* any more than it penalizes consumption.

Hence, the Fisher analysis, for all its sophistication, simply shares the other consumption tax advocates' prejudices against the voluntary free-market allocations between consumption and investment. The argument places greater weight on savings and investment than the market does. A consumption tax is just as disruptive of voluntary time preferences and market allocations as is a tax on savings. In most or all other areas of the market, free market economists understand that allocations on the market tend always to be optimal with respect to satisfying consumers' desires. Why then do they all too often make an exception of consumption-savings allocations, refusing to respect time-preference rates on the market?

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idem, *America's Great Depression*, 4th ed. (New York: Richardson and Snyder, 1983), pp. 296–304; Robert Batemarco, "GNP, PPR, and the Standard of Living," *Review of Austrian Economics* 1 (1987): 181–86.

Perhaps the answer is that economists are subject to the same temptations as anyone else. One of these temptations is to call loudly for you, him, and the other guy to work harder, and save and invest more, thereby increasing one's own present and future standards of living. A follow-up temptation is to call for the *gendarmes* to enforce that desire. Whatever we may call this temptation, economic science has nothing to do with it.

## The Impossibility of Taxing Only Consumption

Having challenged the merits of the goal of taxing only consumption and freeing savings from taxation, we now proceed to deny the very possibility of achieving that goal, i.e., we maintain that a consumption tax will devolve, willy-nilly, into a tax on income and therefore on savings as well. In short, that even if, for the sake of argument, we should want to tax only consumption and not income, we should not be able to do so.

Let us take, first, the Fisher plan, which, seemingly straightforward, would exempt saving and tax only consumption. Let us take Mr. Jones, who earns an annual income of $100,000. His time preferences lead him to spend 90 percent of his income on consumption, and save-and-invest the other 10 percent. On this assumption, he will spend $90,000 a year on consumption, and save-and-invest the other $10,000. Let us assume now that the government levies a 20 percent tax on Jones's income, and that his time-preference schedule remains the same. The ratio of his consumption to savings will still be 90:10, and so, after-tax income now being $80,000, his consumption spending will be $72,000 and his saving-investment $8,000 per year.[9]

Suppose now that instead of an income tax, the government follows the Irving Fisher scheme, and levies a 20 percent annual tax on Jones's consumption. Fisher maintained that such a tax would fall only on consumption, and not on Jones's savings. But this claim is incorrect, since Jones's entire savings-investment is based solely on

[9]We set aside the fact that, at the lower amount of money assets left to him, Jones's time preference rate, given his time preference schedule, will be higher, so that his consumption will be higher, and his savings lower, than we have assumed.

the possibility of his future consumption, which will be taxed equally. Since future consumption will be taxed, we assume, at the same rate as consumption at present, we cannot conclude that savings in the long run receives any tax exemption or special encouragement. There will therefore be no shift by Jones in favor of savings-and-investment due to a consumption tax.[10] In sum, any payment of taxes to the government, whether they be consumption or income, necessarily reduces Jones's net income. Since his time preference schedule remains the same, Jones will therefore reduce his consumption and his savings proportionately. The consumption tax will be shifted by Jones until it becomes equivalent to a lower rate of tax on his own income. If Jones still spends 90 percent of his net income on consumption, and 10 percent on savings-investment, his net income will be reduced by $15,000, instead of $20,000, and his consumption will now total $76,000, and his savings-investment $9,000. In other words, Jones's 20 percent consumption tax will become equivalent to a 15 percent tax on his income, and he will arrange his consumption-savings proportions accordingly.[11]

We saw at the beginning of this paper that an excise tax skewing resources away from more desirable goods does not necessarily mean we can recommend an alternative, such as an income tax. But how about a general sales tax, assuming that one can be levied politically with no exemptions of goods or services? Wouldn't such a tax burden be only on consumption and not income?

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[10]In fact, per note 9, supra, there will be a shift in favor of consumption because a diminished amount of money will shift the taxpayer's time preference rate in the direction of consumption. Hence, paradoxically, a pure tax on consumption will end up taxing savings more than consumption! See Rothbard, *Power and Market*, pp. 108–11.

[11]If net income is defined as gross income minus amount paid in taxes, and for Jones, consumption is 90 percent of net income, a 20 percent consumption tax on $100,000 income will be tantamount to a 15 percent tax on this income. Rothbard, *Power and Market*, pp. 108–11. The basic formula is that net income,

$$N = \frac{G}{1 + tc}$$

where G = gross income, t = the tax rate on consumption, and c, consumption as percent of net income, are givens of the problem, and N = G-T by definition, where T is the amount paid in consumption tax.

In the first place, a sales tax would be subject to the same problems as the Fisher consumption tax. Since future and present consumption would be taxed equally, there would again be shifting by each individual so that future as well as present consumption would be reduced. But, furthermore, the sales tax is subject to an extra complication: the general assumption that a sales tax can be readily shifted forward to the consumer is totally fallacious. In fact, the sales tax cannot be shifted forward at all!

Consider: all prices are determined by the interaction of supply, the stock of goods available to be sold, and by the demand schedule for that good. If the government levies a general 20 percent tax on all retail sales, it is true that retailers will now incur an additional 20 percent cost on all sales. But how can they raise prices to cover these costs? Prices, at all times, tend to be set at the maximum net revenue point for each seller. If the sellers can simply pass the 20 percent increase in costs onto the consumers, why did they have to wait until a sales tax to raise prices? Prices are already at highest net income levels for each firm. Any increase in cost, therefore, will have to be absorbed by the firm; it cannot be passed forward to the consumers. Put another way: the levy of a sales tax has not changed the stock already available to the consumers; that stock has already been produced. Demand curves have not changed, and there is no reason for them to do so. Since supply and demand have not changed, neither will price. Or, looking at the situation from the point of the demand and supply of money, which help determine general price levels, the supply of money has remained as given, and there is also no reason to assume a change in the demand for cash balances either. Hence, prices will remain the same.

It might be objected that, even though shifting forward to higher prices cannot occur immediately, it can do so in the longer run, when factor and resources owners will have a chance to lower their supply at a later point in time. It is true that a partial excise can be shifted forward in this way, in the long run, by resources leaving, let us say, the liquor industry and shifting into other untaxed industries. After a while, then, the price of liquor can be raised by a liquor tax, but only by reducing the future supply, the stock of liquor available for sale at a future date. But such "shifting" is not a painless and prompt passing on of a higher price to consumers; it can only be accomplished in a longer run by a reduction in the supply of a good.

The burden of a sales tax cannot be shifted forward in the same way, however. For resources cannot escape a sales tax as they can an excise tax: by leaving the liquor industry and moving to another. We are assuming that the sales tax is general and uniform; it cannot therefore, be escaped by resources except by fleeing into idleness. Hence, we cannot maintain that the sales tax will be shifted forward in the long run by all supplies of goods falling by something like 20 percent (depending on elasticities). General supplies of goods will fall, and hence prices rise, only to the relatively modest extent that labor, seeing a rise in the opportunity cost of leisure because of a drop in wage incomes, will leave the labor force and become voluntarily idle (or more generally will lower the number of hours worked).[12]

In the long run, of course, and that run is not very long, the retail firms will not be able to absorb a sales tax; they are not unlimited pools of wealth ready to be confiscated. As the retail firms suffer losses, their demand curves for all intermediate goods, and then for all factors of production, will shift sharply downward, and these declines in demand schedules will be rapidly transmitted to all the ultimate factors of production: labor, land, and interest income. And since all firms tend to earn a uniform interest return determined by social time preference, the incidence of the fall in demand curves will rest rather quickly on the two ultimate factors of production: land and labor.

Hence, the seemingly common-sense view that a retail sales tax will readily be shifted forward to the consumer is totally incorrect. In contrast, the initial impact of the tax will be on the net incomes of retail firms. Their severe losses will lead to a rapid downward shift in demand curves, backward to land and labor, i.e., to wage rates and ground rents. Hence, instead of the retail sales tax being quickly and painlessly shifted forward, it will, in a longer-run, be painfully shifted backward to the incomes of labor and landowners. Once again, an alleged tax on consumption has been transmuted by the processes of the market into a tax on incomes.

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[12]Rothbard, *Power and Market*, pp. 88–93. Also see the notable article by Harry Gunnison Brown, "The Incidence of a General Sales Tax," in *Readings in the Economics of Taxation*, R. Musgrave and C. Shoup, eds. (Homewood, Ill.: Irwin, 1959), pp. 330–39.

The general stress on forward shifting, and neglect of backward-shifting, in economics, is due to the disregard of the Austrian theory of value, and its insight that market price is determined only by the interaction of an already produced stock, with the subjective utilities and demand schedules of consumers for that stock. The market supply curve, therefore, should be vertical in the usual supply-demand diagram. The standard Marshallian forward-sloping supply curve illegitimately incorporates a time dimension within it, and it therefore cannot interact with an instantaneous, or freeze-frame, market demand curve. The Marshallian curve sustains the illusion that higher cost can directly raise prices, and not only indirectly by reducing supply. And while we may arrive at the same conclusion as Marshallian supply-curve analysis for a particular excise tax, where partial equilibrium can be used, this standard method breaks down for general sales taxation.

## Conclusion: The Amount vs. the Form of Taxation

We conclude with the observation that there has been far too much concentration on the form, the type of taxation, and not enough on its total amount. The result has been endless tinkering with kinds of taxes, coupled with neglect of a far more critical question: how much of the social product should be siphoned away from the producers? Or, how much income should be retained by the producers and how much income and resources coercively diverted for the benefit of non-producers?

It is particularly odd that economists who proudly refer to themselves as advocates of the free market have in recent years led the way in this mistaken path. It was allegedly free market economists for example, who pioneered in and propagandized for, the alleged Tax Reform Act of 1986. This massive change was supposed to bring us "simplification" of our income taxes. The result, of course, was so simple that even the IRS, let alone the fleet of tax lawyers and tax accountants, has had great difficulty in understanding the new dispensation. Peculiarly, moreover, in all the maneuverings that led to the Tax Reform Act, the standard held up by these economists, a standard apparently so self-evident as to need no justification, was that the sum of tax changes be "revenue neutral." But they never told us what is so great about revenue neutrality. And of course, by

cleaving to such a standard, the crucial question of total revenue was deliberately precluded from the discussion.

Even more egregious was an early doctrine of another group of supposed free-market advocates, the supply-siders. In their original Laffer-curve manifestation, now happily consigned to the dustbin of history, the supply-siders maintained that the tax rate that maximizes tax revenue is the "voluntary" rate, and a rate that should be diligently pursued. It was never pointed out in what sense such a tax rate is "voluntary," or what in the world the concept of "voluntary" has to do with taxation in the first place. Much less did the supply-siders in their Lafferite form ever instruct us why we must all uphold maximizing government revenue as our beau ideal. Surely, for free-market proponents, one might think that minimizing government depredation of the private product would be a bit more appealing.

It is with relief that one turns for a realistic as well as a genuine free-market approach to Jean-Baptiste Say, who contributed considerably more to economics than Say's Law. Say was under no illusion that taxation is voluntary nor that government spending contributes productive services to the economy. Say pointed out that, in taxation, "The government exacts from a taxpayer the payment of a given tax in the shape of money. To meet this demand, the taxpayer exchanges part of the products at his disposal for coin, which he pays to the tax-gatherers." Eventually, the government spends the money on its own needs, so that "in the end . . . this value is consumed; and then the portion of wealth, which passes from the hands of the taxpayer into those of the tax-gatherer, is destroyed and annihilated." Note, that as in the case of the later Calhoun, Say sees that taxation creates two conflicting classes, the taxpayers and the tax-gatherers. Were it not for taxes, the taxpayer would have spent his money on his own consumption. As it is, "The state . . . enjoys the satisfaction resulting from that consumption."

Say proceeds to denounce the "prevalent notion, that the values, paid by the community for the public service, return it again . . .; that what government and its agents receive, is refunded again by their expenditures." Say angrily comments that this "gross fallacy . . . has been productive of infinite mischief, inasmuch as it has been the pretext for a great deal of shameless waste and dilapidation." On the contrary, Say declares, "the value paid to government by the taxpayer is given without equivalent or return; it is expended by the

government in the purchase of personal service, of objects of consumption."

Say goes on to denounce the "false and dangerous conclusion" of economic writers that government consumption increases wealth. Say noted bitterly that "if such principles were to be found only in books, and had never crept into practice one might suffer them without care or regret to swell the monstrous heap of printed absurdity." But unfortunately, he noted, these notions have been put into "practice by the agents of public authority, who can enforce error and absurdity at the point of a bayonet or mouth of the cannon."[13] Taxation, then, for Say is

> the transfer of a portion of the national products from the hands of individuals to those of the government, for the purpose of meeting the public consumption of expenditure. . . . It is virtually a burthen imposed upon individuals, either in a separate or corporate character, by the ruling power . . . for the purpose of supplying the consumption it may think proper to make at their expense.[14]

But taxation, for Say, is not merely a zero-sum game. By levying a burden on the producers, he points out, taxes, over time, cripple production itself. Writes Say:

> Taxation deprives the producer of a product, which he would otherwise have the option of deriving a personal gratification from, if consumed . . . or of turning to profit, if he preferred to devote it to an useful employment. . . . [T]herefore, the subtraction of a product must needs diminish, instead of augmenting, productive power.

J.B. Say's policy recommendation was crystal clear and consistent with his analysis and that of the present paper. "The best scheme of public finance is, to spend as little as possible; and the best tax is always the lightest."[15] What conclusion can be more fitting for April 15?

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[13]Jean-Baptiste Say, *A Treatise on Political Economy*, 6th ed. (Philadelphia: Claxton, Remsen and Heffelfinger, 1880), pp. 412–15. Also see Murray N. Rothbard, "The Myth of Neutral Taxation," *Cato Journal* 1 (Fall, 1981): 551–54; included in this volume as chapter 24.

[14]Say, *Treatise*, pp. 4–6.

[15]Ibid., p. 449.

# 27
# The Case Against the Flat Tax

## "Special Interests": Good or Bad?

The flat tax draws virtually unanimous support from the right-thinking intellectuals in our society, including academics, writers, and media pundits. By "right-thinking" I mean all people who have managed successfully to identify their own views, whatever they may be, with the general welfare. By this time, however, the cautious should be on the alert: any policy that draws unanimous support from these people can't be all good. There must be a catch somewhere.

The flat tax has been cleverly labeled a tax "reform," the very word "reform" being heavy with the implication that no man or woman of good will, be they liberal or conservative, Democrat or Republican, can possibly stand opposed to such a plan. My favorite writer, H.L. Mencken, once wrote that he had learned at his father's knee in Baltimore what "reform" in politics really meant: "mainly a conspiracy of prehensile charlatans to mulct the taxpayer."

So convinced are the flat-taxers that only they have a pipeline to interpret the general welfare, that they invariably charge that any and all critics of their scheme are simply spokesmen for a sinister and shadowy group they commonly refer to as "the special interests." "Special interests" seems to be an effective way to write off substantial opposition to the flat-tax, especially since the convenient tendency of intellectuals is to dismiss all other interests but their own as "special" and hence somehow narrow and sinister.

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But are special interests all bad? Some undoubtedly are. Take, for example, the sugar program to which all of us have been subjected for a half-century. In order to maintain and expand the inefficient U.S. sugar industry, the sugar interests have for decades propped up sugar prices by use of government, and lobbied for severe quotas on the import of sugar. As a result, American consumers (to say nothing of foreign sugar producers) have been hurt severely, the supply of sugar sharply restricted, and the price artificially raised—so that the support price of sugar in the U.S. is now no less than seven times higher than the world market price. Here is a clear-cut example of aggression by special interests.

But there are also cases of special interests acting defensively, rather than aggressively. Several years ago, for example, the movie theaters circulated petitions urging that a new tax on movie admissions be repealed. I was happy to sign that petition both because I believed that the cause of the theaters was just and also that my own and other movie consumers' rights and interests were being invaded by the government.

But wasn't this special pleading on the part of the movie theaters? Yes, and so what? There is no reason to expect that movie theaters will be in the forefront of actions to protect the rights and incomes of, say, restaurants. In all cases where special interests are acting defensively, the front fighters for the rights of consumers will naturally be the particular firms or industries that happen to be under attack. Who else would we expect to sound the alarm?

To return now to the flat tax: the seductive rhetoric invoking the "special interests" has lead most people to believe that everyone will benefit from the flat tax except a few wicked corporations or multimillionaires. Nothing could be further from the truth. If the flat tax is enacted, millions of us will find out, too late and to our chagrin, that, to paraphrase Pogo: "We have met the special interests and they are us." Or as Senator Robert Dole (R-KS) put it recently on the issue of the flat tax as an allegedly fair tax: "Everybody believes in fairness unless they're involved."

Before we go down the list of "special interests" who would be hurt by the enactment of a flat tax, I want to stress that I'm talking about the pure flat tax concept, rather than the current approach to it submitted last fall by then-Secretary of the Treasury Donald Regan or this spring by Treasury Secretary James Baker. These present as

much of the flat tax as the Treasury thought it could get away with politically. But the argument for these plans are that they approach the ideal of the flat tax, and so it is that ideal that should be examined.

The flat tax, quite simply, proposes that every individual and every organization be subjected to the same, uniform proportional income tax. To achieve that uniformity, the flat-taxers propose the ruthless suppression of all credits, deductions, exemptions, and shelters, all of which are sneered at as "loopholes" in the tax system. In the flat-taxers' pure theory, the proportional income tax would apply to everyone regardless of income. But early in the development of the flat-tax movement they decided that, politically, the poor would have to be exempt from the tax. As a result, all flat tax schemes are now "degressive": proportional above an arbitrary minimum income floor, below which line income receivers pay no taxes, The "degressivity" leaves an important element of progressivity in what has been touted as a strictly proportional plan.

## What Is a "Loophole"?

It is instructive to pause for a moment to examine the pejorative term "loophole." What is a "loophole," anyway? It is never defined, but the flat-taxers seem to make the implicit assumption that the government really owns, or should be owning, all of what everyone makes, at least up to some arbitrary percentage decided by the government. Hence, any failure of government to confiscate everyone's property up to that amount is somehow a moral blot that needs to be rectified. But to me it is far from self-evident that the government, rather than we ourselves, should have the primary right to our own earnings.

The "closing of loopholes" under a flat tax will mean a merciless and continuing search-and-destroy mission by which the government will root out and obliterate every little hideyhole in which many of us have been able to squirrel away a bit of our own earnings and our own property, and keep them safe from the ever-expanding maw of the federal government.

Wrapped up in the confusion over the role of "special interests" is a muddle over the concept of "subsidy." Flat-taxers call these exemptions, deductions, and loopholes "subsidies," and being

staunchly opposed to subsidies, flat-taxers propose to eliminate them. But is it really a "subsidy" to be allowed to keep more of your own money? Only if we agree with the curious implicit assumption of the flat-taxers that the government, not us, really owns our earnings and our property, and that therefore being allowed to keep some of them is an arbitrary indulgence on its part.

I submit, to the contrary, that there is a big and crucial difference between the government's taxing Peter to pay Paul, which is a "subsidy" to Paul, and the government's allowing Paul to keep more of his own funds. That can only be called a "subsidy" on the grotesque assumption that the government really owns all of our property to begin with.

Before examining the "special interests" who will lose, and often lose heavily, from the imposition of a flat tax, let me say that, strictly for the sake of argument, I will begin by granting, for the time being, the flat-taxers their insistent point that the shift to their tax will be strictly "revenue-neutral," that is, that total tax revenue will remain exactly the same from the shift, and will not increase.

Let us now go down the list of heavy losers from the imposition of the flat tax:

## Receivers of "Imputed" Income

The flat taxers are nothing if not sophisticated economic theorists, and they realize that we receive our incomes, not only in money but also in other ways, by goods or services "in kind," or in various psychic ways. They also realize that much of the flowering of non-money incomes, to which they "impute" monetary value, has come about precisely in order to avoid some of the confiscations of the taxing system. Since income taxes are levied on money income, people tend to shift as much income as possible from monetary to non-monetary forms.

And so, people pay and receive income in non-monetary ways: if a carpenter goes to a physician for treatment, he may meet his bill by fixing the doctor's house rather than by money payment. Employees receive much of their income in non-monetary "fringe benefits," which may accrue in money only in the future. Salesmen and executives take some of their salary, not in money income, but in blissfully

tax-free "perks" such as expense accounts, and the much-cherished business lunch.

But the flat-taxers, in their puritanical frenzy at seeing anyone escape their allotted payment of taxes, are out to get rid of all that. It is good-bye to the tax-free fringe benefit, the expense account, the business lunch. And what will happen to the restaurant business, the hotel business? The flat-taxers, like all puritans, like all fanatics, care not; they are ready to wreak unlimited havoc in the name of attaining their ideal.

For one thing, there is the American homeowner. Every homeowner is going to get it, but good, under the flat-tax regime. The flat-taxers, for example, have figured out that homeowners benefit, in a real though non-monetary way, by not having to pay rent. And so the flat-taxers propose to tax every homeowner on the "imputed rent" they are earning by not having to pay rent to a landlord. If, for example, you own your own home, and some officials figure out that you would have been paying $1,200 a month if you had been renting the home, then you will have to pay a proportional tax on this imputed total.

Unfortunately, no one has yet figured out a way to pay "imputed" taxes. The IRS insists on cold hard cash. And so it is going to be very painful for many people to have to pay taxes in money on income which is only psychic. As we will see shortly, the flat-taxers are out to tax capital gains fully as much as if they were earned income, as indeed they are. But if they had their druthers, they would tax these gains, not when we realize them in money form, but every year, as they accrue.

It is going to be very difficult for many people to pay through the nose on capital gains from increases in the value of their stocks or their homes, gains which they can only reap when they come to sell their asset. In the regime of the flat-taxers, there will be a great deal of painful forced-selling of homes and other assets. And to think, all this in the sacred name of the twin watchwords of the flat-taxers: "Simplicity" and "Fairness"!

It's a good thing that the flat-taxers haven't yet figured out how to tax us on our leisure, although as good puritans I'm sure they're working on it.

## Payers of Interest

Interest payments are expenses that the government allows us to deduct from taxable income. They will be brought under the heel by the flat-taxers. But if interest payments are no longer deductible, this means that one of the great economic advantages of owning a home, being able to deduct mortgage interest payments from taxes, will disappear. Notice that all of America's homeowners will be clobbered four ways by the ruthless ideologues of the flat-tax movement. One, as we have seen, homeowners will lose by being forced to pay taxes on their "imputed rent"; two, they will no longer be able to deduct interest payments on mortgages; and three and four, the value of their homes, on which they count when they wish to move, will be forced down because the after-tax return on the house will decline from the two increased tax levies.

I fail to follow the logic on this one: I can see why those who earn interest have to pay taxes on this income; but I fail to see why those who pay interest have to shell out more as well. In fact, this looks to me like double taxation on the same income, and if the flat-taxers were not self-proclaimed experts on "fairness," I would even go so far as to say that double taxes on the same income are unfair.

## Receivers of Capital Gains

The flat-taxers are also astute enough to realize that capital gains constitute income. But on the other hand, profits add to capital gains, and since they propose to tax profits too, they are, once again, double-taxing the same income. At the very least then, profits should no longer be taxed if capital gains are as well. Relentless in pursuing any bit of untaxed income, the flat-taxers note that capital gains have been taxed much less in recent years than other income, and so they propose to pile on higher taxes so as to bring about the desired uniformity.

But higher capital gains taxation will strike hardest and foremost at the new, young, venture capitalists going into high-risk, progressive industries. Heavy capital gains taxation will strike a deadly blow precisely at new, high-risk venture capital. Do we really want to cripple these firms and ventures?

We have already pointed to the extra difficulties if flat-taxers pursue their prey to the last ounce and insist on taxation of accrued, and not just realized, capital gains.

It is common knowledge that Great Britain's economy since World War II has suffered grievously from very high levels of income tax. One of the reasons that Britain has not gone completely down the drain is that, fortunately, its government has levied no tax on capital gains, thus allowing many capital ventures to flourish. Our implacable flat-tax Jacobins would make sure to close that loophole.

## Accelerated Depreciators and Investors

But let it not be thought that our flat-taxers are only out to make life difficult for new venture capitalists. The old-line smokestack industries, already in decline, will get theirs too. One of the great problems of the older, heavily capitalized industries is that their profits have not been high enough to permit them to maintain and modernize their capital to allow them to compete with newer firms at home and abroad.

Two highly beneficial tax reforms of the first year of the Reagan administration were (1) allowing investment credit on corporate and personal income tax for investing in capital; and (2) permitting business firms to accelerate the depreciation of their capital at virtually any speed. The investment credit has allowed heavily capitalized firms to keep more of their profits, and invest them in maintaining and expanding their capital.

Now, under the thrall of the flat-tax ideologues, the administration proposes to get rid of its own salutary reforms. Both of them are now derided as "subsidies." But, once again, the investment credit allows people to keep more of their money if used for investment. Neither can one call accelerated depreciation a subsidy. There is no reason why a business should not be able to depreciate its capital at any pace it wants. Its total, long-run tax bill does not even decline; what a business is permitted to do is, instead of extending a depreciation allowance over, say, the ten-year life of a machine, to choose instead to take the entire allowance off now, so as to be able to buy a new machine and pay the same total tax bill out of the returns of the new machine over the next nine years. Accelerated depreciation

simply allows firms to arrange the time-schedule of their payments in the most convenient and efficient ways.

## Owners of Natural Resources

Let it not be thought that owners of natural resources, such as oil, natural gas, and metallic mines, will get off scot free. On the contrary, they will be among the worst losers from the tyranny of the flat-taxers. Economists in general, let alone flat-taxers, have long denounced depletion allowances of natural resource owners as an outrageous subsidy. Since oil and natural gas companies, in the public's folk mythology, are considered especially wicked, this part of the flat-tax creed enjoys wide popularity. Yet, in actuality, apart from the fact that the right to keep one's own money can hardly be called a subsidy, there is another important fallacy in calling depletion allowances a subsidy.

An income tax, by its very name, is designed as a tax on annual income, not on accumulated wealth. A tax on wealth directly confiscates property and brings about a decline in the structure of capital and hence of everyone's standard of living. But then we must realize that if we make the grave mistake of treating a using-up of capital as a firm's income, and tax it accordingly, we will precipitate a decline in its capital structure and impose severe losses upon the firm.

Suppose, for example, that a crude oil company produces and sells oil, and makes a net income from the sale of $100 million. But the oil in its reserves has now been diminished; if we can determine, say, that the value of its underground oil has gone down by $70 million, then the net income of the company has only been $30 million. To tax it as if its income has been $100 million will unwittingly impose crippling losses upon the company. And yet, our flat-taxers, true to form, propose to do precisely that. And the value of stock investments in oil and mineral resource companies will, of course, decline as well.

## Corporations

Lest we think that only the new venture firms and the older smokestack industries will get the axe from our flat-taxers, we should know that all corporations will suffer, for the corporate income tax will increase substantially, to make the tax on a par and uniform with

the tax on the income of individuals. Everything, again, looks neat and "fair," with all individuals and organizations paying a uniform rate.

But if, in the famous Milton Friedman formula, TANSTAAFL (there ain't no such thing as a free lunch), then we can also add the term TANSTAAC (there ain't no such thing as a "corporation"). There is no existing entity called a "corporation" that feels, works, thinks, earns income, and then enjoys that income. A "corporation" is only a label for individuals who organize themselves, and hope to earn income, in certain ways. There is no income-earning thing called a "corporation" that exists and earns income above and beyond the people, that is, the stockholder-owners, who constitute that corporation. Therefore, a tax on corporate income is an unjust and "unfair" (if I may use that term) double tax on the same income, as well as a tax hitting at savings and investment. Instead of raising income tax rates on corporations, as the Treasury plan and the flat-taxers would do, we should move in the other direction, end double taxation, and cut the corporate tax to zero. Stockholders should be taxed just once, on the income they individually earn from the corporate form. Even President Reagan himself had been known to voice such sentiments.

## State and Local Taxpayers

And now we come to a category of losers from the flat tax that I find particularly outrageous, since I live in New York City, where I and millions of other hapless citizens are mulcted into paying the highest state income tax in the nation, the highest city income tax in the country, and the highest sales tax.

After having been chastised for so many years with whips, the flat-taxers now arrive on the scene to chastise us with scorpions. It seems that being able to deduct our massive state and local taxes from our federal taxable income has only been a wicked "subsidy," and so now even that small consolation will be snatched from us.

It goes without saying that flat-taxers are zealots in favor of taxing the interest from municipal bonds—a long-standing goal of liberals in order to aggrandize the power of the federal government as against the states. If municipal bonds are taxed, their value will of course plummet, as will the credit and the power of state and local

government to float bonds. More and more spending will then be centralized in the hands of a super-powerful federal government.

Is that all we really want? I suppose there is no reason to raise the point that federal taxing of municipal bonds is clearly unconstitutional, as would be state taxation of Treasury bonds, for since when has anyone worried about the provisions of the Constitution of the United States?

## The Charitable and the Non-Profitable

One important tax deduction to be swept away would be gifts to charities or other non-profit organizations. Since much charity is now done under the gun of the IRS, the result of the flat-tax would be a drastic crippling of private charitable and educational organizations. Why should giving to charities, the arts, and educational institutions be hobbled and penalized, in the name of "simplicity" and "fairness?" The severe losses of many of these organizations would lead them to turn to the federal government to bail them out, in effect nationalizing private charity and expanding and aggrandizing the federal welfare state. All universities and nonprofit institutions that depend on voluntary giving would be victims of the zeal of our single-minded flat-taxers.

## Victims of Fire, Sickness, and Accident

There are even more helpless victims who will fall under the heel of the flat-taxers. Every man or woman who falls sick and whose medical payments are not insured, will, in flattaxland, be unable to deduct these payments from his taxable income. No victim of fire, uncovered by insurance, will any longer be able to deduct his losses. And so life's unfortunates, run over by accident or disease, will be run over a second time, this time in the name of "equality" and "fairness."

## Entrepreneurial Losers

Some entrepreneurs make profits; others suffer losses. That is the essence of entrepreneurship. While I don't believe that losers should be bailed out or subsidized by the government, it seems like excessive punishment for government to kick them while they're down. But this is precisely what our flat-taxers are planning to do. For while it

is difficult to claim that losses, like profits, somehow constitute net income, this is precisely how flat-taxers regard them: as hidden income to be ferreted out and taxed. We have heard for years about those evil "tax shelters" which "they," the wicked rich, like to indulge in. But mainly these "shelters" are losing propositions, the losses of which partially offset net income in other areas. How can we call such shelters "income"?

I, for example, in addition to being a salaried professor, am a self-employed author and lecturer. Some years, I make a net income from this business, other years I suffer losses. Who are the flat-taxers to come swooping down, and they or the IRS to try to pry into my soul, and announce either that I am a genuine but sometimes losing entrepreneur, or that in my secret heart of hearts I rejoice in my losses because it lowers my taxable income? Are the flat-taxers or the IRS truly qualified to examine everyone's heart and soul and decide on everyone's inner motives? And, in the last analysis, how dare they anyhow?

Let everyone, then, realize that the "they," the "special interests" who will be hurt, and perhaps hurt badly, from the flat tax, are not just a few shadowy and malevolent millionaires.

While it is not really possible to average out pain or loss among individuals and make it disappear, there is every reason to believe that, on the average, upper-income groups will probably benefit on net from the fall in tax rates under the flat tax, whereas the middle class, as usual, will be hit and hit hard. So what else is new?

## The Argument From Fairness

The major argument for the flat tax is not economic but moral, namely that this is the only fair way to distribute taxation. The assumption is that, given an arbitrarily determined total revenue to the government, that revenue should be distributed in a uniform, flat-tax manner.

But the flat-taxers do not really argue their point; they simply assume it as self-evident to all people of good will. Well, sorry, but I don't see it. I don't see why it is particularly "fair" to clobber the sick, the sufferers from accidents, or the homeowners, or why it is fair to impose monetary taxes on earners of non-monetary income.

More specifically, I don't see why proportional taxation is any "fairer" than many other possible patterns of distribution. Take, for example, Mr. A and Mr. B, each of whom earns a net income of, say, $50,000 a year. But Mr. A is a young man, just starting in life, with virtually zero assets. He depends on personal savings to finance a future business.

Mr. B, on the other hand, is an older man who has already built up or inherited millions of dollars in assets. Why is it manifestly fair for him to pay the same tax as Mr. A? Neither is it obvious to me that a sick person with heavy medical bills should pay the same tax as a healthy man with the same income. Note that I am not saying the opposite: I am not advocating a tax on health or on wealth. I'm simply saying that there seems to be no convincing argument for the fairness of one pattern of taxation over another.

In fact, I will go even further, and say that fairness has little or nothing to do with the matter, that, in fact, TANSTAAFT ("there ain't no such thing as a fair tax"). Conservative flat-taxers like to analogize to the free market, and maintain that they are trying to achieve neutrality to the market. But consider: what in the world is a "fair" price on the market?

Many medieval economists came to grief on this issue. What is the "fair price," for example, of Wonder Bread? Who knows? For my part, as a Wonder Bread consumer, I'd love to see the price down to about a penny a loaf, and the Wonder Bread Company would undoubtedly love to be able to charge $100 a loaf. As it is, after the higgling and haggling of the market, we all settle for about one dollar a loaf. There seems to be no sense to the concept of fairness in price except what is arrived at, from day to day, as the result of voluntary transactions on the market.

But what of taxation? Unfortunately, we can't even apply the voluntary transaction criterion here, because by its very nature, taxation is coercive, and is not arrived at by the voluntary bargaining of individuals on the market. So what then is a "fair" tax? I submit that the concept simply doesn't apply.

All I know is that, as a taxpayer, I would like my taxes to be as low as possible. I suggest, then, that we cease the impossible quest for fairness in taxation, and try to arrive at taxes as low as possible. For whom? For everyone.

One of my favorite economists, the nineteenth-century Frenchman, J. B. Say, after pointing out that taxation is a coercive transfer from individuals and groups to the government, crippling their ability to produce and consume, concluded:

"The best scheme of finance is to spend as little as possible; and the best tax is always the lightest." In short, to paraphrase Jefferson, "That government is best which spends and taxes least."

Instead of worrying about distributing taxes "fairly," or what is supposed to amount to the same thing, allocating tax suffering equally, we should set about trying to minimize tax suffering as much as we can down the line. And if we approach the problem that way, we should find it easier to gain broad agreement. Rather than trying to figure out whether a proportional, degressive, regressive, or progressive income tax structure is "fairest," we may find we can agree on reducing the tax burden of everyone.

Thus, let us compare two hypothetical tax systems. In system A, there is a progressive income tax, ranging from one to ten percent. In system B, everyone pays a flat, strictly proportional income tax, of 20 percent. I have a hunch that, in choosing between these systems, even the upper-income groups would opt for the far more progressive, but much lower tax burden. The central point is the lowness of each tax, rather than the distribution of the burden.

People are, or should be, interested in lowering their own tax burden rather than enviously trying to aggravate the burdens of other people. And here is a genuine basis for solidarity among taxpayers of all groups and sizes. The point, then, is not that "they"—whoever "they" are—are paying too little taxes and should be brought to heel. The point is that all of us are paying too much. The flat-tax movement is part of a process by which the government and its allies have been able to split and deflect the tax protest movement from trying to lower the taxes of everyone, into trying to force everyone into paying some arbitrarily defined "fair share."

## The Argument From Neutrality to the Market

An important argument of the flat-taxers, especially those who claim devotion to the free market, is that their plan is needed to restore the allocation of resources to what would have been the pattern on the market: in short, that the flat tax is uniquely neutral to the market.

The argument runs as follows: credits, deductions, loopholes distort resources relative to the free market because more resources go into the loopholes than would otherwise. Thus, an investment tax credit means that more resources will go into investment than would a free market.

Suppose that there are only two industries in the economy, machine tools and wheat. If machine tools receive an investment tax credit, more resources will be poured into machine tools relative to wheat than on the purely free market. Therefore, the tax credit distorts resources, and a flat tax, by eliminating that credit, will correct the distortion and restore genuine market conditions.

But this argument overlooks a crucial point: namely, that even in our simple model, much less in the real world, there is still another channel for the allocation of resources, namely government. In our example, if resources did not go into machine tools because of the special credit, they would have gone not into wheat but into government, and government is far less neutral to the market than any other allocation.

In other words, from the point of view of the free market, any allocation of economic resources in the private sector, whether machine tools, wheat, or whatever, is better, that is, closer to the free market, than those resources going into the maw of government. If neutrality to the free market is really the consideration, then free-marketeers would rejoice with the creation of one more loophole, one more nook and cranny safe from the tax-man. The key point to focus on is private resources *vis-à-vis* government.

It has been completely overlooked that the Reagan administration, while submitting the Treasury flat-tax plan, has at the same time called for further tax credits: for private school tuition and for enterprise zones. Both are laudable, but both are completely opposed to the flat-tax concept.

There is another important point about neutrality to the market, one which also speaks to the fairness issue. The flat-taxers have strongly implied that, in contrast to the progressive tax, the uniform proportionate tax is neutral to the market—for the market would pay in this way for the services of government. But would it really? Where on the market is the price of anything proportionate to the income of the customer? I pay approximately one dollar a loaf for

Wonder Bread; if and when David Rockefeller goes to the market to buy a loaf of Wonder Bread, is he forced to pay one million dollars a loaf—or whatever the proportion would be for our respective annual incomes? One of the great things about the market is that every good or service tends to be at one price: regardless of the race, creed, personality, or income of the customer.

## The Argument From Simplicity

Perhaps the most seductive argument of the flat-taxers is the argument from simplicity: that, in contrast to the maddening complexity of today's tax code, a code that even the IRS itself cannot fully understand, the flat tax would be simplicity itself. Everyone, they promise, would be able to make out their income tax "on a postcard."

But in the first place, it wouldn't be that simple. We would still need a complex process to determine what our net, taxable income might be. Those of us who are self-employed would still have to figure out our expenses and net incomes. But let us set that aside. What the flat-taxers don't seem to realize is that there are worse things in the world than complexity. And one of them is paying higher taxes. In short, they don't seem to understand some of the reasons for all the tax complexity.

The reason is that many people are willing to wade through a great deal of complexity in order to lower their tax burden. So that, in a sense, given the tax system, much of the complexity that everyone denounces is voluntary. In fact, if we desire simplicity, we can achieve it right now, and without the flat tax. Two-thirds of Americans do so now by filling out the simple short form for their taxes. The one-third of us who choose the wearying long-form route do it for one reason alone: to lower our tax bills. Why in the name of simplicity, are the flat-taxers trying to take this choice away from us? Let them keep their gift of simplicity to themselves, thank you.

One variant of the simplicity argument proved so alluring to a friend of mine that he was almost persuaded by the flat-taxers: the promise that the flat tax would get rid of what are apparently one of the most disliked groups in our society: tax lawyers and accountants.

Apart from the fact that the flat tax would still require a lot of cogitating over net income, let me be one of the few Americans to put in a good word for this much vilified and beleaguered group.

Denouncing tax lawyers and accountants is like blaming doctors for the existence of disease, or attacking expenditures on guards, locks, and fences for protecting oneself against crime. Our complaint should not be with tax lawyers and accountants, but with the system that makes them necessary. So long as that system exists, we must realize that they are our shield and our buckler, our defense against the depredations of the tax system.

## REVENUE-NEUTRAL?

It is now time for us to relax the original assumption that I granted the flat-taxers: that their plan would be and remain revenue-neutral. Even if the flat tax would not raise total revenue immediately, who here is naive enough to believe that the government will sit still for long for revenue-neutrality?

The government may be willing to lull us into a false sense of security by promising no increase in total revenue. It doesn't mind cutting tax rates a bit temporarily, for the sake of bringing more revenue sources into its clutches. It is worth a lot to bring previously sheltered hiding places into the grasp of the federal government. I can make that point most dramatically by pointing to the fact that eminent left-liberal economists like Walter Heller champion the flat-tax plan. We might almost point to a picture of Professor Heller, and ask: why is this man smiling? He is smiling because, as he has frankly written, the cut in present tax rates is worth the broadening of the tax base, that is, the bringing of previously exempt income under the grip of federal taxing power.

## THE TERRIBLE SIMPLIFIERS AND THE "GENERAL INTEREST"

If the flat tax is neither evidently fair not genuinely simple nor neutral to the market, if it is merely a snare and a delusion for more confiscatory taxation, it is easy to understand why politicians and bureaucrats may love the idea. But why the enthusiasm of the intellectuals—the alleged spokesmen for the "public" interest? The answer is that the intellectuals may well have a "special interest" of their own.

Jacob Burckhardt, the great nineteenth-century Swiss historian, referred to many of the intellectuals of his day as "terrible simplifiers." What he meant is that many intellectuals, right, left, or center, are

opposed to the messy individuality, the untidy diversity of real life. It is an occupational disease of intellectuals to simplify the reality of people, of other people that is, in order to try to understand them. And so intellectuals like to pigeonhole their subjects—other people—into neat, orderly, and simple categories, and to classify and then deal with them in neat and orderly ways. From that way of thinking is an easy step to classify and then treat people as mere pawns to be pushed around.

To do so, the intellectual turns to the secular arm—that is the enforcement power of government—to do the pushing. Intellectuals, in short, are all too often terrible simplifiers, willing and eager to impose massive and painful losses upon other people for the sake of symmetry, uniformity, flatness, or some other simple and abstract ideal. The nature of the creed, the specific content of the ideal, is not nearly as important as the eagerness to override and bulldoze out of existence the diverse and rumpled reality of individual life. We have, alas, come to know in the twentieth century that totalitarianism can have many faces.

When the Regan plan toward a flat tax was announced last fall, an anonymous White House aide attacked the proposal as one "that looks like a tax system designed by a lot of academics." And a leading New York broker charged that "those guys at Treasury are tax lawyers, assistant professors, or statisticians. They have no understanding of what makes an entrepreneur tick."

Indeed, the main designer of the Regan plan, a former academic, proudly proclaimed his lack of realism. Admitting that the plan was written "in an ivory tower," he declared that "one nice thing you get from the ivory tower, is that you get opinions that tend to be unbiased, that are not affected by special interests, that have the public interest in mind." I hope that we will now begin to treat such arrogant claims with the skepticism they so richly deserve.

# 28

# The Uneasy Case for Degressive Taxation: A Critique of Blum and Kalven

We must all be grateful to Professors Walter J. Blum and Harry J. Kalven, Jr. for providing in a brief space a cogent review and critique of the various arguments for progressive taxation, together with an extensive and valuable bibliography of the varying points of view. We must also be grateful to discover a serious monograph that rejects progressive taxation as such, although it does support a form of such tax which the authors label "Depressive." Unfortunately, that is as far as one can go in granting this important article unqualified support. For its argument is shot through with errors and omissions that need to be carefully sifted from its valuable contributions.

A discussion of taxation is perhaps unique in that it involves fundamental problems in economic theory, political philosophy, ethics, and constitutional law. Taxation cannot be, or, at least, has not been presented as a pure economic problem; it has been tangled with problems of justice, politics, etc. In addition to its involvement in several social science and philosophic fields, it is by its nature a highly controversial field, especially when an author pronounces a value judgment on the type of tax which should or should not be

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This is an unpublished manuscript from the Rothbard papers, written in 1952 for the Volker Fund. In a letter to the Volker Fund's Herbert C. Cournuelle, on August 18, 1952, Rothbard gave his reasons for writing about the Blum and Kalven essay: "[I]t is certainly an important one. . . . However, it is decidedly an article of mixed quality, containing many errors and significant omissions. Because of this, I am at present engaged in writing a detailed critique of the article." The article is Walter J. Blum and Harry J. Kalven, Jr., "The Uneasy Case for Progressive Taxation," *University of Chicago Law Review* 19 (1952): 417–520.

levied. The entire existence and power of the State is wrapped up in the taxation question. It is therefore likely that any article in the field of taxation, especially when its facets have been traditionally treated fallaciously, is bound to be susceptible to numerous errors and pernicious judgments. This article is no exception, and its importance requires it to be measured in detail against the yardsticks of sound economic theory and individualist political philosophy, both of which are involved in the subject of taxation. Since the authors advocate a system of "Depressive income taxation" (proportional income taxes above the minimum subsistence level), they leave themselves open to criticism in both areas.

First, in their discussion of progression the authors fail to consider any other tax than the income tax. The authors recognize that income is not the only base for tax rates: saying "either capital or expenditure could be used." And then they simply and dogmatically state: "The income base, however, appears to offer the best framework for analysis of the case for progression" (p. 419). On expenditures there is only a footnote declaring that a progressive tax on the consumption of milk would be "regressive as measured by income or wealth." Presumably this is enough to damn all further consideration of a spending tax. Indeed, on the same page, the authors make the usual arrogant assumption that "no one" could possibly favor a regressive tax structure.

> The rate of tax . . . may be graduated downward with income and thus be regressive; under this pattern a man with ten times the income of another would pay something less than ten times the tax. It is so clear no one today favors any tax because it is regressive. . . . A regressive tax on income is not a serious alternative.

This casual dismissal of regression is one of the major defects of the entire article. After brusquely dismissing regression, the authors quickly go on to another pernicious assumption: "It is almost unanimously agreed that some exemption keyed to at least a minimum subsistence standard of living is desirable." Again a spurious unanimity is invoked as a means of avoiding reasoned discussion. Such an exemption is by no means obvious; in fact, it is difficult to justify such an exemption at all. Why should the able be especially penalized, and the less able especially privileged? Suppose further the minimum subsistence level is $2,000, and the proportionate tax above

the minimum is 20 percent. A man who makes $2,000 a year would pay no tax at all, while a man who makes $2,500 would pay $100. If we grant for the moment that governmental activities are worthwhile, then it is difficult to see why a man slightly above the minimum should subsidize government activities for a man slightly below the minimum.

Blum and Kalven admit that their proposed "Depressive tax" (proportionate income tax above a minimum subsistence exemption) is in reality a form of progressive tax. Despite their attempts to distinguish between the two forms, and despite the lesser severity of this tax, the fact remains that Blum and Kalven's arguments against progressive taxation only result in their own advocacy of a form of progressive taxation.

A further result of minimum exemption—admitted by the authors—is that a tax-earner with a large family pays less than one with a small family—since the subsistence exemption is larger for the former. Under what principles of justice must bachelors pay to subsidize someone else's prolific breeding?[1] This injustice is part of the larger issue—that any compulsory tax of a more able group to support a less able and more "needy" group is pure highway robbery. It is highly significant that, in an article which devotes much attention to "justice," the robbery aspect of progressive taxation is only barely mentioned, and then in a very unsatisfactory fashion (see below). In the first part of the article dealing with objections to progressive taxation, this key issue is not discussed at all.

There is of course a further objection, which will be treated below, that there is no possible way of setting a "minimum subsistence level" except purely arbitrarily, and that setting exemptions at some other level, as the authors admit, merely brings the system right back to unadulterated progressivism.

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With this inauspicious beginning, the authors set out to examine the arguments against progressive income taxation. They begin with the constitutional argument. Here the sound constitutional objections

[1]Such a subsidy aggravates its own problem, and becomes self-cumulative, by encouraging larger families among the poor.

to a progressive income tax are rudely brushed aside. As in other cases, the authors' review of the history of the subject is useful and interesting, but the position that they uphold is the wrong one. They sneer at the great Pollock decision of 1895, that the income tax is a direct tax. Of even greater importance is the great argument of Justice Field, which they quote, that any progressive or Depressive income tax law violates the constitutional clause requiring uniformity of tax and also violates the Fifth Amendment's due process clause. The authors recognize that the adoption of the Sixteenth Amendment by no means disposed of the constitutional issue, since this amendment did not supersede the uniformity or due-process clauses. They recognize the enormous ignorance of Chief Justice White's Brushaber decision in 1915, which validated the income tax law on erroneous grounds, and which has never been added to or challenged thereafter. Yet, despite this, and despite Hackett's brilliant arguments attacking the constitutionality of progressive or Depressive taxation, the authors simply conclude in one of their offhand statements: "the result seems clearly sound on constitutional grounds" (p. 427).[2]

Blum and Kalven next launch the body of their article devoted (a) to general objections to progressive taxation, and (b) to the arguments in its favor.

In the objections to progression, they fail to mention one of the fundamental ones—that it is unjust highway robbery, especially flagrant since they deal with questions of justice in the course of the discussion.

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[2]This section gives interesting legal references for and against the constitutionality of progressive taxation, such as the Hackett article. They summarize the arguments on state progressive inheritance taxes, without taking sides, but it is clear to this writer that Justice Brewer's dissents on the basis of uniformity and violation of the Fourteenth Amendment, destroying all progressive taxes, were magnificent. The majority decisions by Justice McKenna and Chief Justice White are clearly sheer sophistry. We shall also be interested to read what the authors call one of the most bitter attacks ever made against progressive taxation—the article by David Ames Wells in the 1880 *North American Review*.

The first objection they consider is administrative complications. The authors endorse this objection, and there is little to add to their discussion.

The second objection considered is the basic one that under it a majority can use their ballot power to confiscate the income of a minority, a power limitless under progressive taxation. Blum and Kalven brusquely dismiss this valid objection by merely saying that "majority rule . . . is superior to any other principle for resolving group decisions." And not to agree with this preference for majority rule "is to reject democratic self-government." This is simply a sneer. In the formal sense, all government rests on majority consent. However, to protect the rights of the individual, general and prior majority consent to a rigid constitution that severely limits the powers of government is a far better guarantee than constant reliance on the good sense and discretion of the elected "people's representatives." If this is antidemocratic, so much the worse for "democracy." In a footnote, Blum and Kalven make their argument absurd in their attack on the antiprogressive argument of W.D. Guthrie, by asserting that Guthrie's fears of confiscation "have not been realized in practice" and that these are "fanciful dangers." Their argument consists of an extended quote from Seligman: it is perhaps excusable for Seligman to have made these remarks in 1909, but for Blum and Kalven to rely upon them in 1952 flies in the face of the confiscation ruling in the world today.

Their hopeful citing of the Knutson tax reduction of the Eightieth Congress as an example of the majority's ruling reducing taxes clearly backfires; this "reduction" was a piddling one, and was quickly reversed. The fact that the authors favor restrictions on the majority in the area of free speech and religion makes incomprehensible their accusations of "antidemocratic" against those who wish to place further necessary restrictions on government.

The third objection to which they turn is a crucial one—that the progressive income tax destroys the capital structure and the standard of living of society. Here, Blum and Kalven do a truly abysmal job. They claim that the effect is really "in the realm of conjecture in psychology," and attempt to use the fact that low taxes are better than high taxes to absolve progressive taxation from the guilt involved. They soft-pedal the effect of progressive taxation on incentives to work with the canard that money only really matters "as a

symbol of prestige or success," and that, therefore "Progression does not impair this incentive since the highest income is still the highest income both before and after taxes however high the marginal rate of tax." They quote with approval the ridiculous assertion of Simons that "our captains of industry are mainly engaged, not in making a living, but in playing a great game." Furthermore, they even give credence to the notion that the higher the tax rate, the greater the incentive to work in order to maintain the "net position after taxes."

On the effect of progression on capital formation—a key consideration—they are equally unsatisfactory, backing and filling between the different positions. At one point they will recognize the destructive effect on capital, and a few paragraphs later, they vitiate with doubts, uncertainties, and such inane remarks as the following: "And it may well be that a sufficient group in the society will be disposed to gamble whatever the odds"; "It cannot be taken for granted that the discouragement of the most risky enterprises is, at our present level of technological development, an unqualified evil"; and "It seems equally plausible that the lower effective rates (of return on savings due to a progressive tax) will induce some persons to consume less now and to save and invest more in order to maintain their incomes after taxes at desired levels in the future."

Blum and Kalven conclude by deciding that the effects on capital and work are merely "highly indeterminate." They go on to insist that even if the effects are to destroy capital, "it would take an extremely drastic rate of progression and very high taxes to endanger the existing accumulation of capital," as if the present rates are not drastic! And if it merely restricts further growth of capital, after all, "at some point it is reasonable to question the wisdom of society in always continuing to postpone present consumption for the sake of greater consumption tomorrow." They deprecate the objections to progression on these grounds offered by Lutz and Jundson, and cite favorably such absurd arguments as Simons's that the "cost of our present stock of productive instruments was . . . decades and centuries of terrible poverty for the masses," and Edgeworth-Pigou's that enforced equality really "increases productivity" because of the "improved morale" of the poor, etc., etc.

Blum and Kalven conclude this most unsatisfactory section (pp. 437–44) by asserting that productivity, even if it were clearly injured by progression, is not overriding, because a tax system promoting

savings would be "a regressive tax system" which they blithely consider unjust without further discussion. It is interesting to note here that Blum and Kalven add a footnote dealing with Beale's (and Fisher's) suggestion of a progressive spendings tax as a way of keeping progression without impairing capital.

Instead of coming to grips with this issue, they merely dismiss the spendings tax (even a progressive one) by saying: "Such a tax would inevitably be somewhat regressive at the higher levels of the income scale."

The net effect of Blum and Kalven's backing and filling on this issue is to dismiss this objection to progression. They conclude this part of the discussion with a quotation from Simons. They cite this quotation with approval, but it is so bad that it deserves quoting at length:

> If we deliberately limit the degree of progression, out of regard for effects on accumulation [of capital], we are in effect removing taxes from those who consume too much and transferring them to classes which admittedly consume too little; and against the additional capital resources thus painfully acquired are mortgages, property rights, in the hands of those freed from tax. While the saving will really have been done by those at the bottom of the income scale [presumably because they have abandoned progression for proportionate taxation], those free from tax and their assigns will enjoy the reward. This method of fostering increase in productive capacity thus increases the concentration of property and aggravates inequality. . . . [T]he scheme looks a bit like taxing small incomes to reduce consumption in the hope that those relieved of tax will save more after consuming all they can, and then allowing 1 per cent to those who have really done the saving and 4 per cent to those who have served merely by paying smaller taxes.

It is not surprising that the authors conclude by stating that the objections to progression are "far from conclusive."

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Having begun the article by basing their discussion on several fallacious assumptions, Blum and Kalven treat the case against progressive income taxation in a manner which ranges from omission of important elements to confused backing and filling to outright acceptance of fallacious and antifreemarket arguments. The valuable

parts of the article so far (some biographical references, historical sections, and treatments of administrative confusion due to the tax) have been so brief as to be overshadowed by errors.

Blum and Kalven next turn to the major part of their article: a critique of the arguments for progressive income taxation. They turn first to the argument that this type of tax helps maintain a high, stable level of economic activity. One such approach is that of Mints-Friedman-Simons, who hail the fluctuations in income tax receipts with changes in economic activity. A progressive tax increases the effective tax rate under inflationary conditions and reduces it in a depression. Blum and Kalven unfortunately agree that "there is now general agreement that it is altogether appropriate for the government deliberately to operate with an unbalanced budget whenever significant inflation or deflation is taking place"; that is, to have a surplus in a boom and a deficit in a depression. Blum and Kalven obviously support this fallacious point of view, but are inconclusive on this argument, inferring that the progressive features of the income tax law does not add so much to this feature that it cannot be eliminated.

The second such approach is the Keynes-Hansen mature-economy approach, which supports progressive taxation in order to boost consumption as compared to savings. Their critique of this approach is rather weak; they do not point out that depressions are never caused by "under-consumption," and therefore cannot be relieved by such measures—quite the contrary. Their main argument is that stagnation does not exist so that such a remedy need not be adopted. Finally, they advocate, to counteract temporary depressions, lowering taxes uniformly while maintaining government expenditures. Thus although some of their criticism of the Keynes-Hansen position is valid and useful, it is unfortunately weakened by various concessions.

Having thus disposed, though not very decisively, of the stability case, the authors turn to the taxation arguments based on justice. There are three criteria or principles to use as bases for levying taxes: benefit received, costs incurred, and ability to pay.

They first turn to the benefit principle—that people should pay taxes to government in accordance with the benefits they receive from government. The benefit principle is not a wholly satisfactory one, but it has much merit, especially as compared to the "ability-to-pay" doctrine. According to this theory, for example, the users of

roads are taxed on their gasoline purchases in order to pay for the upkeep of roads. The authors seem to favor benefit taxation in many cases, such as these, where the benefits may easily be traced. In such cases, however, it is difficult to understand why (assuming the government should operate them at all) these services should not be priced and have their expenses paid solely by their customers. Thus, the users of the post office should be the ones to pay for the service, the users of parks to pay for the parks, etc.

Blum and Kalven next proceed to those expenditures where benefits allegedly cannot be definitely traced. Here they are at their best in destroying the fallacy that benefits to property owners increase either proportionately or progressively with the value of property protected (pp. 452–53). This "benefit" argument for progressive (or proportionate) income taxation rests on the fallacious "tax as insurance-premium analogy." They point out that such property-protecting outfits as police, army, and fire fighting, do not benefit the owners of property according to its value, and indicate particularly that owners of intangible property benefit far less than owners of real estate. Furthermore, they agree that the services of government in defense of persons is alike for all individuals, and add that the amount of police and army necessary to protect persons are probably adequate to protect property as well.

Yet, inconsistently, Blum and Kalven approve of Mill's attack on a proposal for equal poll tax on all persons and a proportionate tax on property, which stated: "it is not admissible that the protection of persons and that of property are the sole purposes of government. The ends of government are as comprehensible as those of the social union"—the authors add that mere protection is "only a small fraction of the total services performed by government" in a "modern state." But this is just the point. Individualists believe that this is the maximum of service that the government should bestow—that this is the only field where government is competent to perform service, and the only field in which justice permits the government to be active. By adopting Mill's vague statist criterion instead, they abandon individualism, and they abandon the only field in which government—the organization of force—is competent; instead they adopt the philosophy of collectivism.

Blum and Kalven dispose of the very useful "cost principle" in a footnote: "sometimes the theory is stated in terms of the cost of the

government services performed for each citizen rather than in terms of the *benefits* received from such services." The authors' only comment is, "This refinement may avoid the need of measuring subjective benefits, but it does little else for the theory." This is their sole comment on the *cost principle*. Yet the cost principle is very different and far superior to the benefit principle. In the first place, it is a great advantage that it does not have to measure subjective "benefits." Benefits are purely subjective, and can never be measured, and the fact that some of the best parts of this article are devoted to criticizing "equal sacrifice of utility" theory precisely on this ground makes it even stranger that the authors did not examine the cost theory in more detail. Indeed the impossibility of measuring benefits is also a strong argument against the spendings tax mentioned above, since money-expenditures are not a criterion of psychic benefits.

The cost principle levies the tax on the most accurate estimate of cost of the operation to the government. Services such as the post office, for instance, would be priced on the cost principle, although individualism would eliminate these wasteful, monopolized services entirely. The police-army services of defense of person and property would obtain its revenue (a) from fines on wrongdoers, and (b) from taxes according to cost levied as equal poll taxes on each person under protection; and approximately proportionate to acreage on real property policed. All services on the free market are priced according to marginal utility (which, in turn, sets costs); if it is just for *all* consumers, regardless of wealth or income, to pay *one price* on the market for all these services—food, autos, etc.—why is it not just for all receivers of government protection to pay equally for the same service? Since there is no free market for protection service, a tax levied on the basis of cost is the best approximation to the free-market ideal of one good, one price.

Furthermore, the benefit principle has the unjust feature that those who benefit more must pay more; why should a man be punished because he is happier? The cost principle—based on equal price for equal service—avoids this problem.

In the course of their keen analysis of the benefit principle, the authors successfully attack all phases of the benefit arguments for proportion and progression. As a matter of fact, they point out, with Mill, that the poor and the unpropertied probably benefit more heavily from government police protection than the rich, who could pay

for their own private protection. "If there were any justice, therefore, in [the benefit principle] . . . those who are least capable of helping or defending themselves, being those to whom the protection of government is the most indispensable, ought to pay the greatest share of the price." Thus, under the benefit principle, a poor man would be taxed more heavily than the rich. The cost principle is not open to this objection— since it taxes absolutely equally for any service rendered, regardless of the subjective benefits rendered to each of the consumers.

Blum and Kalven add with horror that the benefit principle would require the specially privileged "underprivileged" who receive welfare subsidies from the government to be precisely the ones to be taxed for their payment. On the contrary, here is one case where the rigorous application of the benefit principle would quickly end agitation for these statist schemes.

Thus, Blum and Kalven retain the benefit principle only where benefits are directly traceable, and the benefits are not "a consequence of deliberate welfare measures." On the contrary, the benefit principle should be retained only in cases of "welfare measures" and all other subsidies to specially privileged groups.

The authors' section on the benefit principle thus contains much keen analysis, but is vitiated by concessions to collectivist and "welfare" philosophy and neglect of the cost principle.

Blum and Kalven next proceed to the "equal sacrifice" criterion of taxation. They make the interesting assertion that this approach treats taxes as though they were a confiscation of property, and "the problem then becomes one of confiscating in an equitable manner." Since this approach toward taxation is quite realistic, it is unfortunate that Blum and Kalven did not raise the obvious question at this point: Why assume that there can be such a thing as "confiscation in an equitable manner"? If taxation confers no benefit, why tolerate taxation at all?

It is clear that this assumption places the entire "equal sacrifice" theory in a highly curious position, and although Blum and Kalven do not pursue this position, it is one of their great contributions that they highlight the fact that "sacrifice theory"—which has loomed the largest by far in all discussions of taxation—rests basically on this taxation-as-harm assumption. As they put it, "An equitable apportioning

of sacrifice requires inflicting equal hurt on each taxpayer." To a thoroughgoing individualist and libertarian, this basic goal of the sacrifice theorists reveals the utter absurdity of their position. Instead of worrying about what constitutes "equal hurt," why inflict any hurt at all? Why tolerate an institution that represents only pain and injury, and then try to find some sort of "equitable means" of spreading it around? The entire concept of "just and equal" in suffering is an absurdity.

Setting aside this point for the moment, we return to Blum and Kalven, who proceed on a lengthy and generally very valuable analysis of the various attempts at measuring "equal sacrifice." This is generally an excellent section and provides valuable analysis and bibliography of the different points of view. This is probably their outstanding contribution.

They analyze the "utility curve" of money and its components, and clarify the different contentions. Best of all, their final devastating attack on the whole "utility of money" analysis as a basis for taxation rests on the Mises-Robbins contention that utility cannot be measured, and therefore cannot be compared between one person and another. They recognize that utility is an ordinal concept, and that therefore "the whole elaborate analysis of progression in terms of sacrifice (disutility) and utility doctrine finally collapses." (It is unfortunate that this conclusion is marred slightly by an absurd footnote quotation from Pigou attempting to deny this.) They point out that the analysis rests on an attempt to measure utility and disutility by the amount of money income, and to compare diminishing marginal utility of money between persons.

Their main error in the course of this sacrifice analysis is their preference for the "proportionate sacrifice" standard over the "equal sacrifice" standard, although it is one of their great merits that they have brought the distinction between the two concepts into clear focus. They prefer the former (although finally discarding both) because the latter is "regressive" in income taxation, although most economists have preferred the equal-sacrifice principle. If we assume for the sake of argument that utility can be measured in units, and compared between persons, the equal-sacrifice formula states that each individual should give up an equal *percentage* of his total utility derived from money. It should be clear to all that the former is more just; at least it preserves some sort of equality before the law that is

a requisite of individualism. The proportionate criterion is the reverse of justice; why should one man sacrifice more units of utility just because the market has made him richer than the next man? This is clearly unjust discrimination and confiscation of the rich. Yet, Blum and Kalven reject the equal-sacrifice principle because it is regressive; a man with $10,000 income would pay more than a man with a $5,000 income but *less* than twice as much. This is all part and parcel of the authors' continual preference for proportionate taxation and horror of equal taxation or "regression."

In the course of this discussion, Blum and Kalven advance their only argument for the proportionate formula in general—that it is "neutral" as compared to the distribution on the market; all people are equally worse off as a result of the tax. And they indicate on page 461 that their rejection of proportionate sacrifice on grounds of immeasurability of utility leaves them with proportionate income taxation on grounds of its "neutrality." The question arises: Is a proportionate income tax best because it is neutral with respect to the market?

At first blush, this argument is superficially appealing. If a tax of 10 percent is levied on all incomes, is not the market distribution left untouched? Each has 10 percent less income after taxes than before. This argument, however misinterprets the nature of the market and "neutrality" toward it. The question should be: How are all prices of goods set on the market? They are set on the basis of one price for each good, *regardless* of the incomes of the people on the market. A pound of butter costs the same to a poor man as to a rich man. Yet this one-price system is considered just, especially by writers like Blum and Kalven who claim to support the market process. It would be considered unjust, and rightly so, if the rich were penalized for their wealth by being forced to pay more for every service than a poor man. Equal price for equal service—discrimination against neither rich nor poor—is the rule on the market. Therefore, if it is the rule of justice to be neutral with regard to the market, then taxing will take place as nearly as possible on a *market basis*; it too would *tax each person equally*. If the government taxes the rich more heavily—in amount, not in "proportion"—than the poor, it is not being neutral; it is introducing a principle of charging, which is foreign to the market.

There are several gems of analysis contained within Blum and Kalven's critique of sacrifice theory. There is the "customary sacrifice" contention of the Stamp which highlights the impossibility of measuring subjective sacrifice; and there is the greater chance of going wrong under progression; there is excellent critique of the Pigou argument for progression based on conspicuous consumption. The authors demonstrate that this Veblenian evil is likely to be more widespread among the middle classes than among the "rich."

A third type of sacrifice theory which the authors analyze is the "minimum social sacrifice" theory of Bentham and others. This assumes some sort of "maximum quantity of social satisfaction," and, of course, makes the same error in assuming measurability of interpersonal satisfaction. The minimum social sacrifice doctrine is, of course, completely vicious—it disposes of all equality before the law or neutrality concepts—and demands what amounts to outright leveling of incomes and confiscation of higher income groups and subsidizing of lower income groups. Aside from considerations of justice or productivity, the fundamental criticism is that sacrifice cannot be measured between persons by simply comparing income. Furthermore, the utilitarian principle of minimum sacrifice assumes that it is the state's function to allocate happiness between persons, which would be vicious even if it could be accomplished. The authors rightly footnote Simons's remark that on the minimum-sacrifice doctrine, those with a greater capacity for pleasure would be taxed less than others—a curious doctrine to say the least. The authors' rejection of the formula, however, is not as strong as it might have been. They concede too much to its being a "variant formulation of the question for the common good or the common welfare."

In the general argument against a measurable diminishing utility of money, the authors are wrong in indicating that the utility of money does not really diminish. It does diminish as the stock increases, but the crucial point is that this decrease cannot be measured, and here the authors are correct.

After disposing of the sacrifice theories, the authors turn to the next principle of taxation, the "ability to pay." They point out correctly that, in general, the term "ability" is simply the converse of the sacrifice doctrine, *the ability to bear a sacrifice*, which also cannot be measured. Again, however, their treatment is marred by an acceptance of proportionate income taxation as being properly commensurate with

ability to pay. The authors fail to proceed further to a critique of the ability-to-pay principle itself. This "principle" is simply that of the highway robber, who takes as much as he can. It is a curious form of "justice" for the state to pursue in taxation.

Blum and Kalven are at their best in an excellent critique of the Seligman argument for progressive taxation, based on the absurd theory of "faculty" of earning money. They also have a fine critique of Hobson's proposal to tax "surplus" economic rent, and of Peck's peculiar plan to tax consumer surplus.

The authors next have a fine critique of the "moral consumption" ideas involved in arguments for progression.

Finally, Blum and Kalven turn to consider the argument that progressive taxation is good simply because it brings about greater economic equality; this is the Henry Simons position. If egalitarianism should be pursued as a policy, progressive taxation is one way of achieving the goal. The authors assert that if Henry Simons rests his case simply on a value judgment that equality is good and is an ultimate one, there can be no further discussion. They fail to recognize that the infinite variety and inequality of talents among human beings makes the goal of egalitarianism absurd and antihuman, better suited to an ant-heap than to human society.

In treating the socialist-communist arguments for progression, it was not necessary for Blum and Kalven to levy an implicit insult on Lutz and Crotty for maintaining that advocates of progressive income taxation are unwitting collaborators of socialists and communists. This charge may not be pleasant, but it is true, and it is out of order for the authors to call this "the rhetorical possibilities of guilt by association" (p. 489).

Passing over the socialist and the Simons position, the authors ably point out that the case for equality rests at bottom on sheer envy, is certainly a gross injustice as a foundation for political policy, and state that envy can certainly not be eliminated even by enforced equality.

Blum and Kalven then keenly examine the "general welfare" argument for progressive taxation. They point out brilliantly that (a) welfare can no more be measured than utility or sacrifice, and that (b) even if it were, such taxation would benefit one group at the expense of another, and that, therefore the welfare considered *not*

general, but special. The authors also point out the difficulty that the egalitarians have with the government—shall the confiscated money be spent by the poor or by the government? Increase in government expenditure may be highly undesirable and lead to a loss in consumer freedom.

The authors next have an excellent critique of the "democratic" argument for equality. This is the Tawney-Lasswell contention that democracy cannot work well if incomes are too unequal, and equality will ensure against revolution. Against this familiar theme song, the authors set Edgeworth's observation, that there may be more danger in whetting the appetite of the poor and thus precipitating revolution, aside their own contention that the money route to political power is far better than status-routes dependent on heredity, caste, and military prestige. Here the authors rely also on some apt statements by Wright. They also dispose rapidly of the inane "money power" and "private sovereignty" arguments against the rich.

Finally, the authors dispose in admirable fashion of the "moral reform" argument for equality, based on the "sense of fellowship" that would ensue. Rivalry would only be shifted to other, more unpleasant areas. The argument could be much stronger here, however; money differences in the ultimate analysis are the main thing that binds man in a sense of fellowship rather than the reverse. These money differences arise from the peaceful cooperation of the market, and it is only as a result of such peaceful cooperation, as Mises has brilliantly pointed out, that any sense of fellowship can emerge. The authors are to be commended for their footnote by Sharp that a sense of fellowship through equality can be highly dangerous and lead to rule by dictators and mobs.

Blum and Kalven conclude by denying that economic inequality is in itself a good, and assert that past arguments that a wealthy group is needed to be the culture bearers of society are now outmoded by universal education. We must differ strongly; universal education has in fact led to a general degradation of cultural and educational standards. It is still true that only a small elite are culture-carriers; although the spread of universal education has made this elite harder to distinguish and to discover. This elite is certainly not identifiable with the wealthy; but it is still true that the wealthy are far more likely to recognize and patronize the elite than are the masses.

Having disposed of the case for economic equality, the authors return to the other side of the coin—the question of whether or not the market's income distribution is a just one. If it is, then the perniciousness of attacking the unequal distribution of income resulting from the market is evident.

The authors first ably point out that even if there is undeserved income on the market due to monopoly and fraud, there is no correlation of *undeserved* income and *total* income and therefore no case for progression. The authors err seriously, however, in (a) attributing monopoly to the market—undeserved monopoly income is attributable to state deviations from the market; (b) treating fraud and duress as part of the market—these too are antimarket phenomena and are illegal; (c) treating shifts in the value of money as causing unjust income rewards—this is only another market phenomenon and no more unjust than any other change; and (d) treating luck as leading to "undeserved income." In the first place, luck cannot be legislated, and second, it is usually the able and enterprising that can take advantage of the luck that comes their way. Each person is equally liable to be confronted with good or bad "luck."

Having disposed of the unjust reward argument, Blum and Kalven do a very fine job in probing further the arguments of the anti-inequality writers. They show that some really base their position on abandonment of all personal responsibility. In this amoral and monstrous view, the able are not to be rewarded because they are not responsible for their talents, and the criminal not to be punished for the same reason. Upheld consistently, this view is antihuman and anti-individualist in the deepest sense. Blum and Kalven do well to attack this deep-seated modern doctrine.

Also, they show that it is nonsense to use the fact that modern production requires division of labor and cooperation to say that therefore no one's rewards can be separated from another's. The authors point out rightly that this separation is precisely what the pricing process accomplishes.

In their final argument, Blum and Kalven consider the argument that the market, in dispensing monetary rewards, does not rate "the whole man," and that perhaps the state should redress the balance. Here, the authors are curiously inarticulate. They merely state that this argument is rarely formulated. They admit in a footnote that the market is not the only rewarder in society, that, for example, there

are nonmonetary markets such as friendship in exchange for praiseworthy qualities, which appraise these other qualities with which the market is not concerned. Yet they seem to favor this argument by implying that the progressive tax provides a useful method for society to review and change the market's distribution of income. The market's rewards are monetary for contributions that can be appraised in terms of money; what justification is there for the state to alter this monetary pattern? If market monetary rewards are just, as Blum and Kalven admit, the contention that they still should be "reviewed" through progressive taxation is an absurd one. Yet, nonmonetary contributions continue to be rewarded in nonmonetary ways.

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Thus, Blum and Kalven began their article unfortunately. Each of their basic assumptions was fallacious, and their treatment of the arguments against progression unsatisfactory. However, we have seen that the great value of their article lies in most of their critique of the arguments for progression—particularly, the sacrifice, ability, and equality arguments. Much of their analysis in this part is of a high order. The merits lie, however, not in any arguments for "degression" but in the arguments against progression.

It is unfortunate that, after concluding the critique of arguments for progressive taxation, the authors should slip back into much fallacious argument in their discussion of "equality of opportunity" and inheritance.

They first make the flat statement that rewards cannot be considered just "unless the contestants start from the same mark," and they continue with a quotation from Tawney that the "game" is not fair "if the rules of a game give a permanent advantage to some of the players." Also, equal opportunity will develop individual talents best.

This position completely misconstrues the nature of the market and of society generally. Blum-Kalven-Tawney err in considering human life and action some sort of "race" or "game," where each should start in an identical position. Life is not a race, but an attempt by each individual to be as happy as possible. Since the world has not just come into being, it is absurd to decree that everyone should "start" the same. Each individual's "reward" for his industry, foresight, and saving consists of property which it is his right to dispose

of as he sees fit. This disposal includes, certainly foremost, the right to accumulate and give to his children. It is an absurd and pernicious doctrine of "justice" that each child should "start" absolutely equally. It is an anti-human position, since each child manifestly begins completely unequally—with unequal abilities and parents. If parents have a right to beget and raise children without state interference, then parents have a concomitant right to provide that environment, and that amount of money for them, that they think best. To provide "equality of opportunity" in the sense of equality of infants would have to mean that the state nationalizes all infants and raises them in State nurseries under precisely "equal" conditions (although, even here, absolute equality is not possible). If private raising of children is admitted, then private inheritance must also be fully admitted.

Blum and Kalven penetrate to the issue by stating that the "important inequalities of environment, in its broadest sense, are for the children." They proceed to endorse inheritance taxes, and go on to restate the old canard: "Today few dispute the force of the equalitarian case in this context." As one of these "few," we reiterate that if freedom for the private family is accepted and the horror of communication of children squarely rejected, there is no case whatsoever for inheritance taxation or "equality of opportunity" in this field. Blum and Kalven do not improve matters much by conceding that this "strong" argument for progressive inheritance taxation must be "counterbalanced" by considering the impairment of incentives to work and disruption of the family standard of living.

The authors merely conclude that the case for progressive inheritance taxation is pretty well established, but not progressive income taxation, and bolster themselves by citing a "tradition" for this program (Hill). On the contrary, a progressive inheritance tax is far worse than progressive income tax. As the authors skim over without pointing out its significance—the inheritance tax is a *pure tax on capital*. It does not tax income at all. It is a pure tax on accumulated capital, and thus leads directly to impoverishment. Not only that, but it is a pure tax on that very form of endeavor that provides the main incentive for long-range accumulation of capital after a man's death—the bequest to one's children. It is therefore a staggering tax on capital. Not only should there be no progressive inheritance tax, there should be no inheritance tax at all. An inheritance tax is pure evil, and no valid arguments can be found for it.

The authors err fundamentally in believing that inheritance leads to a "permanent" handicapping, or inequality of the "rules." Inheritance of wealth is not permanent at all. In contrast to inheritance of status—aristocratic, military, bureaucratic, or political—inheritance on the market is precisely always in danger of being dissipated if the heirs are not careful. Every inheritor must continue to invest profitably not only to increase his wealth, but to maintain it. George Washington was one of the wealthiest men in the America of his day. A few generations later, the Washington family disappeared from the scene.

But for Blum and Kalven an inheritance tax (progressive) is not enough in reducing "inequality of opportunity." For before inheriting the money, the children receive the benefit of parental expenditure on them. Here is a critical loophole indeed. As the authors put it:

> The critical economic inheritance consists of the day-to-day expenditures on the children; it is these expenditures which add up to money investments in the children's health, education and welfare which in the aggregate are . . . gravely disparate.

There is a hint in a footnote that the authors would endorse a system whereby children would be taxed (in practice, of course, the parents) for the "income" (in goods) received from the parents, or the parents would suffer a stiff gift tax on all expenditures made for their children.

Fortunately, however, Blum and Kalven stop this process of reasoning in time to see where it leads. They (inconsistently) begin to draw back from the prospect of steeply progressive income taxes in order to equalize expenditures on children. They seem to look with favor on equalizing opportunities for "formal education, healthful diet, and medical attention" (p. 504), presumably by having the government nationalize these services and providing them equally. There still remain inequalities of cultural education and psychological training that seem unavoidable. At least the authors realize that attempting to remove all inequalities by tackling these areas would lead to complete destruction of the private family. As they put it, "this would call into question the very having of children." Yet they do not follow this thought consistently, but only continue to wrestle with the problem in confusion.

Blum and Kalven summarize by declaring, that for adults, enforced equality rests simply on envy, but "in the case of children these difficulties (in the arguments for egalitarianism) largely disappear. There is an enormously strong ethical claim to equality for the sake of children. What may reduce to envy as among adults surely is justice as among children."

Yet the authors are troubled by what will happen to the family and to private property under such a regime. Also, they realize the important point that if the conditions of children are equalized via progressive income taxation of the parents, then the later incomes of these children when grown up will also be subject to leveling, and "they will be denied the opportunity to enjoy the differential rewards which they have earned." In effect we would be first making certain that the conditions for the race are fair and then calling the race off. Precisely, and this should reveal the absurdity of "equalizing opportunity" to begin with. The authors thus conclude this section in a state of confusion.

Blum and Kalven conclude the discussion of equality with two erroneous footnotes. One purports to refute McCulloch's objection to a progressive tax that it renders the rate pattern arbitrary and uncertain. If the argument is on the merits of equality, then the progressive tax resulting, they claim, will simply be the result of "democratic debate." The fact that something is resolved "democratically" does not make it any the less arbitrary or capricious—indeed, it is likely to make it more so—or undo the harmful effects of such capriciousness. "In the end the distrust of progression on grounds of the uncertainty of the equality standard is only a doubt about the wisdom of entrusting the question of economic equality to the democratic process." Once again, we react to the invocation of the god Democracy, by saying "precisely"—let us see this question removed from the area of the democratic process and prohibited to government by constitutional means.

Another error they make is to pooh-pooh the antiprogression argument that complete leveling will really add little, quantitatively, to the income of the mass of people even in the short run (i.e., aside from effects on productivity and capital). It is true that this algebraic argument has been overworked by opponents of progression (it is interesting that this argument is the central one in Bertrand de Jouvenel's recent *Ethics of Redistribution*), but after all it has its place and

is not to be dismissed so brusquely. Its "cold mathematics" are *not* irrelevant to the agitation for economic equality—for it reveals some of the absurdity of the agitator's passionate pleas for redistribution. And the authors' contention that the quantitative benefits could really be great by "distributing the benefits in the form of community expenditures rather than cash" is singularly unconvincing, especially in light of their own doubts about state (not "community") expenditures and restrictions on consumer freedom.

Except for a brief concluding section, the remainder of the article deals with the Blum-Kalven case for "Depressive" taxation—exemption up to the "minimum standard of subsistence" and a uniform proportionate rate above that. There is not too much of interest here. They explain that the Depressive tax is progressive, but more mildly so than other types of progression. The outcome of their case is not favorable for degression even on their own grounds. They admit that if the exemption is set above the subsistence level, the progression will be far steeper, and explicitly graduated rates are likely and probable if such criteria as "decent standards of living" are set as the exemption. Their arguments against Depressive taxation at high exemption levels are good, and they also have an interesting argument about the ambiguity of graduated rates in their comparison of the income-classes that are being leveled.

The authors conclude that degression would be worse than graduated progression if the exemption of the exemption level were set at a high level, and that graduation would also be necessary if the exemption level were too low, in order to soften the impact on the poor. Even on their own grounds, therefore, degression is only called for if the exemption level is squarely set at the minimum subsistence level. Yet, it is impossible to set such a level scientifically; any such exemption level would be arbitrary and subject to the further capriciousness of the authors' "democratic process." On the authors' own terms, then, their case for "Depressive taxation" evaporates.

Why have exemption anyway? The authors present their brief position on page 509. One argument is the diseconomy of collecting small amounts of tax from many low incomes—this is totally unconvincing considering the "untapped resources" from the many low incomes. A second argument is the futility of the state's giving welfare benefits and then taxing them away—on the contrary, this is a cogent reason for not permitting exemptions, since this will be likely

to end the welfare benefits. A third argument is the alleged "disadvantages of anchoring judgments about tax rates and government expenditures to the capacities of the poorest members of the community" (p. 509). On the contrary, this is a great advantage. A firm anchoring of this sort will ensure a very low level of state taxation and expenditures—precisely what is needed.

Blum and Kalven conclude with a discussion of government expenditures. Where benefits are traceable, though unintended, they advocate taxation of the recipients of the benefit. In discussing expenditures where benefits are not traceable, such as military or other defense expenditures, the authors realize that since we might roughly say that such expenses benefit everyone equally, the benefit principle would lead to *equal taxation*. They recoil with horror from this because it would increase economic inequality, and it "certainly is intolerable to predicate it [a case for increasing economic inequality] on the cost of the indispensable activities of government." But this is completely beside the mark; equal taxation is not a deliberate enforcement of greater inequality, any more than a grocer's charging one price for butter causes "greater inequality" between the rich and poor buyers.

The authors would also pay for welfare expenditures by Depressive taxation. But it would be better to apply the benefit principle strictly, thus quickly ending such expenditures. This aim of reducing such expenditures is not entirely out of place here, since the authors admit that ending progression probably greatly reduces such expenditures.

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I have engaged in this lengthy critique because the article is an important one. Professors Blum and Kalven have written one of the few scholarly attacks on the theory of progressive taxation in recent decades. They deserve commendation for their effort and analysis. In general, their article has been found to be strong in critical analysis of progression, but weak and confused in their positive recommendations and erroneous in attacking many anti-progression arguments.

# 29

# The Single Tax: Economic and Moral Implications

Seventy-five years ago, Henry George spelled out his "single tax" program *Progress and Poverty*, one of the best-selling economic works of all time. According to E.R. Pease, socialist historian and long-time Secretary of the Fabian Society, this volume "beyond all question had more to do with the socialist revival of that period in England than any other book."

Most present-day economists ignore the land question and Henry George altogether. Land is treated as simply capital, with no special features or problems. Yet there *is* a land question, and ignoring it does not lay the matter to rest. The Georgists have raised, and continue to raise, questions that need answering. A point-by-point examination of single tax theory is long overdue.

According to the single tax theory, individuals have the natural right to own themselves and the property they create. Hence they have the right to own the capital and consumer goods they produce. Land, however (meaning all original gifts of nature), is a different matter, they say. Land is God-given. Being God-given, none can justly belong to any individual; all land properly belongs to society as a whole.

Single taxers do not deny that land is improved by man; forests are cleared, soil is tilled, houses and factories are built. But they would separate the economic value of the improvements from the basic, or "site," value of the original land. The former would continue to be owned by private owners; the latter would accrue to "society"—that

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is, to society's representative, the government. Rather than nationalize land outright, the single taxers would levy a 100 percent tax on the annual land *rent*—the annual income from the site—which amounts to the same thing as outright nationalization.

Georgists anticipate that the revenue from such tax on land would suffice to conduct all the operations of government—hence the name "single tax." As population increases and civilization develops, land values (especially urban site values) increase, and single taxers expect that confiscation of this "unearned increment" will keep public coffers overflowing far into the future. The increment is said to be "unearned" because it stems from the growth of civilization rather than from any productive activities of the site owner.

Almost everyone would agree that the abolition of all the other taxes would lift a great blight from the energies of the people. But Georgists generally go beyond this to contend that their single tax would not harm production—since the tax is only levied on the basic site and not on the man-made improvements. In fact, they assert the single tax will spur production; it will penalize idle land and force landowners to develop their property in order to lower their tax burden.

Idle land, indeed, plays a large part in single tax theory, which contends that wicked speculators, holding out for their unearned increment, keep sites off the market, and cause a scarcity of land; that this speculation even causes depressions. A single tax, confiscating unearned increment, is supposed to eliminate land speculation, and so cure depressions and even poverty itself.

How can the single taxers give such importance to their program? How can they offer it as a panacea to end poverty? A clue may be found in the following comments about the plight of the undeveloped countries:

> Most of us have learned to believe that the people of . . . so-called backward nations are poor because they lack capital. Since . . . capital is nothing more than . . . human energy combined with land in one form or another, the absence of capital too often suggests that there is a shortage of land or of labor in backward countries like India or China. But that isn't true. For these "poor" countries have many times more land and labor than they can use . . .

> they have everything it takes—both land and labor—to produce as much capital as people anywhere.[1]

And since these countries have plenty of land and labor, the trouble must be idle land withheld from production by speculative landlords!

The deficiency in that argument is the neglect of the time factor in production. Capital is the product of human energy and land . . . *and time*. The time-block is the reason that people must abstain from consumption, and save. Laboriously, these savings are invested in capital goods. We are further along the road to a high standard of living than India or China because we and our ancestors have saved and invested in capital goods, building up a great structure of capital. India and China, too, could achieve our living standards after years of saving and investment.

The single tax theory is further defective in that it runs up against a grave practical problem. How will the annual tax on land be levied? In many cases, the same person owns both the site and the man-made improvement, and buys and sells both site and improvement together, in a single package. How, then, will the government be able to separate site value from improvement value? No doubt, the single taxers would hire an army of tax assessors. But assessment is purely an arbitrary act and cannot be anything else. And being under the control of politics, it becomes purely a political act as well. Value can only be determined in exchange on the market. It cannot be determined by outside observers.

In the case of *agricultural* land, for instance, it is clear that you cannot, in practice, separate the value of the original ground from the value of the cleared, prepared, and tilled soil. This is obviously impossible, and even assessors would not attempt the task.

But the single taxers are also interested in *urban* land where the value of the lot is often separable, on the market, from the value of the building over it. Even so, the urban lot today is not the site as found in nature. Man had to find it, clear it, fence it, drain it, and the like; so the value of an "unimproved" lot includes the fruits of man-made improvements.

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[1]Phil Grant, *The Wonderful Wealth Machine* (New York: Devin-Adair, 1953), pp. 105–07.

Thus, pure site value could never be found in practice, and the single tax program could not be installed except by arbitrary authority. But let us waive this fatal flaw for the moment and pursue the rest of the theory. Let us suppose that pure site value *could* be found. Would a single tax program then be wise?

Well, what about idle land? Should the sight of it alarm us? On the contrary, we should thank our stars for one of the great economic facts of nature: *that labor is scarce relative to land*. It is a fact that there is more land available in the world, even quite useful land, than there is labor to keep it employed. This is a cause for rejoicing, not lament.

Since labor is scarce relative to land, and much land *must* therefore remain idle, any attempt to force *all* land into production would bring economic disaster. Forcing all land into use would take labor and capital away from more productive uses, and compel their wasteful employment on land, a disservice to consumers.

The single taxers claim that the tax could not possibly have any ill effects; that it could not hamper production because the site is already God-given, and man does not have to produce it; that, therefore, taxing the earnings from a site could not restrict production, as do all other taxes.[2] This claim rests on a fundamental assumption—the hard core of single tax doctrine: Since the site-owner performs no productive service he is, therefore, a parasite and an exploiter, and so taxing 100 percent of his income could not hamper production.

But this assumption is totally false. The owner of land does perform a very valuable productive service, a service completely separate from that of the man who builds on, and improves, the land. The site owner brings sites into use and allocates them to the most productive user. He can only earn the highest ground rents from his land by allocating the site to those users and uses that will satisfy the consumers in the best possible way. We have seen already that the site owner must decide whether or not to work a plot of land or keep it idle. He must also decide which use the land will best satisfy. In doing

[2]Unfortunately, most economists have accepted this claim uncritically and only dispute the practicality of the single tax program.

so, he also insures that each use is situated on its most productive *location*. A single tax would utterly destroy the market's important job of supplying efficient locations for all man's productive activities, and the efficient use of available land.

A 100 percent tax on rent would cause the capital value of all land to fall promptly to zero. Since owners could not obtain any net rent, the sites would become valueless on the market. From that point on, sites, in short, would be free. Further, since all rent would be siphoned off to the government, there would be no incentive for owners to charge any rent at all. Rent would be zero as well, and rentals would thus be free.

The first consequence of the single tax, then, is that no revenue would accrue from it. Far from supplying all the revenue of government, the single tax would yield no revenue at all. For if rents are zero, a 100 percent tax on rents will also yield nothing.

In our world, the only naturally free goods are those that are superabundant—like air. Goods that are scarce, and therefore the object of human action, command a price on the market. These goods are the ones that come into individual ownership. Land generally is abundant in relation to labor, but lands, particularly the better lands, are scarce relative to their possible uses.

All productive lands, therefore, command a price and earn rents. Compelling any economic goods to be free wreaks economic havoc. Specifically, a 100 percent tax means that land sites pass from individual ownership into a state of *no-ownership* as their price is forced to zero. Since no income can be earned from the sites, people will treat the sites as if they were free—as if they were superabundant. But we know they are not superabundant; they are highly scarce. The result is to introduce complete chaos in land sites. Specifically, the very scarce locations—those in high demand—will no longer command a higher price than the poorer sites.

Therefore, the market will no longer be able to insure that these locations will go to the most efficient bidders. Instead, everyone will rush to grab the best locations. A wild stampede will ensue for the choice downtown urban locations, which will now be no more expensive than lots in the most dilapidated suburbs. There will be great overcrowding in the downtown areas and underuse of outlying areas. As in other types of price ceilings, favoritism and "queuing up"

will settle allocation, instead of economic efficiency. In short, there will be land waste on a huge scale. Not only will there be no incentive for those in power to allocate the sites efficiently; there will also be no market rents and therefore no way that anyone could find out how to allocate sites properly.

In brief, the inevitable result of a single tax would be nothing less than *locational chaos*. And since location—land—must enter into the production of every good, chaos would be injected into every aspect of economic calculation. Waste in location leads to waste and misallocation of all productive resources.

The government, of course, might try to combat the disappearance of market rentals by levying an arbitrary assessment, declaring by fiat that every rent is "really" such and such, and taxing the site owner 100 percent of that amount. Such arbitrary decrees would bring in revenue, but they would only compound chaos further. Since the rental market would no longer exist, the government could never guess what the rent would be on the free market. Some users would be paying a tax of more than 100 percent of the true rent, and the use of these sites would be discouraged. Finally, private owners would still have no incentive to manage and allocate their sites efficiently. An arbitrary tax in the face of zero rentals is a long step toward replacing a state of no-ownership by government ownership.

In this situation, the government would undoubtedly try to bring order out of chaos by nationalizing (or municipalizing) land outright. *For in any economy, a useful resource cannot go unowned without chaos setting in; somebody must manage and own—either private individuals or the government.*

George himself expected that the single tax would "accomplish the same thing (as land nationalization) in a simpler, easier, and quieter way."[3] The hollow *form* of private ownership in land would remain, but the substance would have been drained away.

Government ownership of land would end one particular form of utter chaos brought about by the single tax, but it would add other great problems. It would raise all the problems created by any

[3]Henry George, *Progress and Poverty* (New York: Modern Library, 1916), p. 404.

government ownership, and on a very large scale.[4] In short, there would be no incentive for government officials to allocate sites efficiently, and land would be allocated on the basis of politics and favoritism. Efficient allocation also would be impossible, due to the inherent defects of government operation; the absence of a profit and loss test, the conscription of initial capital, the coercion of revenue—the calculational chaos that government ownership and invasion of the free market create. Since land must be used in every productive activity, this chaos would permeate the entire economy. Socialization as a remedy for the evils of the single tax would be a jump from the frying pan into the fire.

Thus we see that private site owners, by allocating sites to productive uses, perform an extremely important service to all members of society. It is a service we would not do without, and the income to owners is but their return for this service.

The view that the site owner is nonproductive is a hangover from the old Smith-Ricardo doctrine that "productive" labor must be employed on material objects. The site owner does not solely transform matter into a more useful shape, as the builder does, though he may do that in addition. Lawyers and musicians provide intangible services, just as site owners perform a truly vital function although it may not be a directly physical one.

What about the maligned speculator, the holder of idle land? He, too, performs an important service—a subdivision of the general site-owner function. The speculator allocates sites over time. Even if a speculator reaps an "unearned increment" of capital value by holding land as its price rises, he can gain no such increment by keeping land idle. Why shouldn't he use the land and earn rents *in addition* to his capital gain? Idle land by itself cannot benefit him. The reason he keeps the land apparently idle, therefore, is either that the land is still too poor to be used by current labor and capital goods, or that it is not yet clear *which* use for the site is best. The "speculative" landowner has the difficult job of deciding when to *commit* the site to a specific use. A wrong decision would waste the land. By waiting and judging, the speculative landowner picks the right moment for

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[4]For a further discussion of these problems, see the author's "Government in Business," *The Freeman* (September 1956): 39–41.

bringing his land into use, and the right employment for the land. Land speculators, therefore, perform as vital a market function as their fellow site owners whose land is already in use. Land that seems idle to a passer-by probably is not idle in the eyes of its owner who is responsible for its use.

We have seen that the economic arguments for the single tax are fallacious at every important turn, and that the economic effects of a single tax would be disastrous indeed. But we should not neglect the *moral* arguments. Undoubtedly, the passion and fervor that have marked the single taxers through the years stems from their moral belief in the injustice of private ownership of land. Anyone who holds this belief will not be fully satisfied with explanations of the economic error and dangers of the single tax. He will continue to call for battle against what he believes to be a moral injustice.

The single taxers complain that site owners benefit unjustly by the rise and development of civilization. As population grows and the economy advances, site owners reap the benefit through a rise in land values. Is it justice for site owners who contribute little or nothing to this advance, to reap such handsome rewards?

All of us reap the benefits of the social division of labor, and the capital invested by our ancestors. We all gain from an expanding market—and the landlord is no exception. The landowner is not the only one who gains an "unearned increment" from these changes. All of us do. Is he, or are we, to be confiscated and taxed out of this happiness in the fruits of advancement? Who in "fairness" could receive the loot? Certainly it could not be given to our dead ancestors, who became our benefactors by investing in capital.[5]

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> [5] "What gives value to land?," asks Rev. Hugh O. Pentecost. And he answers: "The presence of population—the community. Then rent, or the value of land, morally belongs to the community." What gives value to Mr. Pentecost's preaching? The presence of population—salary, or the value of his preaching, morally belongs to the community. (Benjamin R. Tucker, *Instead of a Book* [New York: B.R. Tucker, 1893], p. 357)

Also see Leonard E. Read, "Unearned Riches," in *On Freedom and Free Enterprise*, Mary Sennholz, ed. (Princeton, N.J.: D. Van Nostrand, 1956), pp. 188–95; and F.A. Harper, "The Greatest Economic Charity," in ibid., pp. 94–108.

As the supply of capital goods increases, land and labor become more scarce in relation to them, and therefore more productive. The incomes both of laborers and landowners increase as civilization expands. As a matter of fact, the landowner does not reap as much reward as the laborer from a progressing economy. For landowning is a business like any other, the return from which is regulated and minimized, in the long run, by competition. If land temporarily offers a higher rate of return, more people invest in it, thereby driving up its market price, or capital value, until the annual rate of return falls to the level of all other lines of business. The man who buys a site in mid-Manhattan now will earn no more than in any other business. He will only earn more if the market has not fully discounted future increases in rent through increasing the capital value of the land. In other words, he can only earn more if he can pick up a bargain. And he can only do this if, like other successful profit-makers, his foresight is better than that of his fellows.

Thus, the only landowners who reap special gains from progress are the ones more farsighted than their fellows—the ones who earn more than the usual rate of return by accurately predicting future developments. Is it bad for the rest of us, or is it good, that sites go into the hands of those men with the most foresight and knowledge of that site?

Among the specially farsighted is the original pioneer—the man who first found a new site and acquired ownership. Furthermore, in the act of clearing the site, fencing it, and the like, the pioneer inextricably mixes his labor with the original land. Confiscation of land would not only retroactively rob heroic men who cleared the wilderness, it would completely discourage any future pioneering efforts. Why should anyone find new sites and bring them into use when the gain will be confiscated? And how moral is this confiscation?

We have still to deal with the critical core of single tax moral theory—that no individual has the right to own value in land. Single taxers agree with libertarians that every individual has the natural right to own himself and the property he creates, and to transmit it to his heirs and assigns. They part company with libertarians in challenging the individual's right to claim property in original, God-given, land. Since it is God-given, they say, the land should belong to society as a whole, and each individual should have an equal right to

its use. They say, therefore, that appropriation of any land by an individual is immoral.

We can accept the premise that land is God-given, but we cannot therefore infer that it is given to society; it is given for the use of individual persons. Talents, health, beauty may all be said to be God-given, but obviously they are properties of individuals, not of society. Society cannot own anything. There is no entity called society; there are only interacting individuals. Ownership of property means control over use and the reaping of rewards from that use. When the State owns, or virtually owns, property, in no sense is society the owner. The government officials are the true owners, whatever the legal fiction adopted. Public ownership is only a fiction; actually, when the government owns anything, the mass of the public are in no sense owners. You or I cannot sell our "shares" in TVA, for example.

Any attempt by society to exercise the function of land ownership would mean land nationalization. Nationalization would not eliminate ownership by individuals; it would simply transfer this ownership from producers to bureaucrats.

Neither can any scheme exist where every individual will have "equal access" to the use of land. How could this possibly happen? How can a man in Timbuktu have as equal access as a New Yorker to Broadway and 42nd Street? The only way such equality could be enforced is for *no one* to use any land at all. But this would mean the end of the human race. The only type of equal access, or equal right to land, that makes any sense is precisely the equal access through private ownership and control on the free market—where every man can buy land at the market price.

The single taxer might still claim that individual ownership is immoral, even if he can find no plausible remedy. But he would be wrong. For his claim is self-contradictory. A man cannot produce *anything* without the cooperation of original land, if only as standing room. A man cannot produce anything by his labor alone. He must mix his labor with original land, as standing room and as raw materials to be transformed into more valuable products.

Man comes into the world with just himself and the world around him—with the land and natural resources given him by nature. He takes these resources and transforms them by his labor

and energy into goods more useful to man. Therefore, if an individual cannot own original land, neither can he in the same sense own the fruits of his labor. The single taxers cannot have their cake and eat it; they cannot permit a man to own the fruits of his labor while denying him ownership of the original materials which he uses and transforms. It is either one or the other. To own his product, a man must also own the material which was originally God-given, and now has been remolded by him. Now that his labor has been inextricably mixed with land, he cannot be deprived of one without being deprived of the other.

But if a producer is *not* entitled to the fruits of his labor, who is entitled to them? It is difficult to see why a newborn Pakistani baby should have a moral claim to ownership of a piece of Iowa land someone has just transformed into a wheat field. Property in its original state is unused and unowned. The single taxers may claim that the whole world really "owns" it, but if no one has yet used it, it is really owned by no one. The pioneer, the first user of this land, is the man who first brings this simple valueless thing into production and social use. It is difficult to see the morality of depriving him of ownership in favor of people who never got within a thousand miles of the land, and whose only claim to its title is the simple fact of being born—who may not even know of the existence of the property over which they are supposed to have claim.

Surely, the moral course is to grant ownership of land to the person who had the enterprise to bring it into use, the one who made the land productive. The moral issue will be even clearer if we consider the case of *animals*. Animals are "economic land"—since they are original nature-given resources. Yet will anyone deny full title to a horse to the man who finds and domesticates it? Or should every person in the world put in his claim to one two-billionth of the horse—or to one two-billionth of a government assessor's estimate of the "original horse's" worth? Yet this is precisely the single taxer's ethic. In all cases of land, some man takes previously undomesticated, "wild" land, and "tames" it by putting it to productive use. Mixing his labor with land sites should give him just as clear a title as in the case of animals.

As two eminent French economists have written:

> Nature has been appropriated by him (man) for his use; she has become his own; she is his property. This property is legitimate; it constitutes a right as sacred for man as is the free exercise of his faculties. Before him, there was scarcely anything but matter; since him, and by him, there is interchangeable wealth. The producer has left a fragment of his own person in the things which . . . may hence be regarded as a prolongation of the faculties of man acting upon external nature. As a free being he belongs to himself; that is to say the productive force, is himself; now, the cause, that is to say, the wealth produced, is still himself. Who shall dare contest title of ownership so clearly marked by the seal of his personality?[6]

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[6]Louis Wolowski and Émile Levasseur, "Property" in *Lalor's Cyclopedia of Political Science* (Chicago: M.B. Cary, 1884), p. 392.

# 30

# The Value-Added Tax is Not the Answer

One of the great and striking facts of recent months is the growing resistance to further taxes on the part of the long-suffering American public. Every individual, business, or organization in American society acquires its revenue by the peaceful and voluntary sale of productive goods and services to the consumer, or by voluntary donations from people who wish to further whatever the group or organization is doing. Only government acquires its income by the coercive imposition of taxes. The welcome new element is the growing resistance to further tax exactions by the American people

In its endless quest for more and better booty, the government has contrived to tax everything it can find, and in countless ways. Its motto can almost be said to be "If it moves, tax it!"

Every income, every activity, every piece of property, every person in the land is subject to a battery of tax extortions, direct and indirect, visible and invisible. There is of course nothing new about this; what is new is that the accelerating drive of the government to tax has begun to run into determined resistance on the part of the American citizenry.

It is no secret that the income tax, the favorite of government for its ability to reach in and openly extract funds from everyone's income, has reached its political limit in this country. The poor and the middle class are now taxed so heavily that the federal government, in particular, dares not try to extort even more ruinous levies.

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The outraged taxpayer, after all, can easily become the outraged voter. How outraged the voters can be was brought home to the politicians last November, when locality after locality throughout the country rose in wrath to vote down proposed bond issues, even for the long-sacrosanct purpose of expanding public schools.

## Defeat in New York

The most heartening example—and one that can only give us all hope for a free America—was in New York City, where every leading politician of both parties, aided and abetted by a heavily financed and demagogic TV campaign, urged the voters to support a transportation bond issue. Yet the bond issue was overwhelmingly defeated—and this lesson for all of our politicians was a sharp and salutary one.

Finally, the property tax, the mainstay of local government as the income tax is at the federal level, is now generally acknowledged to have a devastating effect on the nation's housing. The property tax discourages improvements and investments in housing, has driven countless Americans out of their homes, and has led to spiraling tax abandonments in, for example, New York City, with a resulting deterioration of blighted slum housing.

Government, in short, has reached its tax limit; the people were finally saying an emphatic "No!" to any further rise in their tax burden. What was ever-encroaching government going to do? The nation's economists, most of whom are ever eager to serve as technicians for the expansion of state power, were at hand with an answer, a new rabbit out of the hat to save the day for Big Government.

They pointed out that the income tax and property tax were too evident, too visible, and that so are the generally hated sales tax and excise taxes on specific commodities. But how about a tax that remains totally *hidden*, that the consumer or average American cannot identify and pinpoint as the object of his wrath? It was this deliciously hidden quality that brought forth the rapt attention of the Nixon administration, the "Value Added Tax" (VAT).

The VAT is essentially a national sales tax, levied in proportion to the goods and services produced and sold. But its delightful concealment comes from the fact that the VAT is levied at each step of

the way in the production process: on farmer, manufacturer, jobber and wholesaler, and only slightly on the retailer.

The difference is that when a consumer pays a 7 percent sales tax on every purchase, his indignation rises and he points the finger of resentment at the politicians in charge of government; but if the 7 percent tax is hidden and paid by every firm rather than just at retail, the inevitably higher prices will be charged, *not* to the government where it belongs, but to grasping businessmen and avaricious trade unions.

While consumers, businessmen, and unions all blame each other for inflation like Kilkenny cats, Papa government is able to preserve its lofty moral purity, and to join in denouncing all of these groups for "causing inflation."

It is now easy to see the enthusiasm of the federal government and its economic advisers for the new scheme for a VAT. It allows the government to extract many more funds from the public—to bring about higher prices, lower production, and lower incomes—and yet totally escape the blame, which can easily be loaded on business, unions, or the consumer as the particular administration sees fit.

The VAT is, in short, a looming gigantic swindle upon the American public, and it is therefore vitally important that it not pass. For if it does, the encroaching menace of Big Government will get another, and prolonged, lease on life.

One of the selling points for VAT is that it is supposed only to *replace* the property tax for its prime task of financing local public schools. Any relief of the onerous burden of the property tax sounds good to many Americans.

But anyone familiar with the history of government or taxation should know the trap in this sort of promise. For we should all know by now that taxes never go down. Government, in its insatiable quest for new funds, never relaxes its grip on any source of revenue.

You know and I know that the property tax, even if replaced for school financing, will not really go down; it will simply be shifted to other expensive boondoggles of local government. And we also know full well that the VAT will not long be limited to financing the schools; its vast potential (a 10 percent VAT would bring in about $60 billion in revenue) is just too tempting for the government not

to use it to the hilt, and, in the famous words of New Dealer Harry Hopkins, "to tax and tax, spend and spend, elect and elect."

Let us now delve more deeply into the specific nature of the VAT. A given percentage (the Nixon administration proposal is 3 percent) is levied, not on retail sales, but on the sales of each stage of production, with the business firm deducting from its liability the tax embodied in the purchases that he makes from previous stages. It is thus a sales tax hidden at each stage of production, from the farmer or miner down to the retailer.

## A "Regressive" Tax

The most common criticism is that the VAT, like the sales tax, is a "regressive" tax, falling largely on the poor and the middle class, who pay a greater percentage of their income than the rich. This is a proper and important criticism, especially coming at a time when the middle class is already suffering from an excruciating tax burden.

The Nixon administration proposes to alleviate the burden on the poor by rebating the taxes through the income tax. While this may alleviate the tax burden on the poor, the middle class, which pays most of our taxes anyway, will hardly be benefited.

Furthermore, there is a more sinister element in the rebate plan: for some of the poor will get cash payments from the IRS, thereby bringing in the disastrous principle of the guaranteed annual income (FAP) through the back door.

But the VAT is in many ways far worse than a sales tax, apart from its hidden and clandestine nature. In the first place, the VAT advocates claim that since each firm and stage of production will pay in proportion to its "value added" to production, there will be no misallocation effects along the way.

But this ignores the fact that every business firm will be burdened by the cost of innumerable record keeping and collection for the government. The result will be an inexorable push of the business system toward "vertical mergers" and the reduction of competition.

Suppose, for example, that a crude-oil producer adds the value of $1,000, and that an oil refiner adds another $1,000, and suppose for simplicity that the VAT is 10 percent. Theoretically, it should make no difference if the firms are separate or "integrated"; in the former case, each firm would pay $100 to the government; in the latter, the

integrated firm would pay $200. But since this comforting theory ignores the substantial costs of record keeping and the collection, in practice if the crude-oil firm and the oil refiner were integrated into one firm, making only one payment, their costs would be lower.

## Vertical Mergers

Hence, vertical mergers will be induced by the VAT, after which the Antitrust Division of the Department of Justice would begin to clamor that the free market is producing "monopoly" and that the merger must be broken by government fiat.

The costs of record keeping and payment pose another grave problem for the market economy. Obviously, small firms are less able to bear these costs than big ones, and so the VAT will be a powerful burden on small business, and hamper it gravely in the competitive struggle. It is no wonder that some big businesses look with favor on the VAT!

There is another grave problem with VAT, a problem that the Western European countries which have adopted VAT are already struggling with.

In the VAT, every firm sends its invoices to the federal government, and gets credit for the VAT embodied in its invoices for the goods bought from other firms. The result is an irresistible opening for cheating, and in Western Europe there are special firms whose business is to write out fake invoices which can reduce the tax liabilities of their "customer." Those businesses more willing to cheat will then be favored in the competitive struggle of the market.

A further crucial flaw exists in the VAT, a flaw which will bring much grief to our economic system. Most people assume that such a tax will simply be passed on in higher prices to the consumer. But the process is not that simple. While, in the long run, prices to consumers will undoubtedly rise, there will be two other important effects: a large short-run reduction in business profits, and a long-run fall in wage incomes.

The critical blow to profits, while perhaps only "short-run," will take place at a time of business recession, when many firms and industries are suffering from low profits and even from business losses. The low-profit firms and industries will be severely hit by the imposition of VAT, and the result will be to cripple any possible

recovery and plunge us deeper into recession. Furthermore, new and creative firms, which usually begin small and with low profits, will be similarly crippled before they have scarcely begun.

The VAT will also have a severe, and so far unacknowledged, effect in aggravating unemployment, which is already at a high recession rate. The grievous impact on unemployment will be twofold. In the first place, any firm that buys, say, machinery, can deduct the embodied VAT from its own tax liability; but if it hires workers, it can make no such deduction. The result will be to spur over-mechanization and the firing of laborers.

Second, part of the long-run effect of VAT will be to lower the demand for labor and wage incomes; but since unions and the minimum-wage laws are able to keep wage rates up indefinitely, the impact will be a rise in unemployment. Thus, from two separate and compounding directions, VAT will aggravate an already serious unemployment problem.

Hence, the American public will pay a high price indeed for the clandestine nature of the VAT. We will be mulcted of a large and increasing amount of funds, extracted in a hidden but no less burdensome manner, just at a time when the government seemed to have reached the limit of the tax burden that the people will allow. It will be funds that will aggravate the burdens on the already long-suffering average middle-class American. And to top it off, the VAT will cripple profits; injure competition, small business, and new creative firms; raise prices; and greatly aggravate unemployment. It will pit consumers against business, and intensify conflicts within society.

One of Parkinson's justly famous "laws" is that, for government, "expenditure rises to meet income." If we allow the government to find and exploit new sources of tax funds, it will simply use those funds to spend more and more, and aggravate the already fearsome burden of Big Government on the American economy and the American citizen.

The only way to reduce Big Government is to cut its tax revenue, and to force it to stay within its more limited means. We must see to it that government has less tax funds to play with, not more. The first step on this road to lesser government and greater freedom is to see the VAT for the swindle that it is, and to send it down to defeat.

# 31

# A Reply to Georgist Criticisms

Overall, it seems that one of the main Georgist fallacies is a confusion of economic and moral arguments for their program. Both types of arguments have their place, we can all agree, but the Georgists persist in using moral arguments in places where technical economic arguments are called for. In the strictly economic sense, land is not a unique asset in two main ways: (1) in the nature of "rent" and (2) in its being *capitalized* on the market.

Rent, as Frank A. Fetter brilliantly pointed out, is the hire-price of a unit of a durable asset. (We might even go further and say that rent is any unit-price of a good.) The selling-price of an asset on the market will be the capitalized value of its expected future rents: the capitalization to take place at the going rate of interest. The rate of interest is the price of "time," and hence future earnings are discounted back to the present at this rate. A piece of land sells now at the discounted sum of its future rents. Similarly, *any* asset will sell at the capitalized value of its future earnings; and where these earnings accrue from hiring out, the rent selling-price relation will be the same. If Rembrandts are habitually rented out to museums, they will earn, say, per monthly rents; tuxedos will earn nightly rents, and so on. Admittedly, land differs from improvable capital because land is not replaceable, and therefore land earns ultimate rents. Or, to phrase it differently, a machine may earn rents (usually in self-

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imputed earnings, but sometimes as being "hired out") but they are *gross* rents, since it in turn must be produced by land and labor. Over the whole economy, then, the prices of capital goods are imputed backward to land and labor, until finally, the *net* incomes are earned by: land, time, labor (including entrepreneurship). However, *land* is also capitalized on the market and any increase in its prospective earnings raises its capital value. Hence, land's net rents are also capitalized, and we have as ultimate net incomes only: labor (earning wages), time (earning interest) and profits (for entrepreneurial foresight) minus losses (for poor entrepreneurial judgment).

Rembrandts are similar to land because both are fixed in quantity (Rembrandts even more so) and because the same question arises as to markets and productivity. In short, does the Georgist believe that the rental value of Rembrandts (assume that all Rembrandts are rented out to museums) will continue to be the same, because the "market" will take care of things, even if the rental earnings from Rembrandts are taxed 100 percent? The Georgist has a curious conception of the market; he considers that the market is independent of the actions of an important part of its constituent individuals: the suppliers. On the contrary, there is no entity "market" which will take care of finding correct rents. If the shell of ownership is left and its contents confiscated by the State, there will be no incentive for owners (whether of land or Rembrandts) to allocate the assets to the highest bidders and most productive uses. There is no inconsistency when I point out that everyone will rush to grab the best locations if land were free; it would be the same if Rembrandts were suddenly declared free by the government (or if there were a 100 percent tax on their value). The point is that the *owners* will have no incentive to allocate. Rembrandts, which also earn net rents, are the same as land; the difference of course being that chaos in land sites is a far more serious thing than chaos in the price of Rembrandts.

The Georgist rejects the analogy of the Rembrandts because, he says, land value is created by the community. But what of Rembrandt values? Does not the increase in population, the development of the community, account for the increase in Rembrandt values? Will anyone pay much for Rembrandts in a primitive society? The Georgist rejects the application of the same "community" argument to the Reverend Pentecost because he served the community by his labor;

the theatrical costumer also is said to earn "wages." The entrepreneur earns some wages for his labor, but he also earns profits for his foresight, and particularly interest for his advancement of capital, or time. In fact, many investors earn interest and profit without doing any "work" at all. Would Georgists then join the Marxists and confiscate such "unearned" interest? Why not?

It seems to me that Georgists give away their entire case when they graciously allow the landowners to keep 5–10 percent of their rent. This concedes that the landowner does perform *some* service, and if one concedes that he should keep some rent, where are we to draw the line? Why not let him keep 25 percent, or 50 percent, or 99 percent? Apparently, some Georgists would let the landowner keep the equivalent of a broker's commission for distributing sites. But this again puts a very narrow "labor theory of value" on the owner's service. The Rembrandt owner, for example, may hire a broker for 5–10 percent to sell or rent his paintings. Would Georgists then confiscate 90 percent of Rembrandt values?

The fact remains that just as the customer earns interest plus managerial wages plus profit, so will a landowner earn interest plus managerial wages plus profit (and "wages" can include wages of "decision-making"). The profit goes to better forecasters, and poorer ones will suffer losses.

Assessment may be done every day, but this does not make it any less arbitrary. Assessment where the entire rent market is abolished, as the single tax will effectively do, will be all the more impossible and arbitrary. Further, we learn that improvements which last beyond the owner's life are considered part of the land by the Georgists and would be taxed accordingly. Things get worse and worse. This means that long-range improvements will be penalized by the single tax and will not be made. Thus, the single tax will tax long-range improvements as well as original site value.

Georgists may deny that they wish to force all land into production, but they imply this when they keep referring to currently idle land that should be used, and "idling" land that should be used for more valuable things. Nowhere have I seen Georgists say that any currently-used land should be rendered idle. Actually, there is no reason for speculators to abstain from earning rents on their land unless it were too poor to earn rents; earning rents does not prevent land values from rising. Further, if idle land earns no rents, then it has

no "rental value" to be taxed. The "rental value" is only the discounted sum of expected *future* rents, and is unrelated to current rents. Taxing them, therefore, will tax land *more* than 100 percent of its rental value.

I will not deal with what I consider grave fallacies in capital and production theory because they take us too far afield from the main problem. I will simply state that production takes place in many stages, and involves an ever-greater structure of capital—and that we would not be able to replace depreciating capital were it not for the growing structure of capital invested by our ancestors, improving our living standards. The "contemporaneous pipeline" is not only inventory; it is the gradual wearing down of fixed equipment and plant—which must be built ahead of time for use in advancing future consumption. Governments err in backward countries in not allowing security of private property and therefore the accumulation of savings.

Finally, if wages are OK because earned in the market place, then so are rents, and interest, and profits.

So much for the economical rebuttal. On the strictly ethical problem, I am willing to refer again to my essay. What I am advocating is appropriation of unused land by the first user—the "pioneer"—and I did not at all consider the problem of feudal land, which America fortunately escaped. I am no friend to feudal landownership based on conquest—but a discussion of this would have gotten us far afield. What I am arguing for in this essay is the ethical validity of absolute ownership by the pioneer and his heirs and assigns.

Some Georgists lay great emphasis on the *fixity* of land: the supply of land sites is fixed and so increased population raises land values; again, horses are not fixed in supply but land is. Rebuttal to this is in two parts: (a) land sites may be fixed, but so are Rembrandts. Why not confiscate Rembrandt value? (b) *physical* land may be fixed, but the *service* of supplying the land is *not*; it is the productive service by the site-owner that generates value, and it will be gravely discouraged by taxes on land values. A 100 percent tax on land values will generate chaos in land and therefore in production generally; a lesser degree of taxes will inflict lesser damage, but damage there most certainly will be.

Finally, many Georgists have, by inference, accused me of wishing to levy taxes on production, and have expounded on the beneficial effects that would flow once such taxes were lifted from the economy. I have great respect for many aspects of Henry George; and none more than for his passages on the benefits that would ensue once taxes were removed from production. Our difference is that I believe that land value taxation would also blight production, and, further, be unjust rather than the contrary. If we wish to establish justice and remove taxes from production, some other means than land value taxation will have to be found.

## Section Five

# Trade and Freedom

# 32

# Freedom, Inequality, Primitivism, and the Division of Labor

## I.

If men were like ants, there would be no interest in human freedom. If individual men, like ants, were uniform, interchangeable, devoid of specific personality traits of their own, then who would care whether they were free or not? Who, indeed, would care if they lived or died? The glory of the human race is the uniqueness of each individual, the fact that every person, though similar in many ways to others, possesses a completely individuated personality of his own. It is the fact of each person's uniqueness—the fact that no two people can be wholly interchangeable—that makes each and every man irreplaceable and that makes us care whether he lives or dies, whether he is happy or oppressed. And, finally, it is the fact that these unique personalities need freedom for their full development that constitutes one of the major arguments for a free society.

Perhaps a world exists somewhere where intelligent beings are fully formed in some sort of externally determined cages, with no need for internal learning or choices by the individual beings themselves. But man is necessarily in a different situation. Individual human beings are not born or fashioned with fully formed knowledge, values, goals, or personalities; they must each form their own values and goals, develop their personalities, and learn about themselves and the world around them. Every man must have freedom, must have the scope to form, test, and act upon his own choices, for any sort of development of his own personality to take place. He must, in short, be free in order that he may be fully human. In a

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sense, even the most frozen and totalitarian civilizations and societies have allowed at least a modicum of scope for individual choice and development. Even the most monolithic of despotisms have had to allow at least a bit of "space" for freedom of choice, if only within the interstices of societal rules. The freer the society, of course, the less has been the interference with individual actions, and the greater the scope for the development of each individual. The freer the society, then, the greater will be the variety and the diversity among men, for the more fully developed will be every man's uniquely individual personality. On the other hand, the more despotic the society, the more restrictions on the freedom of the individual, the more uniformity there will be among men and the less the diversity, and the less developed will be the unique personality of each and every man. In a profound sense, then, a despotic society prevents its members from being fully human.[1]

If freedom is a necessary condition for the full development of the individual, it is by no means the only requirement. Society itself must be sufficiently developed. No one, for example, can become a creative physicist on a desert island or in a primitive society. For, as an economy grows, the range of choice open to the producer and to the consumer proceeds to multiply greatly.[2] Furthermore, only a society with a standard of living considerably higher than subsistence can afford to devote much of its resources to improving knowledge and to developing a myriad of goods and services above the level of brute subsistence. But there is another reason that full development of the creative powers of each individual cannot occur in a primitive or

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[1]On the interrelations between freedom, diversity, and the development of each individual, see the classic work of Wilhelm von Humboldt, *The Limits of State Action* (New York: Cambridge University Press, 1969). On freedom as necessary for the development of individuality, see also Josiah Warren, *Equitable Commerce* (New York: Burt Franklin, 1965) and Stephen Pearl Andrews, *The Science of Society* (London: C.W. Daniel, 1913).

[2]The economists Bauer and Yamey cogently define economic development as "the widening of the range of alternatives open to people as consumers and as producers." Peter T. Bauer and Basil S. Yamey, *The Economics of Underdeveloped Countries* (Cambridge: Cambridge University Press, 1957), p. 151.

undeveloped society, and that is the necessity for a wide-ranging division of labor.

No one can fully develop his powers in any direction without engaging in *specialization*. The primitive tribesman or peasant, bound to an endless round of different tasks in order to maintain himself, could have no time or resources available to pursue any particular interest to the full. He had no room to specialize, to develop whatever field he was best at or in which he was most interested. Two hundred years ago, Adam Smith pointed out that the developing division of labor is a key to the advance of any economy above the most primitive level. A necessary condition for any sort of developed economy, the division of labor is also requisite to the development of any sort of civilized society. The philosopher, the scientist, the builder, the merchant—none could develop these skills or functions if he had had no scope for specialization. Furthermore, no individual who does not live in a society enjoying a wide range of division of labor can possibly employ his powers to the fullest. He cannot concentrate his powers in a field or discipline and advance that discipline and his own mental faculties. Without the opportunity to specialize in whatever he can do best, no person can develop his powers to the full; no man, then, could be fully human.

While a continuing and advancing division of labor is needed for a developed economy and society, the extent of such development at any given time limits the degree of specialization that any given economy can have. There is, therefore, no room for a physicist or a computer engineer on a primitive island; these skills would be premature within the context of that existing economy. As Adam Smith put it, "the division of labor is limited by the extent of the market." Economic and social development is therefore a mutually reinforcing process: the development of the market permits a wider division of labor, which in turn enables of further extension of the market.[3]

If the scope of the market and the extent of the division of labor are mutually reinforcing, so too are the division of labor and the diversity of individual interests and abilities among men. For just as an ever greater division of labor is needed to give full scope to the

[3]See George J. Stigler, "The Division of Labor is Limited by the Extent of the Market," *Journal of Political Economy* (June 1951), p. 193.

abilities and powers of each individual, so does the existence of that very division depend upon the innate diversity of men. For there would be no scope at all for a division of labor if every person were uniform and interchangeable. (A further condition of the emergence of a division of labor is the variety of natural resources; specific land areas on the earth are also not interchangeable.) Furthermore, it soon became evident in the history of man that the market economy based on a division of labor was profoundly *cooperative*, and that such division enormously multiplied the productivity and hence the wealth of every person participating in the society. The economist Ludwig von Mises put the matter very clearly:

> Historically division of labor originates in two facts of nature: the inequality of human abilities and the variety of the external conditions of human life on the earth. These two facts are really one: the diversity of Nature, which does not repeat itself but creates the universe in infinite, inexhaustible variety. . . .
>
> These two conditions . . . are indeed such as almost to force the division of labor on mankind. Old and young, men and women cooperate by making appropriate use of their various abilities. Here also is the germ of the geographical division of labor; man goes to the hunt and woman to the spring to fetch water. Had the strength and abilities of all individuals and the external conditions of production been everywhere equal the idea of division of labor could never have arisen. . . . No social life could have arisen among men of equal natural capacity in a world which was geographically uniform. . . .
>
> Once labor has been divided, the division itself exercises a differentiating influence. The fact that labor is divided makes possible further cultivation of individual talent and thus cooperation becomes more and more productive. Through cooperation men are able to achieve what would have been beyond them as individuals. . . .
>
> The greater productivity of work under the division of labor is a unifying influence. It leads men to regard each other as comrades in a joint struggle for welfare, rather than as competitors in a struggle for existence.[4]

[4]Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (New Haven, Conn.: Yale University Press, 1951), pp. 292–95 and 303.

Freedom, then, is needed for the development of the individual, and such development also depends upon the extent of the division of labor and the height of the standard of living. The developed economy makes room for, and encourages, an enormously greater specialization and flowering of the powers of the individual than can a primitive economy, and the greater the degree of such development, the greater the scope for each individual.

If freedom and the growth of the market are each important for the development of each individual and, therefore, to the flowering of diversity and individual differences, then so is there a causal connection between freedom and economic growth. For it is precisely freedom, the absence or limitation of interpersonal restrictions or interference, that sets the stage for economic growth and hence of the market economy and the developed division of labor. The Industrial Revolution and the corollary and consequent economic growth of the West were a product of its relative freedom for enterprise, for invention and innovation, for mobility and the advancement of labor. Compared to societies in other times and places, eighteenth and nineteenth century Western Europe and the United States were marked by a far greater social and economic freedom—a freedom to move, invest, work, and produce—secure from much harassment and interference by government. Compared to the role of government elsewhere, its role in these centuries in the West was remarkably minimal.[5]

By allowing full scope for investment, mobility, the division of labor, creativity, and entrepreneurship, the free economy thereby creates the conditions for rapid economic development. It is freedom and the free market, as Adam Smith well pointed out, that develop the "wealth of nations." Thus, freedom leads to economic development, and both of these conditions in turn multiply individual development and the unfolding of the powers of the individual man. In

[5]Historians have been reminding us in recent decades that neither in England nor in the United States did government confine itself strictly to the ideal of *laissez faire*. True enough; but we must compare this era to the role of government in earlier—and later—days to see the significance of the difference. Thus, cf. Karl Wittfogel, *Oriental Despotism* (New Haven, Conn.: Yale University Press, 1957).

two crucial ways, then, freedom is the root; only the free man can be fully individuated and, therefore, can be fully human.

If freedom leads to a widening division of labor, and the full scope of individual development, it leads also to a growing population. For just as the division of labor is limited by the extent of the market, so is total population limited by total production. One of the striking facts about the Industrial Revolution has been not only a great rise in the standard of living for everyone, but also the viability of such ample living standards for an enormously larger population. The land area of North America was able to support only a million or so Indians five hundred years ago, and that at a barely subsistence level. Even if we wished to eliminate the division of labor, we could not do so without literally wiping out the vast majority of the current world population.

## II.

We conclude that freedom and its concomitant, the widening division of labor, are vital for the flowering of each individual, as well as the literal survival of the vast bulk of the world's population. It must give us great concern, then, that over the past two centuries mighty social movements have sprung up which have been dedicated, at their heart, to the stamping out of all human differences, of all individuality.

It has become apparent in recent years, for example, that the heart of the complex social philosophy of Marxism does not lie, as it seemed to in the 1930s and 40s, in Marxian economic doctrines: in the labor theory of value, in the familiar proposal for socialist state ownership of the means of production, and in the central planning of the economy and society. The economic theories and programs of Marxism are, to use a Marxian term, merely the elaborate "superstructure" erected on the inner core of Marxian aspiration. Consequently, many Marxists have, in recent decades, been willing to abandon the labor theory of value and even centralized socialist planning, as the Marxian economic theory has been increasingly abandoned and the practice of socialist planning shown to be unworkable. Similarly, the Marxists of the "New Left" in the United States and abroad have been willing to jettison socialist economic theory and practice. What they have not been willing to abandon is the philosophic heart of the Marxian ideal—not socialism or socialist planning, concerned

anyway with what is supposed to be a temporary "stage" of development, but communism itself. It is the communist ideal, the ultimate goal of Marxism, that excites the contemporary Marxist, that engages his most fervent passions. The New Left Marxist has no use for Soviet Russia because the Soviets have clearly relegated the communist ideal to the remotest possible future. The New Leftist admires Che Guevara, Fidel Castro, Mao Tse-Tung not simply because of their role as revolutionaries and guerrilla leaders, but more because of their repeated attempts to leap into communism as rapidly as possible.[6]

Karl Marx was vague and cloudy in describing the communist ideal, let alone the specific path for attaining it. But one essential feature is the eradication of the division of labor. Contrary to current belief, Marx's now popular concept of "alienation" had little to do with a psychological sense of apartness or discontent. The heart of the concept was the individual's "alienation" from the product of labor. A worker, for example, works in a steel mill. Obviously, he himself will consume little or none of the steel he produces; he earns the value of his product in the shape of a money-commodity, and then he happily uses that money to buy whatever he chooses from the products of other people. Thus, A produces steel, B eggs, C shoes, etc., and then each exchanges them for products of the others through the use of money. To Marx this phenomenon of the market and the division of labor was a radical evil, for it meant that no one consumed any of his own product. The steelworker thus became "alienated" from his steel, the shoemaker from his shoes, etc.

The proper response to this "problem," it seems to me, is: "So what?" Why should anyone care about this sort of "alienation"? Surely the farmer, shoemaker, and steelworker are very happy to sell their product and exchange it for whatever products they desire; deprive them of this "alienation" and they would be most unhappy, as well as dying from starvation. For if the farmer were not allowed to produce more wheat or eggs than he himself consumes, or the shoemaker more

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[6]The New Left, for example, ignores and scorns Marshall Tito despite his equally prominent role as Marxian revolutionary, guerrilla leader, and rebel against Soviet Russian dictation. The reason, as will be seen further below, is because Tito has pioneered in shifting from Marxism toward an individualistic philosophy and a market economy.

shoes than he can wear, or the steelworker more steel than he can use, it is clear that the great bulk of the population would rapidly starve and the rest be reduced to a primitive subsistence, with life "nasty, brutish, and short."[7] But to Marx this condition was the evil result of individualism and capitalism and had to be eradicated.

Furthermore, Marx was completely ignorant of the fact that each participant in the division of labor cooperates through the market economy, exchanging for each other's products and increasing the productivity and living standards of everyone. To Marx, *differences* between men and, therefore, any specialization in the division of labor, is a "contradiction," and the communist goal is to replace that "contradiction" with harmony among all. This means that to the Marxist any individual differences, any diversity among men, are "contradictions" to be stamped out and replaced by the uniformity of the antheap. Friedrich Engels maintained that the emergence of the division of labor shattered the alleged classless harmony and uniformity of primitive society, and was responsible for the cleavage of society into separate and conflicting classes. Hence, for Marx and Engels, the division of labor must be eradicated in order to abolish class conflict and to usher in the ideal harmony of the "classless society," the society of total uniformity.[8]

Thus, Marx foresees his communist deal only "after the enslaving subordination of individuals under division of labor, and therewith also the antithesis between mental and physical labor, has vanished."[9] To Marx the ideal communist society is one where, as Professor Gray puts it, "everyone must do everything." According to Marx in *The German Ideology*,

> In communist society, where nobody has one exclusive sphere of activity but each can become accomplished in any branch he

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[7]It is difficult, of course, to see how intangible *services* could be produced at all without "alienation." How can a teacher teach, for example, if he is not allowed to "alienate" his teaching services by providing them to his students?

[8]Thus, see Alexander Gray, *The Socialist Tradition* (London: Longmans, Green, 1947), pp. 306, 328.

[9]Karl Marx, *Critique of the Gotha Programme* (New York: International Publishers, 1938), p. 10.

> wishes, society regulates the general production and thus makes it possible for me to do one thing today and another tomorrow, to hunt in the morning, fish in the afternoon, rear cattle in the evening, criticize after dinner, just as I have a mind, without ever becoming hunter, fisherman, shepherd or critic.[10]

And the Marxist, August Bebel, consistently applied this dilettantish notion to the role of women:

> At one moment a practical worker in some industry she is in the next hour educator, teacher, nurse; in the third part of the day she exercises some art or cultivates a science; and in the fourth part she fulfills some administrative function.[11]

The concept of the *commune* in socialist thought takes on its central importance precisely as a means of eradicating individual differences. It is not just that the commune owns all the means of production among its members. Crucial to the communal ideal is that every man takes on every function, either all at once or in rapid rotation. Obviously, the commune has to subsist on no more than a primitive level, with only a few common tasks, for this ideal to be achieved. Hence the New Left commune, where every person is supposed to take turns equally at every task; again, specialization is eradicated, and no one can develop his powers to the full. Hence the current admiration for Cuba, which has attempted to stress "moral" rather than economic incentives in production, and which has established communes on the Isle of Pines. Hence the admiration of Mao, who has attempted to establish uniform urban and rural communes, and who recently sent several million students into permanent exile into the frontier agricultural areas, in order to eliminate the "contradiction between intellectual and physical labor."[12] Indeed, at the

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[10]Quoted in Gray, *The Socialist Tradition*, p. 328. Gray amusingly adds: "A short weekend on a farm might have convinced Marx that the cattle themselves might have some objection to being reared in this casual manner, in the evening."

[11]August Bebel, in *Women and Socialism*. Quoted in Mises, *Socialism*, p. 190*n*.

[12]A recent news report disclosed that China has now softened its assault on intellectual labor. The policy of interchanging students and workers seems to have worked badly, and it has been found that "a lack of teachers and of

heart of the split between Russia and China is Russia's virtual abandonment of the communist ideal in the face of China's "fundamentalist" devotion to the original creed. The shared devotion to the commune also accounts for the similarities between the New Left, the Utopian socialists of the nineteenth century,[13] and the communist anarchists, a wing of anarchism that has always shared the communal ideal with the Marxists.[14]

The communist would deny that his ideal society would suppress the personality of every man. On the contrary, freed from the confines of the division of labor, each person would fully develop all of his powers in every direction. Every man would be fully rounded in all spheres of life and work. As Engels put it in his *Anti-Dühring*, communism would give "each individual the opportunity to develop and exercise all his faculties, physical and mental, in all direction[s] . . ."[15] And Lenin wrote in 1920 of the "abolition of the division of labor among people . . . the education, schooling and training of people with *an all-round development and an all-round training, people able to do everything*. Communism is marching and must march toward this goal, and *will reach it*. . . ."[16]

This absurd ideal—of the man "able to do everything"—is only viable if (a) everyone does everything very badly, or (b) there are only a very few things to do, or (c) everyone is miraculously transformed into a superman. Professor Mises aptly notes that the ideal communist man is the dilettante, the man who knows a little of everything and does nothing well. For how can he develop *any* of his

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technical training has hampered industrial development and production in recent years." Furthermore, "workers appear often to have been not tempered but softened by their exposure to a more sedentary life as many students, rather than finding life on the farm rewarding, fled China or killed themselves." Lee Lescase, "China Softens Attitude on Profs. School Policy," *The Washington Post* (July 23, 1970), p. A12.

[13]On the Utopian socialists, see Mises, *Socialism*, p. 168.

[14]It is probable that Mao's particular devotion to the communist ideal was influenced by his having been an anarchist before becoming a Marxist.

[15]Quoted in Gray, *The Socialist Tradition*, p. 328.

[16]Italics as Lenin's. V.I. Lenin, *Left-Wing Communism: An Infantile Disorder* (New York: International Publishers, 1940), p. 34.

powers and faculties if he is prevented from developing any one of them to any sustained extent? As Mises says of Bebel's Utopia,

> Art and science are relegated to leisure hours. In this way, thinks Bebel, the society of the future "will possess scientists and artists of all kinds in countless numbers." These, according to their several inclinations, will pursue their studies and their arts in their spare time. . . . All mental work he regards as mere dilettantism. . . . But nevertheless we must inquire whether under these conditions the mind would be able to create that freedom without which it cannot exist.
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> Obviously all artistic and scientific work which demands time, travel, technical education and great material expenditure, would be quite out of the question.[17]

Every person's time and energy on the earth are necessarily limited; hence, in order to develop any of his faculties to the full, he must specialize and concentrate on some rather than others. As Gray writes,

> That each individual should have the opportunity of developing *all* his faculties, physical *and* mental, in *all* directions, is a dream which will cheer the vision only of the simple-minded, oblivious of the restrictions imposed by the narrow limits of human life. For life is a series of acts of choice, and each choice is at the same time a renunciation. . . .
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> Even the inhabitant of Engels' future fairyland will have to decide sooner or later whether he wishes to be Archbishop of Canterbury or First Sea Lord, whether he should seek to excel as a violinist or as a pugilist, whether he should elect to know all about Chinese literature or about the hidden pages in the life of the mackerel.[18]

Of course, the only way to resolve this dilemma is to fantasize that the New Communist Man will be a superman. The Marxist, Karl Kautsky, asserted that in the future society "a new type of man will arise . . . a superman . . . an exalted man." Leon Trotsky prophesied that under communism

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[17]Mises, *Socialism*, p. 190.

[18]Gray, *The Socialist Tradition*, p. 328.

> man will become incomparably stronger, wiser, finer. His body more harmonious, his movements more rhythmical, his voice more musical. . . . The human average will rise to the level of an Aristotle, a Goethe, a Marx. Above these other heights new peaks will arise.[19]

In recent years, communists have intensified their efforts to end the division of labor and reduce all individuals to uniformity. Fidel Castro's attempts to "build Communism" in the Isle of Pines, and Mao Tse-Tung's Cultural Revolution, have been echoed in miniature by the American New Left in numerous attempts to form hippies' communes and to create organizational "collectives" in which everyone does everything without benefit of specialization.[20] In contrast, Yugoslavia has been the quiet despair of the communist movement by moving rapidly in the opposite direction—toward every-increasing freedom, individuality, and free-market operations—and has proved influential in leading the other "communist" countries of Eastern Europe (notably, Hungary and Czechoslovakia) in the same direction.[21]

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[19]Quoted in Mises, *Socialism*, p. 164.

[20]Thus, one of the major criticisms of the New Left journal, *The Guardian*, by its rebellious split-off, *The Liberated Guardian*, was that the former functioned in the same way as any "bourgeois" magazine, with specialized editors, typists, copyreaders, business staff, etc. The latter is run by a "collective" in which, assertedly, everyone does every task without specialization. The same criticism, along with the same solution, was applied by the women's caucus which confiscated the New Left weekly, Rat. Some of the "Women's Liberation" groups have been so extreme in the drive to extirpate individuality as to refuse to identify the names of individual members, writers, or spokesmen.

[21]Thus, a shock to orthodox communists throughout the world was the 1958 Program of the League of Communists of Yugoslavia, which declared that the individual's "personal interest . . . is the moving force of our social development. . . . The objectivity of the category of personal interest lies in the fact that [Yugoslavia] socialism . . . cannot subject the personal happiness of man to any ulterior 'goals' or 'higher aims,' for the highest aims of socialism is the personal happiness of man." From *Kommunist* (Belgrade), August 8, 1963. Quoted in R.V. Burks, "Yugoslavia: Has Tito Gone Bourgeois?" *East Europe* (August 1965): 2–14. Also see T. Peter Svennevig, "The Ideology of the Yugoslav Heretics," *Social Research* (Spring, 1960): 39–48.

## III.

One way of gauging the extent of "harmonious" development of all of the individual's powers in the absence of specialization is to consider what actually happened during primitive or preindustrial eras. And, indeed, many socialists and other opponents of the Industrial Revolution exalt the primitive and preindustrial periods as a golden age of harmony, community, and social belonging—a peaceful and happy society destroyed by the development of individualism, the Industrial Revolution, and the market economy. In their exaltation of the primitive and the preindustrial, the socialists were perfectly anticipated by the reactionaries of the Romantic movement, those men who longed to roll back the tide of progress, individualism, and industry, and return to the supposed golden age of the preindustrial era. The New Left, in particular, also emphasizes a condemnation of technology and the division of labor, as well as a desire to "return to the earth" and an exaltation of the commune and the "tribe." As John W. Aldridge perceptively points out, the current New Left virtually constitutes a generational tribe that exhibits all the characteristics of a uniform and interchangeable herd, with little or no individuality among its members.[22]

Similarly, the early nineteenth century German reactionary, Adam Müller, denounced the

> vicious tendency to divide labor in all branches of private industry. . . . [The] division of labor in large cities or industrial or mining provinces cuts up man, the completely free man, into wheels, rollers, spokes, shafts, etc., forces on him an utterly one-sided scope in the already one-sided field of the provisioning of one single want.[23]

The leading French conservatives of the early nineteenth century, Bonald and de Maistre, who idealized the feudal order,

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For attacks by orthodox communists, see Shih Tung-Hsiang, "The Degeneration of the Yugoslav Economy Owned by the Whole People," *Peking Review* (June 12, 1964): 11–16; and "Peaceful Transition from Socialism to Capitalism?" *Monthly Review* (March 1964): 569–90.

[22]John W. Aldridge, *In the Country of the Young* (New York: Harper & Row, 1970).

[23]Quoted in Mises, *Socialism*, p. 304.

denounced the disruption by individualism of the pre-existing social order and social cohesion.[24] The contemporary French reactionary, Jacques Ellul, in *The Technological Society*, a book much in favor on the New Left, condemns "our dehumanized factories, our unsatisfied senses . . . our estrangement from nature." In the Middle Ages, in contrast, claims Ellul, "Man sought open spaces . . . the possibility of moving about . . . of not constantly colliding with other people."[25] In the meanwhile, on the socialist side, the economic historian Karl Polanyi's influential *The Great Transformation* makes this thesis of the disruption of a previous social harmony by individualism, the market economy, and the division of labor the central theme of the book.

For its part, the worship of the primitive is a logical extension of the worship of the preindustrial. This worship by modern sophisticated intellectuals ranges from Rousseau's "noble savage" and the lionizing of that creature by the Romantic movement, all the way to the adoration of the Black Panthers by white intellectuals.[26] Whatever other pathology the worship of the primitive reflects, a basic part of it is a deep-seated hatred of individual diversity. Obviously, the more primitive and the less civilized a society, the less diverse and individuated it can be.[27] Also part of this primitivism reflects a hatred for the intellect and its works, since the flowering of reason and intellection leads to diversity and inequality of individual achievement.

For the individual to advance and develop, reason and the intellect must be *active*, it must embody the individual's mind working upon and transforming the materials of reality. From the time of

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[24]On the strong influence of these reactionary thinkers on the anti-individualism of nineteenth century Marxists and socialists, see in particular Leon Bramson, *The Political Context of Sociology* (Princeton, N.J.: Princeton University Press, 1961), pp. 12–16 and passim.

[25]See the critique of Ellul in Charles Silberman, *The Myths of Automation* (New York: Harper & Row, 1966), pp. 104–05.

[26]Thus, see the perceptively satiric article by Tom Wolfe, "Radical Chic: That Party at Lenny's," *New York* (June 8, 1970).

[27]This worship of the primitive permeates Polanyi's book, which at one point seriously applies the term "noble savage" to the Kaffirs of South Africa. Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 1957), p. 157.

Aristotle, the classical philosophy presented man as only fulfilling himself, his nature, and his personality through purposive action upon the world. It is from such rational and purposive action that the works of civilization have developed. In contrast, the Romantic movement has always exalted the passivity of the child who, necessarily ignorant and immature, only reacts passively to his environment rather than acts to change it. This tendency to exalt passivity and the young, and to denigrate intellect, has reached its present embodiment in the New Left, which worships both youth *per se* and a passive attitude of ignorant and purposeless spontaneity. The passivity of the New Left, its wish to live simply and in "harmony" with "the earth" and the alleged rhythms of nature, harks back completely to the Rousseauist Romantic movement. Like the Romantic movement, it is a conscious rejection of civilization and differentiated men on behalf of the primitive, the ignorant, the herd-like "tribe."[28]

If reason, purpose, and action are to be spurned, then what replace them in the Romantic pantheon are unanalyzed, spontaneous "feelings." And since the range of feelings is relatively small compared to intellectual achievements, and in any case is not objectively known to another person, the emphasis on feelings is another way to iron out diversity and inequality among individuals.

Irving Babbitt, a keen critic of Romanticism, wrote about the Romantic movement:

> The whole movement is filled with the praise of ignorance and of those who still enjoy its inappreciable advantages—the savage, the peasant and above all the child. The Rousseauist may indeed be said to have discovered the poetry of childhood . . . but at what would seem at times a rather heavy sacrifice of rationality. Rather than consent to have the bloom taken off things by analysis one should, as Coleridge tells us, sink back to the devout state of child-like wonder. However, to grow ethically is not to sink back but to struggle painfully forward. To affirm the contrary is to proclaim one's inability to mature. . . . [The Romantic] is ready to assert

[28]Both the passive and the tribal aspects of New Left culture were embodied in its ideal of the "Woodstock Nation," in which hundreds of thousands of herd-like, undifferentiated youth wallowed passively in the mud listening to their tribal ritual music.

> that what comes to the child spontaneously is superior to the deliberate moral effort of the mature man. The speeches of all the sages are, according to Maeterlinck, outweighed by the unconscious wisdom of the passing child.[29]

Another perceptive critique of Romanticism and primitivism was written by Ludwig von Mises. He notes that "the whole tribe of romantics" have denounced specialization and the division of labor. "For them the man of the past who developed his powers 'harmoniously' is the ideal: an ideal which alas no longer inspires our degenerate age. They recommend retrogression in the division of labor." with the socialists surpassing their fellow Romantics in this regard.[30] But are primitives or preindustrial men privileged to develop themselves freely and harmoniously? Mises answers:

> It is futile to look for the harmoniously developed man at the outset of economic evolution. The almost self-sufficient economic subject as we know him in the solitary peasant of remote valleys shows none of that noble, harmonious development of body, mind, and feeling which the romantics ascribe to him. Civilization is a product of leisure and the peace of mind that only the division of labor can make possible. Nothing is more false than to assume that man first appeared in history with an independent individuality and that only during the evolution [of society] . . . did he lose . . . his spiritual independence. All history, evidence and observation of the lives of primitive peoples is directly contrary to this view. Primitive man lacks all individuality in our sense. Two South Sea Islanders resemble each other far more closely than two twentieth-century Londoners. Personality was not bestowed upon man at the outset. It has been acquired in the course of evolution of society.[31]

Or we may note Charles Silberman's critique of Jacques Ellul's rhapsodies on the "traditional rhythms of life and nature" lived by preindustrial man, as compared to "dehumanized factories . . . our estrangement from nature." Silberman asks:

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[29]Irving Babbitt, *Rousseau and Romanticism* (New York: Meridian Books, 1955), pp. 53–54. The New Left's emphasis on passivity, primitivism, the irrational, and the dissolution of individuality may account for the current popularity of Taoist and Buddhist philosophy. See ibid., pp. 297ff.

[30]Mises, *Socialism*, p. 304.

[31]Ibid., p. 305.

> But with what shall we contrast this dehumanized world? The beautiful, harmonious life being lived by, say, the Chinese or Vietnamese peasant woman, who works in the fields close to nature, for twelve hours a day—roughly the conditions under which the great bulk women (and men) have worked . . . through all of human history? For this is the condition that Ellul idealizes.

And, as for Ellul's paean to the Middle Ages as being mobile, spacious, and uncrowded:

> This would have been startling news to the medieval peasant, who lived with his wife and children, other relatives, and probably animals as well in a one-room thatched cottage. And even for the nobility, was there really more possibility of "moving about" in the Middle Ages, when travel was by foot or hoof, than today, when steelworkers spend sabbaticals in Europe?[32]

The savage is supposed not only to be "noble" but also supremely happy. From the Rousseauans to what Erich Fromm has called "the infantile Paradise" of Norman O. Brown and Herbert Marcuse, the Romantics have extolled the happiness yielded by the spontaneous and the childlike. To Aristotle and the classic philosophers, happiness was acting in accordance with man's unique and rational nature. To Marcuse, any purposive, rational action is by definition "repressive," to which he contrasts the "liberated" state of spontaneous play. Aside from the universal destitution that the proposed abolition of work would bring, the result would be a profound unhappiness, for no individual would be able to fulfill himself, his individuality would largely disappear, for in a world of "polymorphous" play everyone would be virtually alike.

If we consider the supposed happiness of primitive man, we must also consider that his life was, in the famous phrase of Hobbes, "nasty, brutish, and short." There were few medical aids against disease; there were none against famine, for in a world cut off from interregional markets and barely above subsistence any check to the local food supply will decimate the population. Fulfilling the dreams of Romantics, the primitive tribe is a passive creature of its given environment and has no means for acting to overcome and transform it. Hence, when the local food supply within an area is depleted, the "happy-go-lucky" tribe dies *en masse*.

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[32]Silberman, *The Myths of Automation*, pp. 104–05.

Furthermore, we must realize that the primitive faces a world which he cannot understand, since he has not engaged in much of a rational, scientific inquiry into its workings. We know what a thunderstorm is, and therefore take rational measures against it; but the savage does not know, and therefore surmises that the God of Thunder is displeased with him and must be propitiated with sacrifices and votive offerings. Since the savage has only a limited concept of a world knit together by natural law (a concept which employs reason and science), he believes that the world is governed by a host of capricious spirits and demons, each of which can only be propitiated by ritual or magic, and by a priest-craft of witch doctors who specialize in their propitiation.[33] The renaissance of astrology and similar mystic creeds on the New Left marks a reversion to such primitive forms of magic. So fearful is the savage, so bound is he by irrational taboo and by the custom of his tribe, that he cannot develop his individuality.

If tribal custom crippled and repressed the development of each individual, then so too did the various caste systems and networks of restriction and coercion in preindustrial societies that forced everyone to follow the hereditary footsteps of his father's occupation. Each child knew from birth that he was doomed to tread where his ancestors had gone before him, regardless of ability or inclination to the contrary. The "social harmony," the "sense of belonging," supplied by mercantilism, by the guilds, or by the caste system, provided such contentment that its members left the throes of the system when given an opportunity. Given the freedom to choose, the tribesmen abandon the bosom of their tribe to come to the freer, "atomistic" cities looking for jobs and opportunity. It is curious, in fact, that those Romantics who yearn to restore the mythical golden age of caste and status refuse to allow each individual the freedom to

[33]Neither is the magic used by primitive tribes any evidence of superior, "idealistic," as opposed to this worldly, "materialistic," ends. On the contrary, the magic rites were unsound and erroneous means *by which* the tribes hoped to attain such materialistic ends as a good harvest, rainfall, etc. Thus, the Cargo Cult of New Guinea, on observing Europeans obtaining food from overseas by sending away scraps of paper, imitated the Europeans by writing ritualistic phrases on slips of paper and sending them out to sea, after which they waited for cargoes from overseas. Cf. Ludwig von Mises, *Epistemological Problems of Economics* (Princeton, N.J.: D. Van Nostrand, 1960), pp. 62–66, 102–05.

choose between market on the one hand, or caste and tribal commune on the other. Invariably, the new golden age has to be imposed by coercion.

Is it, indeed, a coincidence that the natives of undeveloped countries, when given a chance, invariably abandon their "folk culture" on behalf of Western ways, living standards, and "Coca-Colaization?" Within a few years, for example, the people of Japan were delighted to abandon their centuries-old traditional culture and folkways, and turn to the material achievements and market economy of the West. Primitive tribes, too, given a chance, are eager to differentiate and develop a market economy, to shed their stagnant "harmony" and replace their magic by knowledge of discovered law. The eminent anthropologist, Branislaw Malinowski, pointed out that primitives allow magic only to cover those areas of nature of which they are ignorant; in those areas where they have come to understand the natural processes at work, magic is, quite sensibly, not employed.[34]

A particularly striking example of the eager development of a pervasive market economy among primitive tribesmen is the largely unheralded case of West Africa.[35] And Bernard Siegel has pointed out that when, as among the Penajachel of Guatemala, a primitive society becomes large and technologically and societally complex, a market economy inevitably accompanies this growth, replete with specialization, competition, cash purchases, demand and supply, prices and costs, etc.[36]

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[34]Bronislaw Malinowski, *Magic, Science, Religion and Other Essays* (New York: Doubleday Anchor Books, 1955), pp. 27–31. Also see Mises, *Epistemological Problems of Economics*.

[35]See the inspiring discussion in Peter T. Bauer, *West African Trade* (Cambridge: Cambridge University Press, 1954).

[36]Bernard J. Siegel, "Review of Melville J. Herskovits, *Economic Anthropology*," *American Economic Review* (June 1953): 402. On developing individualism among the Pondo of South Africa, see Bauer and Yamey, *The Economics of Underdeveloped Countries*, p. 67*n*. Also see Raymond Firth, *Human Types* (New York: Mentor Books, 1958), p. 122; Sol Tax, *Penny Capitalism: A Guatemalan Indian Economy* (Washington, D.C., 1953); and Raymond Firth and Basil S. Yamey, eds., *Capital, Saving and Credit in Peasant Societies* (Chicago: Aldine, 1963).

There is thus ample evidence that even primitive tribesmen themselves are not fond of their primitivism and take the earliest opportunity to escape from it; the main stronghold of love for primitivism seems to rest among the decidedly non-primitive Romantic intellectuals.

Another primitivistic institution that has been hailed by many social scientists is the system of the "extended family," a harmony and status supposedly ruptured by the individualistic "nuclear family" of the modern West. Yet the extended family system has been responsible for crippling the creative and productive individual as well as repressing economic development. Thus, West African development has been impeded by the extended family concept that, if one man prospers, he is duty bound to share this bounty with a host of relatives, thus draining off the reward for his productivity and crippling his incentive to succeed, while encouraging the relatives to live idly on the family dole. And neither do the productive members of the tribe seem very happy about this supposedly harmonious societal bond. Professor Bauer points out that

> many admit in private discussion that they dread these extensive obligations. . . . The fear of the obligations of the family system is partly responsible for the widespread use of textiles and trinkets as outlets for savings, in preference to more productive forms of investment which are more likely to attract the attention of relatives.

And many Africans distrust banks, "fearing that they may disclose the size of their accounts to members of their families. They, therefore, prefer to keep their savings under the fireplace or buried in the ground."[37]

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[37]Bauer, *West African Trade*, p. 8. Also see Bauer and Yamey, *The Economics of Underdeveloped Countries*, pp. 64–67. Similarly, Professor S. Herbert Frankel reports on how West Africans habitually wait at entrances of banks to fall upon their relatives to demand money as they leave. Any man who accumulates money must go to great lengths to deceive his relatives on his actual status. Cited in Helmut Schoeck, *Envy: A Theory of Social Behaviour* (New York: Harcourt, Brace & World, 1970), pp. 59–60. On the responsiveness of African natives to market economic incentives, see (in addition to Bauer, (West African Trade) Peter Kilby, "African Labour Productivity Reconsidered," *Economic Journal* (June, 1961), pp. 273–91.

In fact, the primitive community, far from being happy, harmonious, and idyllic, is much more likely to be ridden by mutual suspicion and envy of the more successful or better-favored, an envy so pervasive as to cripple, by the fear of its presence, all personal or general economic development. The German sociologist Helmut Schoeck, in his important recent work on Envy, cites numerous studies of this pervasive crippling effect. Thus the anthropologist Clyde Kluckhohn found among the Navaho the absence of any concept of "personal success" or "personal achievement"; and such success was automatically attributed to exploitation of others, and, therefore, the more prosperous Navaho Indian feels himself under constant social pressure to give his money away. Allan Holmberg found that the Siriono Indian of Bolivia eats alone at night because, if he eats by day, a crowd gathers around him to stare in envious hatred. The result among the Siriono is that, in reaction to this pervasive pressure, no one will voluntarily share food with anybody. Sol Tax found that envy and fear of envy in "a small community where all neighbors watch and where all are neighbors" accounted for the unprogressiveness, the slowness of change toward a productive economy among the Indians of Guatemala. And when a tribe of Pueblo Indians showed the beginnings of specialization and the division of labor, the envy of their fellow tribesmen impelled them to take measures to end this process, including physical destruction of the property of those who seemed in any way better off than their fellows.

Oscar Lewis discovered an extremely pervasive fear of the envy of others in a Mexican Indian village, a fear producing intense secretiveness. Wrote Lewis:

> The man who speaks little, keeps his affairs to himself, and maintains some distance between himself and others has less chance of creating enemies or of being criticized or envied. A man does not generally discuss his plans to buy or sell or take a trip.[38]

[38]The works cited are Clyde Kluckhohn, *The Navaho* (Cambridge, Mass.: Harvard University Press, 1946) and *Navaho Witchcraft* (1944; Boston: Beacon Press, 1967); Allan R. Holmberg, *Nomads of the Lon Bow: The Siriono of Eastern Bolivia* (Washington, D.C.: U.S. Government Printing Office, 1950); Sol Tax, "Changing Consumption in Indian Guatemala," *Economic Development and Cultural Change* (1957); and Oscar Lewis, *Life in a Mexican Village: Tepoztlan Restudied* (Urbana: University of Illinois Press, 1951). See Schoeck, *Envy*, pp. 26–61.

Professor Schoeck comments:

> it is difficult to envisage what it means for the economic and technical development of a community when, almost automatically and as a matter of principle, the future dimension is banned from human intercourse and conversation, when it cannot even be discussed. Ubiquitous envy, fear of it and those who harbor it, cuts off such people from any kind of communal action directed towards the future. . . . All striving, all preparation and planning for the future can be undertaken only by socially fragmented, secretive beings.[39]

Furthermore, in this Mexican village no one will warn or tell anyone else of imminent danger to the other's property; there is no sense of human social solidarity whatsoever.

Among the Indians of Aritama in Colombia, the Reichel-Dolmatoffs reported:

> Every individual lives in constant fear of the magical aggression of others, and the general social atmosphere in the village is one of mutual suspicion, of latent danger, and hidden hostility, which pervade every aspect of life. The most immediate reason for magical aggression is envy. Anything that might be interpreted as a personal advantage over others is envied: good health, economic assets, good physical appearance, popularity, a harmonious family life, a new dress. All these and other aspects imply prestige, and with it power and authority over others. Aggressive magic is, therefore, intended to prevent or to destroy this power and to act as a leveling force.[40]

The Reichel-Dolmatoffs also noted that if one member of a group in Aritama should work faster or better than his fellows, his place of work is marked with a cross before he arrives the next morning, and his envious colleagues pray to God to make this more able worker slow and tired.

Finally, Watson and Samora found that the major reason for the failure of a group of lower-class Spanish-speaking citizens of a mountain township in southern Colorado to rise into parity with the

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[39]Clyde Kluckhohn, *The Navaho* and *Navaho Witchcraft*, p. 50.

[40]From Gerardo and Alicia Reichel-Dolmatoff, *The People of Aritama: The Cultural Personality of a Colombian Mestizo Village* (Chicago: University of Chicago Press, 1961), p. 396. Quoted in Schoeck, *Envy*, pp. 51–52.

upper-class Anglo community, was the bitter envy of the Spanish group toward any of their number who managed to rise upward. Anyone who works his way upward is regarded as a man "who has sold himself to the Anglos," "who has climbed on the backs of his people."[41]

The anthropologist Eric Wolf has even coined the term "institutionalized envy" to describe such pervasive institutions, including the practice and fear of black magic in these primitive societies.[42] Schoeck notes:

> *Institutionalized envy* . . . or the ubiquitous fear of it, means that there is little possibility of individual economic advancement and no contact with the outside world through which the community might hope to progress. No one dares to show anything that might lead people to think he was better off. Innovations are unlikely. Agricultural methods remain traditional and primitive, to the detriment of the whole village, because every deviation from previous practice comes up against the limitations set by envy.[43]

And Schoeck aptly concludes:

> There is nothing to be seen here of the close community which allegedly exists among primitive peoples in pre-affluent times—the poorer, it is held, the greater the sense of community. Sociological theory would have avoided many errors if those phenomena had been properly observed and evaluated a century ago. The myth of a golden age, when social harmony prevailed because each man had about as little as the next one, the warm and generous community spirit of simple societies, was indeed for the most part just a myth, and social scientists should have known better than to fashion out of it a set of utopian standards with which to criticize their own societies.[44]

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[41]James B. Watson and Julian Samora, "Subordinate Leadership in a Bicultural Community: An Analysis," *American Sociological Review* 19, no. 4 (August 1954): 413–21.

[42]Eric R. Wolf, "Types of Latin American Peasantry: A Preliminary Discussion," *American Anthropologist* 57, no. 3 (June 1955): 460.

[43]Reichel-Dolmatoff, *The People of Aritama*, quoted in Schoeck, *Envy*, p. 47.

[44]Ibid., p. 31.

In sum, Ludwig von Mises's strictures against Romanticism do not seem to be overdrawn:

> Romanticism is man's revolt against reason, as well as against the condition under which nature has compelled him to live. The romantic is a daydreamer; he easily manages in imagination to disregard the laws of logic and nature. The thinking and rationally acting man tries to rid himself of the discomfort of unsatisfied wants by economic action and work; he produces in order to improve his position. The romantic . . . imagines the pleasures of success but he does nothing to achieve them[:] he does not remove the obstacles; he merely removes them in imagination. . . . He hates work, economy, and reason.
>
> The romantic takes all the gifts of a social civilization for granted and desires, in addition, everything fine and beautiful that, as he thinks, distant times and creatures had or have to offer. Surrounded by the comforts of European town life he longs to be an Indian rajah, bedouin, corsair, or troubadour. But he sees only that portion of these people's lives which seems pleasant to him. . . . The perilous nature of their existence, the comparative poverty of their circumstances, their miseries and their toil—these things his imagination tactfully overlooks: all is transfigured by a rosy gleam. Compared with this dream ideal, reality appears arid and shallow. There are obstacles to overcome which do not exist in the dream. . . . Here there is work to do, ceaselessly, assiduously. . . . Here one must plough and sow if one wishes to reap. The romantic does not choose to admit all this. Obstinate as a child, he refuses to recognize it. He mocks and jeers; he despises and loathes the bourgeois.[45]

The Romantic, or primitivist, attitude was also brilliantly criticized by the Spanish philosopher, Ortega y Gasset:

> it is possible to have peoples who are perennially primitive . . . those who have remained in the motionless, frozen twilight, which never progresses towards midday.
>
> This is what happens in the world which is mere Nature. But it does not happen in the world of civilization which is ours. Civilization is not "just there," it is not self-supporting. It is artificial. . . . If you want to make use of the advantages of civilization, but

[45]Mises, *Socialism*, pp. 463–64. See also José Ortega y Gasset, *The Revolt of the Masses* (New York: W.W. Norton, 1932), pp. 63–65.

> are not prepared to concern yourself with the upholding of civilization—you are done. In a trice you find yourself left without civilization. . . . The primitive forest appears in its native state. . . . The jungle is always primitive and, vice versa, everything primitive is mere jungle.[46]

Ortega adds that the type of man he sees rising to the fore, the modern "mass-man," "believes that the civilization into which he was born and which he makes use of, is as spontaneous and self-producing as Nature." But the mass-man, the herd-man, is also characterized by his desire to stamp out those individuals who differ from the mass: "The mass . . . does not wish to share life with those who are not of it. It has a deadly hatred of all that is not itself.[47]

## IV.

The Left, of course, does not couch its demands in terms of stamping out diversity; what it seeks to achieve sounds semantically far more pleasant: *equality*. It is in the name of equality that the Left seeks all manner of measures, from progressive taxation to the ultimate stage of communism.

But what, philosophically, *is* "equality?" The term must not be left unanalyzed and accepted at face value. Let us take three entities: A, B, and C. A, B, and C are said to be "equal" to each other (i.e., A=B=C) *if* a particular characteristic is found in which the three entities are uniform or identical. In short, here are three individual men: A, B, and C. Each may be similar in some respects but different in others. If each of them is precisely 5'10" *in height*, they are then *equal* to each other in height. It follows from our discussion of the concept of equality that A, B, and C can be *completely* "equal" to each other only if they are identical or uniform in *all* characteristics—in short, if all of them are, like the same size of nut or bolt, completely interchangeable. We see, then, that the ideal of human equality *can only* imply total uniformity and the utter stamping out of individuality.

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[46]Ortega y Gasset, *The Revolt of the Masses*, pp. 97.

[47]Ibid., pp. 98, 84. For Ortega, the great looming danger is that the mass-man will increasingly use the State "to crush beneath it any creative minority which disturbs it—disturbs it in any order of things: in politics, in industry." Ibid., p. 133.

It is high time, then, for those who cherish freedom, individuality, the division of labor, and economic prosperity and survival, to stop conceding the supposed nobility of the ideal of equality. Too often have "conservatives" conceded the ideal of equality only to cavil at its "impracticality." Philosophically, there can be no divorce between theory and practice. Egalitarian measures do not "work" because they violate the basic nature of man, of what it means for the individual man to be truly human. The call of "equality" is a siren song that can only mean the destruction of all that we cherish as being human.

It is ironic that the term, "equality," brings its favorable connotation to us from a past usage that was radically different. For the concept of "equality" achieved its widespread popularity during the classical liberal movements of the eighteenth century, when it meant, not uniformity of status or income, but freedom for each and every man, without exception. In short, "equality" in those days meant the liberation and individualist concept of full liberty for all persons. Thus, the biochemist Roger Williams correctly points out that the "'free and equal' phrase in the Declaration of Independence was an unfortunate paraphrase of a better statement contained in the Virginia Bill of Rights . . . 'all men are by nature equally free and independent.' In other words, men can be *equally free* without being *uniform*."[48]

This libertarian credo was formulated with particular cogency by Herbert Spencer in his "Law of Equal Liberty" as the suggested fundamental core of his social philosophy:

> man's happiness can be obtained only by the exercise of his faculties. . . . But the fulfillment of this duty necessarily presupposes freedom of action. Man cannot exercise his faculties without certain scope. He must have liberty to go and to come, to see, to feel,

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[48]Roger J. Williams, *Free and Unequal: The Biological Basis of Individual Liberty* (Austin, Texas: University of Texas Press, 1953), pp. 4–5. Williams adds: "Does not our love of liberty, which seems to be inherent in all of us, rest squarely upon our inequalities? If at birth we all possessed the same potential tastes . . . would we care about being free to pursue them as we individually desire? . . . It seems to me clear that the idea of freedom arose directly out of this human variability. If we were all alike there would seem to be no reason for wanting freedom; 'living my own life' would be an empty, meaningless expression." Ibid., pp. 5, 12.

> to speak, to work; to get food, raiment, shelter, and to provide for each and all the needs of his nature. . . . To exercise his faculties he must have liberty to do all that his faculties actually impel him to do. . . . Therefore, he has a *right* to that liberty. This, however, is not the right of one but all. All are endowed with faculties. All are bound to . . . [exercise] them. All, therefore, must be free to do those things in which the exercise of them consists. That is, all must have rights to liberty of action.
>
> And hence there necessarily arises a limitation. For if men have like claims to that freedom which is needful for the exercise of their faculties, then must the freedom of each be bounded by the similar freedom of all. . . . Wherefore we arrive at the general proposition, that every man may claim the fullest liberty to exercise his faculties compatible with the possession of like liberty by every other man.[49]

Thus, only the specific equality of *liberty*—the older view of human equality—is compatible with the basic nature of man. Equality of *condition* would reduce humanity to an antheap existence. Fortunately, the individuated nature of man, allied to the geographical diversity on the earth, makes the ideal of total equality unattainable. But an enormous amount of damage—the crippling of individuality, as well as economic and social destruction—could be generated in the attempt.

Let us turn from equality to the concept of inequality, the condition that exists when every man is *not* identical to every other in all characteristics. It is evident that inequality flows inevitably out of specialization and the division of labor. Therefore, a free economy will lead not only to diversity of occupation, with one man a baker, another an actor, a third a civil engineer, etc., but specific *in*equalities will also emerge in monetary income and in status and scope of control within each occupation. Each person will, in the free-market economy, tend to earn a monetary income equal to the value placed upon his productive contribution in satisfying the desires and demands of the consumers. In economic terminology each man will

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[49]Herbert Spencer, *Social Statics* (London: John Chapman, 1851), pp. 76–78. In the remainder of the book, Spencer spins out the concrete implications of his basic principle. For a critique of the *Law of Equal Liberty*, see Murray N. Rothbard, *Power and Market* (Menlo Park, Calif.: Institute for Humane Studies, 1970), pp. 159–60.

tend to earn an income equal to his "marginal productivity," to his particular productivity in satisfying consumer demands. Clearly, in a world of developed individual diversity, some men will be more intelligent, others more alert and farsighted, than the remainder of the population. Still others, meanwhile, will be more interested in those areas reaping greater monetary gain; those who succeed at wildcatting of crude oil will reap greater monetary rewards than those who remain in secretarial jobs.

Many intellectuals are wont to denounce the "unfairness" of the market in granting a far higher monetary income to a movie star than, say, a social worker, in that way rewarding "material" far more than "spiritual"; it strikes one that if the social worker's alleged "goodness" indeed resides in her "spirituality," then it is surely inappropriate and inconsistent to demand that she receive more of the "material" amenities (money) *vis-à-vis* the movie star. In the free society, those who are capable of providing goods and services that the consumers value and are willing to purchase, will receive precisely what the consumers are willing to spend. Those who persist in entering lower-priced occupations, either because they prefer the work or because they are not sufficiently capable in the higher-paid fields, can scarcely complain when they earn a lower salary.

If, then, *in*equality of income is the inevitable corollary of freedom, then so too is inequality of control. In *any* organization, whether it be a business firm, a lodge, or a bridge club, there will always be a minority of people who will rise to the position of leaders and others who will remain as followers in the rank and file. Robert Michels discovered this as one of the great laws of sociology, "The Iron Law of Oligarchy." In every organized activity, no matter the sphere, a small number will become the "oligarchical" leaders and the others will follow.

In the market economy, the leaders, being more productive in satisfying the consumers, will inevitably earn more money than the rank and file. Within other organizations, the difference will only be that of control. But, in either case, ability and interest will select those who rise to the top. The best and most dedicated steel producer will rise to the leadership of the steel corporation; the ablest and most energetic will tend to rise to leadership in the local bridge club; and so on.

This process of ability and dedication finding its own level works best and most smoothly, it is true, in institutions such as business firms in the market economy. For here every firm places itself under the discipline of monetary profits and income earned by selling a suitable product to the consumers. If managers or workers fall down on the job, a loss of profits provides a very rapid signal that something is wrong and that these producers must mend their ways. In non-market organizations, where profit does not provide a test of efficiency, it is far easier for other qualities extraneous to the actual activity to play a role in selecting the members of the oligarchy. Thus, a local bridge club may select its leaders, not only for ability and dedication to the activities of the club, but also for extraneous racial or physical characteristics preferred by the membership. This situation is far less likely where monetary losses will be incurred by yielding to such external factors.

We need only look around us at every human activity or organization, large or small, political, economic, philanthropic, or recreational, to see the universality of the Iron Law of Oligarchy. Take a bridge club of fifty members and, regardless of legal formalities, half-a-dozen or so will really be running the show. Michels, in fact, discovered the Iron Law by observing the rigid, bureaucratic, oligarchic rule that pervaded the Social Democratic parties in Europe in the late nineteenth century, even though these parties were supposedly dedicated to equality and the abolition of the division of labor.[50] And it is precisely the obviously frozen inequality of income and power, and the rule by oligarchy, that has totally disillusioned the equality-seeking New Left in the Soviet Union. No one lionizes Brezhnev or Kosygin.

It is the egalitarian attempt by the New Left to escape the Iron Law of inequality and oligarchy that accounts for its desperate efforts to end elite leadership within its own organizations. (Certainly there has been no indication of any disappearance of the power elite in oft-heralded Cuba or China.) The early drive toward egalitarianism in the New Left emerged in the concept of "participatory democracy."

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[50]Robert Michels, *Political Parties* (Glencoe, Ill.: Free Press, 1949). See also the brilliant work by Gaetano Mosca, *The Ruling Class* (New York: McGraw-Hill, 1939), which focuses on the inevitability of a minority "ruling class" wielding power in government.

Instead of the members of an organization electing an elite leadership, so the theory ran, each person would participate equally in all of the organization's decision-making. It was, by the way, probably this *sense* of direct and intense participation by each individual that accounted for the heady enthusiasm of the masses in the very early stages of the revolutionary regimes in Soviet Russia and Cuba—an enthusiasm that quickly waned as the inevitable oligarchy began to take control and mass participation to die.

While the would-be participatory democrats have made keen criticisms of bureaucratic rule in our society, the concept itself, when applied, runs rapidly against the Iron Law. Thus, anyone who has sat through sessions of any organization engaged in participatory democracy knows the intense boredom and inefficiency that develop rapidly. For if each person must participate equally in all decisions, the time devoted to decision-making must become almost endless, and the processes of the organization *become* life itself for the participants. This is one of the reasons why many New Left organizations quickly begin to insist that their members live in communes and dedicate their entire lives to the organization—in effect, to merge their lives with the organization. For if they truly live and pursue participatory democracy, they can hardly do anything else. But despite this attempt to salvage the concept, the inevitable gross inefficiency and aggravated boredom ensure that all but the most intensely dedicated will abandon the organization. In short, if it can work at all, participatory democracy can work only in groups so tiny that they are, in effect, the "leaders" shorn of their following.

We conclude that, to succeed, any organization must eventually fall into the hands of specialized "professionals," of a minority of persons dedicated to its tasks and able to carry them out. Oddly enough, it was Lenin who, despite his lip service to the ultimate ideal of egalitarian communism, recognized that a revolution, too, in order to succeed, must be led by a minority, a "vanguard," of dedicated professionals.

It is the intense egalitarian drive of the New Left that accounts, furthermore, for its curious theory of education—a theory that has made such an enormous impact on the contemporary student movement in American universities in recent years. The theory holds that, in contrast to "old-fashioned" concepts of education, the teacher knows *no more* than any of his students. All, then, are

"equal" in condition; one is no better in any sense than any other. Since only an imbecile would actually proclaim that the student knows as much about the content of any given discipline as his professor, this claim of equality is sustained by arguing for the abolition of content in the classroom. This content, asserts the New Left, is "irrelevant" to the student and hence not a proper part of the educational process. The only proper subject for the classroom is not a body of truths, not assigned readings or topics, but open-ended, free-floating participatory discussion of the student's feelings, since only his feelings are truly "relevant" to the student. And since the lecture method implies, of course, that the lecturing professor knows more than the students to whom he imparts knowledge, the lecture too must go. Such is the caricature of "education" propounded by the New Left.

One question that this doctrine calls to mind, and one that the New Left has never really answered, of course, is *why* the students should then be in college to begin with. Why couldn't they just as well achieve these open-ended discussions of their feelings at home or at the neighborhood candy store? Indeed, on this educational theory, the school as such has no particular function; it *becomes*, in effect, the local candy store, and it, too, merges with life itself. But then, again, why have a school at all? And why, in fact, should the students pay tuition and the faculty receive a salary for their nonexistent services? If all are truly equal, why is the faculty alone paid?

In any case, the emphasis on feelings rather than rational content in courses again insures an egalitarian school; or rather, the school as such may disappear, but the "courses" would surely be egalitarian, for if only "feelings" are to be discussed, then surely everyone's feelings are approximately "equal" to everyone else's. Once allow reason, intellect, and achievement full sway, and the demon of inequality will quickly raise its ugly head.

If, then, the natural inequality of ability and of interest among men must make elites inevitable, the only sensible course is to abandon the chimera of equality and accept the universal necessity of leaders and followers. The task of the libertarian, the person dedicated to the idea of the free society, is not to inveigh against elites which, like the need for freedom, flow directly from the nature of man. The goal of the libertarian is rather to establish a free society, a society in which each man is free to find his best level. In such a free

society, everyone will be "equal" only in liberty, while diverse and unequal in all other respects. In this society the elites, like everyone else, will be free to rise to their best level. In Jeffersonian terminology, we will discover "natural aristocracies" who will rise to prominence and leadership in every field. The point is to allow the rise of these natural aristocracies, but not the rule of "artificial aristocracies"—those who rule by means of coercion. The artificial aristocrats, the coercive oligarchs, are the men who rise to power by invading the liberties of their fellowmen, by denying them their freedom. On the contrary, the natural aristocrats live in freedom and harmony with their fellows, and rise by exercising their individuality and their highest abilities in the service of their fellows, either in an organization or by producing efficiently for the consumers. In fact, the coercive oligarchs invariably rise to power by suppressing the natural elites, along with other men; the two kinds of leadership are antithetical.

Let us take a hypothetical example of a possible case of such conflict between different kinds of elites. A large group of people voluntarily engage in professional football, selling their services to an eager consuming public. Quickly rising to the top is a natural elite of the best—the most able and dedicated—football players, coaches, and organizers of the game. Here we have an example of the rise of a natural elite in a free society. Then, the power elite in control of the government decides in its wisdom that all professional athletics, and especially football, are evil. The government then decrees that pro football is outlawed and orders everyone to take part instead in a local eurythmics club as a mass-participatory substitute. Here the rulers of the government are clearly a coercive oligarchy, an "artificial elite," using force to repress a voluntary or natural elite (as well as the rest of the population).

The libertarian view of freedom, government, individuality, envy, and coercive *versus* natural elites has never been put more concisely or with greater verve than by H.L. Mencken:

> All government, in its essence, is a conspiracy against the superior man: its one permanent object is to oppress him and cripple him. If it be aristocratic in organization, then it seeks to protect the man who is superior only in law against the man who is superior in fact; if it be democratic, then it seeks to protect the man who is inferior in every way against both. One of its primary functions

> is to regiment men by force, to make them as much alike as possible and as dependent upon one another as possible, to search out and combat originality among men. All it can see in an original idea is potential change, and hence an invasion of its prerogatives. The most dangerous man to any government is the man who is able to think things out for himself, without regard to the prevailing superstitions and taboos.[51]

Similarly, the libertarian writer Albert Jay Nock saw in the political conflicts between Left and Right "simply a tussle between two groups of mass-men, one large and poor, the other small and rich. . . . The object of the tussle was the material gains accruing from control of the State's machinery. It is easier to seize wealth (from the producers) than to produce it; and as long as the State makes the seizure of wealth a matter of legalized privilege, so long will the squabble for that privilege go on."[52]

Helmut Schoeck's *Envy* makes a powerful case for the view that the modern egalitarian drive for socialism and similar doctrines is a pandering to envy of the different and the unequal, but the socialist attempt to eliminate envy through egalitarianism can never hope to succeed. For there will always be personal differences, such as looks, ability, health, and good or bad fortune, which no egalitarian program, however rigorous, can stamp out, and on which envy will be able to fasten its concerns.

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[51]H.L. Mencken, *A Mencken Chrestomathy* (New York: Alfred A. Knopf, 1949), p. 145.

[52]Albert Jay Nock, *Memoirs of a Superfluous Man* (New York: Harper, 1943), p. 121.

# 33

# Restrictionist Pricing of Labor

It might be asserted that labor unions, in exacting higher wage rates on the free market, are achieving monopoly prices. However, it is *not* true that a union wage rate could ever be called a monopoly price. For the characteristic of the monopolist is precisely that he monopolizes a factor or commodity.. To obtain a monopoly price, he sells only part of his supply and withholds selling the other part, because selling a lower quantity raises the price on an inelastic demand curve. It is the unique characteristic of labor in a free society, however, that it *cannot* be monopolized. Each individual is a self-owner and cannot be owned by another individual or group. Therefore, in the labor field, no one man or group can own the total supply and withhold part of it from the market. Each man owns himself.

A monopolist's action is always limited by loss of revenue from the withheld supply. But in the case of labor unions, this limitation does not apply. Since each man owns himself, the "withheld" suppliers are *different people* from the ones getting the increased income. If a union, in one way or another, achieves a higher price than its members could command by individual sales, its action is *not* checked by the loss of revenue suffered by the "withheld" laborers. If a union achieves a higher wage, some laborers are earning a higher price, while others are excluded from the market and lose the revenue they would have obtained.

These discharged workers are the main losers in this procedure. Since the union represents the remaining workers, it does not have to concern itself, as the monopolist would, with the fate of these workers. At best, they must shift to some other—nonunionized—

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industry. The trouble is, however, that the workers are less suited to the new industry. Their having been in the now unionized industry implies that their worth in that industry was higher than in the industry to which they must shift; consequently, their wage rate is now lower. Moreover, their entry into the other industry depresses the wage rates of the workers already there.

Consequently, at best, a union can achieve a higher, restrictionist wage rate for its members only at the expense of lowering the wage rates of all other workers in the economy. Production efforts in the economy are also distorted. But, in addition, the wider the scope of union activity and restrictionism in the economy, the more difficult it will be for workers to shift their locations and occupations to find nonunionized havens in which to work. And more and more the tendency will be for the displaced workers to remain permanently or quasi-permanently unemployed, eager to work but unable to find nonrestricted opportunities for employment. The greater the scope of unionism, the more a permanent mass of unemployment will tend to develop.

Unions try as hard as they can to plug all the "loopholes" of nonunionism, to close all the escape hatches where the dispossessed workmen can find jobs. This is termed "ending the unfair competition of nonunion, low-wage labor." A universal union control and restrictionism would mean permanent mass unemployment, growing ever greater in proportion to the degree that the union exacted its restrictions.

It is a common myth that only the old-style "craft" unions, which deliberately restrict their occupational group to highly skilled trades with relatively few numbers, can restrict the supply of labor. They often maintain stringent standards of membership and numerous devices to cut down the supply of labor entering the trade. This direct restriction of supply doubtless makes it easier to obtain higher wage rates for the remaining workers. But it is highly misleading to believe that the newer-style "industrial" unions do not restrict supply. The fact that they welcome as many members in an industry as possible cloaks their restrictionist policy.

## Unemployment by Decree

The crucial point is that the unions insist on a minimum wage rate higher than what would be achieved for the given labor factor

without the union. By doing so, they necessarily cut the number of men whom the employer can hire. *Ergo*, the consequence of their policy is to restrict the supply of labor, while at the same time they can piously maintain that they are inclusive and democratic, in contrast to the snobbish "aristocrats" of craft unionism.

In fact, the consequences of industrial unionism are more devastating than those of craft unionism. For the craft unions, being small in scope, displace and lower the wages of only a few workers. The industrial unions, larger and more inclusive, depress wages and displace workers on a large scale and, what is even more important, can cause permanent mass unemployment.

The unemployment and the misemployment of labor, caused by restrictionist wage rates, need not always be directly visible. Thus, an industry might be particularly profitable and prosperous, either as a result of a rise in consumer demand for the product or from a cost-lowering innovation in the productive process. In the absence of unions, the industry would expand and hire more workers in response to the new market conditions. But if a union imposes a restrictionist wage rate, it may not cause the unemployment of any current workers in the industry; it may, instead, simply prevent the industry from expanding in response to the requirements of consumer demand and the conditions of the market. Here, in short, the union destroys *potential* jobs in the making and imposes a misallocation of production by preventing expansion. It is true that, without the union, the industry will bid up wage rates *in the process* of expansion; but if unions impose a higher wage rate at the beginning, the expansion will not occur.

## Why Workers Agree

Some opponents of unionism go to the extreme of maintaining that unions can *never* be free-market phenomena and are always "monopolistic" or coercive institutions. Although this might be true in actual practice, it is not *necessarily* true. It is very possible that labor unions might arise on the free market and even gain restrictionist wage rates. How can unions achieve restrictionist wage rates on the free market? The answer can be found by considering the displaced workers. The key problem is: Why do the workers let *themselves* be displaced by the union's minimum wage scale? Since they were willing to work for less before, why do they now meekly agree

to being fired and looking for a poorer-paying job? Why do some remain content to continue in a quasi-permanent pocket of unemployment in an industry, waiting to be hired at the excessively high rate? The only answer, in the absence of coercion, is that they have adopted on a commandingly high place on their value scales the goal of *not undercutting union wage rates*. Unions, naturally, are most anxious to persuade workers, both union and nonunion, as well as the general public, to believe strongly in the sinfulness of undercutting union wage rates.

This is shown most clearly in those situations where union members refuse to continue working for a firm at a wage rate below a certain minimum (or on other terms of employment). This situation is known as a *strike*. The most curious thing about a strike is that the unions have been able to spread the belief throughout society that the striking members are still "really" working for the company even when they are deliberately and proudly *refusing* to do so. The natural answer of the employer, of course, is to turn somewhere else and to hire laborers who *are* willing to work on the terms offered. Yet unions have been remarkably successful in spreading the idea through society that anyone who accepts such an offer—the "strikebreaker"—is the lowest form of human life.

To the extent, then, that nonunion workers feel ashamed or guilty about "strikebreaking" or other forms of undercutting union-proclaimed wage scales, the displaced or unemployed workers agree to their own fate. These workers, in effect, are being displaced to poorer and less satisfying jobs voluntarily, and remain unemployed for long stretches of time *voluntarily*. It is voluntary because that is the consequence of their voluntary acceptance of the *mystique* of "not crossing the picket line" or of not being a strikebreaker.

There are undoubtedly countless numbers of workers who do not realize that their refusal to cross a picket line, their "sticking to the union," may result in their losing their jobs and remaining unemployed.

## When the People Learn

As for the unions, the consequences of their activity, when discovered (for example, displacement or unemployment for oneself or others), will be considered unfortunate by most people. Therefore,

it is certain that when knowledge of these consequences becomes widespread, far fewer people will be "pro-union" or hostile to "non-union" competitors.

Such conclusions will be reinforced when people learn of another consequence of trade union activity: that a restrictionist wage raises costs of production for the firms in the industry. This means that the marginal firms in the industry—the ones whose entrepreneurs earn only a bare rent—will be driven out of business, for their costs have risen above their most profitable price on the market—the price that had *already* been attained. Their ejection from the market and the general rise of average costs in the industry signify a general fall in productivity and output, and hence a loss to the consumers. Displacement and unemployment, of course, also impair the general standard of living of the consumers.

Unions have had other important economic consequences. Unions are not *producing* organizations; they do not work for capitalists to improve production. Rather they attempt to persuade workers that they can better their lot at the expense of the employer. Consequently, they invariably attempt as much as possible to establish work rules that hinder management's directives. These work rules amount to preventing management from arranging workers and equipment as it sees fit. In other words, instead of agreeing to submit to the work orders of management in exchange for his pay, the workers now set up not only minimum wages, but also work rules without which they refuse to work.

## Everyone Loses

The effect of these rules is to *lower the marginal productivity of all union workers*. The lowering of marginal value-product schedules has a two-fold result: (1) it itself establishes a restrictionist wage scale with its various consequences, for the marginal value product has fallen while the union insists that the wage rate remain the same; (2) consumers lose by a general lowering of productivity and living standards. Restrictive work rules therefore also lower output. All this is perfectly consistent with a society of individual sovereignty, however, provided always that no force is employed by the union.

To advocate coercive abolition of these work rules would imply literal enslavement of the workers to the dictates of consumers. But,

once again, it is certain that knowledge of these various consequences of union activity would greatly weaken the voluntary adherence of many workers and others to the *mystique* of unionism.

Unions, therefore, are theoretically compatible with the existence of a purely free market. In actual fact, however, it is evident to any competent observer that unions acquire almost all their power through the wielding of force, specifically force against strikebreakers and against the property of employers. An implicit license to unions to commit violence against strikebreakers is practically universal. Police commonly either remain "neutral" when strikebreakers are molested or else blame the strikebreakers for "provoking" the attacks upon them. Certainly, few pretend that the institution of mass picketing by unions is simply a method of advertising the fact of a strike to anyone passing by.

When unions are permitted to resort to violence, the state or other enforcing agency has implicitly delegated this power to the unions. The unions, then, have become "private states."

## Frustrating the Market

We have investigated the consequences of unions achieving restrictionist prices. This is not to imply, however, that unions always achieve such prices in collective bargaining. Indeed, because unions do not own workers and therefore do not sell their labor, the collective bargaining of unions is an artificial replacement for the smooth workings of "individual bargaining" on the labor market. Whereas wage rates on the nonunion labor market will always tend toward equilibrium in a smooth and harmonious manner, its replacement by collective bargaining leaves the negotiators with little or no rudder, with little guidance on what the proper wage rates would be.

Even with both sides trying to *find* the market rate, neither of the parties to the bargain could be sure that a given wage agreement is too high, too low, or approximately correct. Almost invariably, furthermore, the union is not *trying* to discover the market rate, but to impose various arbitrary "principles" of wage determination, such as "keeping up with the cost of living," a "living wage," the "going rate" for comparable labor in other firms or industries, an annual average "productivity" increase, "fair differentials," and so forth.

# 34

# Mercantilism: A Lesson for Our Times?

Mercantilism has had a "good press" in recent decades, in contrast to nineteenth-century opinion. In the days of Adam Smith and the classical economists, mercantilism was properly regarded as a blend of economic fallacy and state creation of special privilege. But in our century, the general view of mercantilism has changed drastically: Keynesians hail mercantilists as prefiguring their own economic insights; Marxists, constitutionally unable to distinguish between free enterprise and special privilege, hail mercantilism as a "progressive" step in the historical development of capitalism; socialists and interventionists salute mercantilism as anticipating modern state-building and central planning.

Mercantilism, which reached its height in the Europe of the seventeenth and eighteenth centuries, was a system of statism which employed economic fallacy to build up a structure of imperial state power, as well as special subsidy and monopolistic privilege to individuals or groups favored by the state. Thus, mercantilism held that exports should be encouraged by the government and imports discouraged. Economically, this seems to be a tissue of fallacy; for what is the point of exports if not to purchase imports, and what is the point of piling up monetary bullion if the bullion is not used to purchase goods?

But mercantilism cannot be viewed satisfactorily as merely an exercise in economic theory. The mercantilist writers, indeed, did not consider themselves economic theorists, but practical men of

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affairs who argued and pamphleteered for specific economic policies, generally for policies which would subsidize activities or companies in which those writers were interested. Thus, a policy of favoring exports and penalizing imports had two important practical effects: it subsidized merchants and manufacturers engaged in the export trade, and it threw up a wall of privilege around inefficient manufacturers who formerly had to compete with foreign rivals. At the same time, the network of regulation and its enforcement built up the state bureaucracy as well as national and imperial power.

The famous English Navigation Acts, which played a leading role in provoking the American Revolution, are an excellent example of the structure and purpose of mercantilist regulation. The network of restriction greatly penalized Dutch and other European shippers, as well as American shipping and manufacturing, for the benefit of English merchants and manufacturers, whose competition was either outlawed or severely taxed and crippled. The use of the state to cripple or prohibit one's competition is, in effect, the grant by the state of monopolistic privilege; and such was the effect for Englishmen engaged in the colonial trade.

A further consequence was the increase of tax revenue to build up the power and wealth of the English government, as well as the multiplying of the royal bureaucracy needed to administer and enforce the regulations and tax decrees. Thus, the English government, and certain English merchants and manufacturers, benefited from these mercantilist laws, while the losers included foreign merchants, American merchants and manufacturers, and, above all, the *consumers* of all lands, including England itself. The consumers lost, not only because of the specific distortions and restrictions on production of the various decrees, but also from the hampering of the international division of labor imposed by all the regulations.

## ADAM SMITH'S REFUTATION

Mercantilism, then, was not simply an embodiment of theoretical fallacies; for the laws were only fallacies if we look at them from the point of view of the consumer, or of each individual in society. They are not fallacious if we realize that their aim was to confer special privilege and subsidy on favored groups; since subsidy and privilege can only be conferred by government at the expense of the

remainder of its citizens, the fact that the bulk of the consumers lost in the process should occasion little surprise.[1]

Contrary to general opinion, the classical economists were not content merely to refute the fallacious economics of such mercantilist theories as bullionism or protectionism; they also were perfectly aware of the drive for special privilege that propelled the "mercantile system." Thus, Adam Smith pointed to the fact that linen yarn could be imported into England duty free, whereas heavy import duties were levied on finished woven linen. The reason, as seen by Smith, was that the numerous English yarn-spinners did not constitute a strong pressure-group, whereas the master-weavers were able to pressure the government to impose high duties on their product, while making sure that their raw material could be bought at as low a price as possible. He concluded that the

> motive of all these regulations, is to extend our own manufactures, not by their own improvement, but by the depression of those of all our neighbors, and by putting an end, as much as possible, to the troublesome competition of such odious and disagreeable rivals.
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> Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as

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[1]The laws and proclamations . . . were the product of conflicting interests of varying degrees of respectability. Each group, economic, social, or religious, pressed constantly for legislation in conformity with its special interest. The fiscal needs of the crown were always an important and generally a determining influence on the course of trade legislation. Diplomatic considerations also played their part in influencing legislation, as did the desire of the crown to award special privileges, to its favorites, or to sell them, or to be bribed into giving them, to the highest bidders. . . . The mercantilist literature, on the other hand, consisted in the main of writings by or on behalf of "merchants" or businessmen . . . tracts which were partly or wholly, frankly or disguisedly, special pleas for special economic interests. Freedom for themselves, restrictions for others, such was the essence of the usual program of legislation of the mercantilist tracts of merchant authorship. (Jacob Viner, *Studies in the Theory of International Trade* [New York: Harper and Bros., 1937], pp. 58–59)

> it may be necessary for promoting that of the consumer. . . . But in the mercantile system, the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce.

In the restraints upon the importation of all foreign commodities which can come into competition with those of our own growth, or manufacture, the interest of the home-consumer is evidently sacrificed to that of the producer. It is altogether for the benefit of the latter, that the former is obliged to pay that enhancement of price which this monopoly almost always occasions.

It is altogether for the benefit of the producer that bounties are granted upon the exportation of some of his productions. The home-consumer is obliged to pay, first, the tax which is necessary for paying the bounty, and secondly, the still greater tax which necessarily arises from enhancement of the price of the commodity in the home market.[2]

## Before Keynes

Mercantilism was not only a policy of intricate government regulations; it was also a pre-Keynesian policy of inflation, of lowering interest rates artificially, and of increasing "effective demand" by heavy government spending and sponsorship of measures to increase the quantity of money. Like the Keynesians, the mercantilists thundered against "hoarding," and urged the rapid circulation of money throughout the economy; furthermore, they habitually pointed to an alleged "scarcity of money" as the cause of depressed trade or unemployment.[3] Thus, in a prefiguration of the Keynesian "multiplier," William Potter, one of the first advocates of paper money in the Western world (1650), wrote:

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[2]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937), p. 625.

[3]See the laudatory "Note on Mercantilism" in chapter 23 of John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt, Brace, 1936).

> The greater quantity . . . of money . . . the more commodity they sell, that is, the greater is their trade. For whatsoever is taken amongst men . . . though it were ten times more than now it is, yet if it be one way or other laid out by each man, as fact as he receives it . . . it doth occasion a quickness in the revolution of commodity from hand to hand . . . much more than proportional to such increase of money.[4]

And the German mercantilist F.W. von Schrötter wrote of the importance of money changing hands, for one person's spending is another's income; as money "pass[es] from one hand to another . . . the more useful it is to the country, for . . . the sustenance of so many people is multiplied," and employment increased. Thrift, according to von Schrötter, causes unemployment, since saving withdraws money from circulation. And John Cary wrote that if everyone spent more, everyone would obtain larger incomes, and "might then live more plentifully."[5]

Historians have had an unfortunate tendency to depict the mercantilists as inflationists and *therefore* as champions of the poor debtors, while the classical economists have been considered hard-hearted apologists for the *status quo* and the established order. The truth was almost precisely the reverse. In the first place, inflation did not benefit the poor; wages habitually lagged behind the rise in prices during inflations, especially behind agricultural prices. Furthermore, the "debtors" were generally not the poor but large merchants and quasi-feudal landlords, and it was the landlords who benefited triply from inflation: from the habitually steep increases in food prices, from the lower interest rates and the lower purchasing-power of money in their role as debtors, and from the particularly large increases in land values caused by the fall in interest rates. In fact, the English government and Parliament was heavily landlord-dominated, and it is no coincidence that one of the main arguments of the mercantilist writers for inflation was that it would greatly raise the value of land.

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[4]Quoted in Viner, *Studies in the Theory of International Trade*, p. 38.

[5]Quoted in Eli F. Heckscher, *Mercantilism*, 2nd ed. (New York: Macmillan, 1955), vol. 2, pp. 208–09. Also see Edgar S. Furniss, *The Position of the Laborer in a System of Nationalism* (New York: Kelley and Miliman, 1957), p. 41.

## Exploitation of Workers

Far from being true friends of laborers, the mercantilists were frankly interested in exploiting their labor to the utmost; full employment was urged as a means of maximizing such exploitation. Thus, the mercantilist William Petyt wrote frankly of labor as "capital material . . . raw and undigested . . . committed into the hands of supreme authority, in whose prudence and disposition it is to improve, manage, and fashion it to more or less advantage."[6] Professor Furniss comments that "it is characteristic of these writers that they should be so readily disposed to trust in the wisdom of the civil power to 'improve, manage, and fashion' the economic 'raw material' of the nation. Bred of this confidence in statecraft, proposals were multiplied for exploiting the labor of the people as the chief source of national wealth, urging upon the rulers of the nation diverse schemes for directing and creating employment."[7] The mercantilists' attitude toward labor and full employment is also indicated by their dislike of holidays, by which the "nation" was deprived of certain amounts of labor; the desire of the individual worker for leisure was never considered worthy of note.

## Compulsory Employment

The mercantilist writers realized frankly that corollary to a guarantee of full employment is coerced labor for those who don't wish to work or to work in the employment desired by the guarantors. One writer summed up the typical view: "it is absolutely necessary that employment should be provided for persons of every age that are able and willing to work, and the idle and refractory should be sent to the house of correction, there to be detained and constantly kept to labor." Henry Fielding wrote that "the constitution of a society in this country having a claim on all its members, has a right to insist on the labor of the poor as the only service they can render." And George Berkeley asked rhetorically "whether temporary servitude would not be the best cure for idleness and beggary. . . . Whether sturdy beggars may not be seized and made slaves to the

[6]Quoted in ibid., p. 41.

[7]Ibid.

public for a certain term of years?"[8] William Temple proposed a scheme to send the children of laborers, from the age of four on, to public workhouses, where they would be kept "fully employed" for at least twelve hours a day, "for by these means we hope that the rising generation will be habituated to constant employment." And another writer expressed his amazement that parents tended to balk at these programs:

> Parents . . . from whom to take for time the idle, mischievous, least useful and most burdensome part of their family to bring them up without any care or expense to themselves in habits of industry and decency is a very great relief; are very much adverse to sending their children . . . from what cause, it is difficult to tell.[9]

Perhaps the most misleading legend about the classical economists is that they were apologists for the *status quo*; on the contrary, they were "radical" libertarian opponents of the established Tory mercantilist order of big government, restrictionism, and special privilege. Thus, Professor Fetter writes that during the first half of the nineteenth century, the

> *Quarterly Review* and *Blackwood's Edinburgh Magazine*, staunch supporters of the established order, and opponents of change in virtually all fields, had no sympathy with political economy or with *laissez-faire*, and were constantly urging maintenance of tariffs, expenditures by government, and suspension of the gold standard in order to stimulate demand and increase employment. On the other hand the *Westminster's* [journal of the classical liberals] support of the gold standard and free trade, and its opposition to any attempt to stimulate the economy by positive government action, came not from believers in authority or from defenders of the dominant social force behind authority, but from the most articulate intellectual radicals of the time and the severest critics of the established order.[10]

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[8]See ibid., pp. 79–84.

[9]Ibid., p. 115.

[10]Frank W. Fetter, "Economic Articles in the *Westminster Review* and their Authors, 1824–51," *Journal of Political Economy* (December 1962): 572.

## SOUTHEY FAVORS NATIONALIZATION

In contrast, let us consider the *Quarterly Review*, a high Tory journal which always "assumed that the unreformed Parliament, the dominance of a landed aristocracy . . . the supremacy of the established church, discrimination of some sort against Dissenter, Catholic, and Jew, and the keeping of the lower classes in their place were the foundations of a stable society." Their leading writer on economic problems, the poet Robert Southey, repeatedly urged government expenditure as a stimulant to economic activity, and attacked England's resumption of specie payments (return to the gold standard) after the Napoleonic Wars. Indeed, Southey proclaimed that an increase in taxes or in the public debt was never a cause for alarm, since they "give a spur to the national industry, and call forth national energies." And, in 1816, Southey advocated a large public works program for relief of unemployment and depression.[11]

The *Quarterly Review*'s desire for stringent government control and even ownership of the railroads was at least frankly linked with its hatred of the benefits that railroads were bringing to the mass of the British population. Thus, where the classical liberals hailed the advent of railroads as bringing cheaper transportation and as thereby increasing the mobility of labor, the *Quarterly*'s John Croker denounced railroads as "rendering travel too cheap and easy—unsettling the habits of the poor, and tempting them to improvident migration."[12]

The arch-Tory, William Robinson, who often denounced his fellow Tories for compromising even slightly on such principles as high tariffs and no political rights for Catholics, wrote many pre-Keynesian articles, advocating inflation to stimulate production and employment, and denouncing the hard-money effects of the gold standard. And the Tory, Sir Archibald Alison, inveterate advocate of inflation who even ascribed the fall of the Roman Empire to a shortage of money, frankly admitted that it was the "agricultural class"

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[11]See Frank W. Fetter, "Economic Articles in the *Quarterly Review* and their Authors, 1809–52," *Journal of Political Economy* (February 1958): 48—51.

[12]Ibid., p. 62.

that had suffered from the lack of inflation since resumption of the gold standard.[13]

## Controls Under Elizabeth

A few case studies will illustrate the nature of mercantilism, the reasons for mercantilist decrees, and some of the consequences that they brought to the economy.

One important part of mercantilist policy was wage controls. In the fourteenth century, the Black Death killed one-third of the laboring population of England, and naturally brought sharp advances in wage rates. Wage controls came in as wage-ceilings, in desperate attempts by the ruling classes to coerce wage rates below their market rates. And since the vast bulk of employed laborers were agricultural workers, this was clearly legislation for the benefit of the feudal landlords and to the detriment of the workers.

## Textiles vs. Agriculture

The result was a persistent shortage of agricultural and other unskilled laborers for centuries, a shortage mitigated by the fact that the English government did not try to enforce the laws very rigorously. When Queen Elizabeth tried to enforce the wage controls strictly, the agricultural labor shortage was aggravated, and the landlords found their statutory privileges defeated by the more subtle laws of the market. Consequently, Elizabeth passed, in 1563, the famous Statute of Artificers, imposing comprehensive labor control.

Attempting to circumvent the shortage caused by previous interventions, the statute installed forced labor on the land. It provided that: (1) whoever had worked on the land until the age of 12 be compelled to remain there and not leave for work at any other trade; (2) all craftsmen, servants, and apprentices who had no great reputation in their fields be forced to harvest wheat; and (3) unemployed persons were compelled to work as agricultural laborers. In addition, the statute prohibited any worker from quitting his job

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[13]See Frank W. Fetter, "Economic Articles in *Blackwood's Edinburgh Magazine*, and their Authors, 1817–1853," *Scottish Journal of Political Economy* (June 1960): 91–96.

unless he had a license proving that he had already been hired by another employer. And, furthermore, justices of the peace were ordered to set maximum wage rates, geared to changes in the cost of living.

The statute also acted to restrict the growth of the woolen textile industry; this benefited two groups: the landlords, who would no longer lose laborers to industry and suffer the pressure of paying higher wage rates, and the textile industry itself, which received the privilege of keeping out the competition of new firms or new craftsmen. The coerced immobility of labor, however, led to suffering for all workers, including textile craftsmen; and to remedy the latter, Queen Elizabeth imposed a minimum wage law for textile craftsmen, thundering all the while that the wicked clothing manufacturers were responsible for the craftsmen's plight. Fortunately, textile employers and workers persisted in agreeing on terms of employment below the artificially-set wage rate, and heavy textile unemployment did not yet arise.

## Enforcing Bad Laws

The programs of wage controls could not cause undue dislocations until they were stringently enforced, and this came to pass under King James I, the first Stuart king of England. Upon assuming the throne in 1603, James decided to enforce the Elizabethan control program with great stringency, including extremely heavy penalties against employers. Rigorous enforcement was imposed on minimum wage controls for textile craftsmen, and on maximum wage decrees for agricultural laborers and servants.

The consequences were the inevitable result of tampering with the laws of the market: chronic severe unemployment throughout the textile industry, coupled with a chronic severe shortage of agricultural labor. Misery and discontent spread throughout the land. Citizens were fined for paying their servants more than ceiling wages, and servants fined for accepting the pay. James, and his son Charles I, decided to stem the tide of unemployment in textiles by compelling employers to remain in business even when they were losing money. But even though many employers were jailed for infractions, such Draconian measures could not keep the textile industry from depression, stagnation, and unemployment. Certainly the consequences of

the policy of wage controls was one of the reasons for the overthrow of the Stuart tyranny in the mid-seventeenth century.

## Mercantilist Practices in Colonial Massachusetts

The young colony of Massachusetts engaged in a great many mercantilist ventures, with invariably unfortunate results. One attempt was a comprehensive program of wage and price controls, which had to be abandoned by the 1640s. Another was a series of subsidies to try to create industries in the colony before they were economically viable, and therefore before they would be created on the free market. One example was iron manufacture. Early iron mines in America were small and located in coastal swamps ("bog iron"); and primarily manufactured, or "wrought," iron was made cheaply in local bloomeries, at an open hearth. The Massachusetts government decided, however, to force the creation of the more imposing—and far more expensive—indirect process of wrought iron manufacture at a blast furnace and forge. The Massachusetts legislature therefore decreed that any new iron mine must have a furnace and forge constructed near it within ten years of its discovery. Not content with this measure, the legislature in 1645 granted a new Company of Undertakers For An Iron Works In New England, a 21-year monopoly of all ironmaking in the colony. In addition, the legislature granted the company generous subsidies of timberland.

But despite these subsidies and privileges, as well as additional large grants of timberland from the town governments of Boston and Dorchester, the Company's venture failed dismally and almost immediately. The Company did its best to salvage its operations, but to no avail. A few years later, John Winthrop, Jr., the main promoter of the older venture, induced the authorities of New Haven colony to subsidize an iron manufacture of his at Stony River. From the governments of New Haven colony and New Haven township, Winthrop was granted a whole host of special subsidies: land grants, payment of all costs of building the furnace, a dam on the river, and the transportation of fuel. One of Winthrop's partners in the venture was the deputy-governor of the colony, Stephen Goodyear, who was thus able to use the power of government to grant himself substantial privileges. But again, economic law was not to be denied, and the ironworks proved to be another rapidly failing concern.

## Debtors' Relief a Scheme to Aid the Rich

One of the most vigorously held tenets of the dominant neo-Marxist historians of America has been the view that inflation and debtors' relief were always measures of the "lower classes," the poor farmer-debtors and sometimes urban workers, engaging in a Marxian class struggle against conservative merchant-creditors. But a glance at the origins of debtors' relief and paper money in America easily shows the fallacy of this approach; inflation and debtors' relief were mercantilist measures, pursued for familiar mercantilist ends.

Debtors' relief began in the colonies, in Massachusetts in 1640. Massachusetts had experienced a sharp economic crisis in 1640, and the debtors turned immediately to special privilege from the government. Obediently, the legislature of Massachusetts passed the first of a series of debtors' relief laws in October, including a minimum-appraisal law to force creditors to accept insolvent debtors' property at an arbitrarily inflated assessment, and a legal-tender provision to compel creditors to accept payment in an inflated, fixed rate in the monetary media of the day: corn, cattle, or fish.

Further privileges to debtors were passed in 1642 and 1644, the latter permitting a debtor to escape foreclosure simply by leaving the colony. The most drastic proposal went to the amazing length of providing that the Massachusetts government assume all private debts that could not be paid! This plan was passed by the upper house, but defeated in the house of deputies.

The fact that this astounding bill was passed by the *upper* house—the council of magistrates—is evidence enough that this was not a proto-Marxian eruption of poor debtors. For this council was the ruling group of the colony, consisting of the wealthiest merchants and landowners. If not for historical myths, it should occasion no surprise that the biggest debtors were the wealthiest men of the colony, and that in the mercantilist era a drive for special privilege should have had typically mercantilist aims. On the other hand, it is also instructive that the more democratic and popularly responsible lower house was the one far more resistant to the debt relief program.

## Paper Money Inflation

Massachusetts has the dubious distinction of having promulgated the first governmental paper money in the history of the Western

world—indeed, in the history of the entire world outside of China. The fateful issue was made in 1690, to pay for a plunder expedition against French Canada that had failed drastically. But even before this, the leading men of the colony were busy proposing paper money schemes. The Rev. John Woodbridge, greatly influenced by William Potter's proposals for an inflationary land bank, proposed one of his own, as did Governor John Winthrop, Jr., of Connecticut. Captain John Blackwell proposed a land bank in 1686, the notes of which would be legal tender in the colony, and such wealthy leaders of the colony as Joseph Dudley, William Stoughton, and Wait Winthrop were prominently associated with the plan.

The most famous of the inflationary land-bank schemes was the Massachusetts Land Bank of 1740, which has generally been limned in neo-Marxist terms as the creation of the mass poor farmer-debtors over the opposition of wealthy merchant-creditors of Boston. In actuality, its founder, John Colman, was a prominent Boston merchant and real-estate speculator; and its other supporters had similar interests—as did the leading opponents, who were also Boston businessmen. The difference is that the advocates had generally been receivers of land grants from the Massachusetts government, and desired inflation to raise the value of their speculatively-held land claims.[14] Once again—a typically mercantilist project.

## Keynes Wouldn't Learn

From just a brief excursion into mercantilist theory and practice, we may conclude that Lord Keynes might have come to regret his enthusiastic welcome to the mercantilists as his forbears. For they were his forbears indeed; and the precursors as well of the interventions, subsidies, regulations, grants of special privilege, and central planning of today. But in no way could they be considered as "progressives" or lovers of the common man; on the contrary, they were frank exponents of the Old Order of statism, hierarchy, landed oligarchy, and special privilege—that entire "Tory" regime against which *laissez-faire* liberalism and classical economics leveled their liberating "revolution" on behalf of the freedom and prosperity of all

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[14]See the illuminating study by Dr. George Athan Billias, "The Massachusetts Land Bankers of 1740," *University of Maine Bulletin* (April 1959).

productive individuals in society, from the wealthiest to the humblest. Perhaps the modern world will learn the lesson that the contemporary drive for a new mercantilism may be just as profoundly "reactionary," as profoundly opposed to the freedom and prosperity of the individual, as its pre-nineteenth-century ancestor.

# 35

# Capitalism versus Statism

From the very first we run into grave problems with the term "capitalism." When we realize that the word was coined by capitalism's most famous enemy, Karl Marx, it is not surprising that a neutral or a pro-"capitalist" analyst might find the term lacking in precision. For capitalism tends to be a catchall, a portmanteau concept that Marxists apply to virtually every society on the face of the globe, with the exception of a few possible "feudalist" countries and the Communist nations (although, of course, the Chinese consider Yugoslavia and Russia "capitalist," while many Trotskyites would include China as well). Marxists, for example, consider India as a "capitalist" country, but India, hagridden by a vast an and monstrous network of restrictions, castes, state regulations, and monopoly privileges is about as far from free-market capitalism as can be imagined.[1]

If we are to keep the term "capitalism" at all, then, we must distinguish between "free-market capitalism" on the one hand, and "state capitalism" on the other. The two are as different as day and night in their nature and consequences. Free-market capitalism is a network of free and voluntary exchanges in which producers work,

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[1]For a view of India by free-market economists, see Peter T. Bauer, *United States Aid and Indian Economic Development* (Washington, D.C.: American Enterprise Association, 1959) and B.R. Shenoy, *Indian Planning and Economic Development* (Bombay and New York Asia Publishing House, 1963).

produce, and exchange their products for the products of others through prices voluntarily arrived at. State capitalism consists of one or more groups making use of the coercive apparatus of the government—the State—to accumulate capital for themselves by expropriating the production of others by force and violence.

Throughout history, states have existed as instruments for organized predation and exploitation. It doesn't much matter which group of people happen to gain control of the State at any given time, whether it be oriental despots, kings, landlords, privileged merchants, army officers, or Communist parties. The result is everywhere and always the coercive mulcting of the mass of the producers—in most centuries, of course, largely the peasantry—by a ruling class of dominant rulers and their hired professional bureaucracy. Generally, the State has its inception in naked banditry and conquest, after which the conquerors settle down among the subject population to exact permanent and continuing tribute in the form of "taxation" and to parcel out the land of the peasants in huge tracts to the conquering warlords, who then proceed to extract "rent." A modern paradigm is the Spanish conquest of Latin America, when the military conquest of the native Indian peasantry led to the parcelling out of Indian lands to the Spanish families, and the settling down of the Spaniards as a permanent ruling class over the native peasantry.

To make their rule permanent, the State rulers need to induce their subject masses to acquiesce in at least the legitimacy of their rule. For this purpose the State has always taken a corps of intellectuals to spin apologia for the wisdom and the necessity of the existing system. The apologia differ over the centuries; sometimes it is the priestcraft using mystery and ritual to tell the subjects that the king is divine and must be obeyed; sometimes it is Keynesian liberals using their own form of mystery to tell the public that government spending, however seemingly unproductive, helps everyone by raising the GNP and energizing the Keynesian "multiplier." But everywhere the purpose is the same—to justify the existing system of rule and exploitation to the subject population; and everywhere the means are the same—the State rulers sharing their rule and a portion of their booty with their intellectuals. In the nineteenth century the intellectuals, the "monarchical socialists" of the University of Berlin, proudly declared that their chief task was to serve as "the intellectual bodyguard of the House of Hohenzollern." This has always been the

function of the court intellectuals, past and present—to serve as the intellectual bodyguard of their particular ruling class.

In a profound sense, the free market is the method and society "natural" to man; it can and does therefore arise "naturally" without an elaborate intellectual system to explain and defend it. The unlettered peasant knows in his heart the difference between hard work and production on the one hand, and predation and expropriation on the other. Unmolested then, there tends to grow up a society of agriculture and commerce where each man works at the task at which he is best suited in the conditions of the time, and then trades his product for the products of others. The peasant grows wheat and exchanges it for the salt of other producers or for the shoes of the local craftsman. If disputes arise over property or over contracts, the peasants and villagers take their problem to the wise men of the area, sometimes the elders of the tribe, to arbitrate their dispute.

There are numerous historical examples of the growth and development of such a purely free-market society. Two may be mentioned here. One is the fair at Champagne, that for hundreds of years in the Middle Ages was the major center of international trade in Europe. Seeing the importance of the fairs, the kings and barons left them unmolested, untaxed, and unregulated, and any disputes that arose at the fairs were settled in one of many competing, voluntary courts, maintained by church, nobles, and the merchants themselves. A more sweeping and lesser-known example is Celtic Ireland, which for a thousand years maintained a flourishing free-market society without a State. Ireland was finally conquered by the English State in the seventeenth century, but the statelessness of Ireland, the lack of a governmental channel to transmit and enforce the orders and dictates of the conquerors, delayed the conquest for centuries.[2]

The American colonies were blessed with a strain of individualist libertarian thought that managed to supersede Calvinist authoritarianism, a stream of thought inherited from the libertarian and

[2]In a similar way, the British in the late nineteenth century had a great deal of difficulty in establishing their rule over the stateless, free-market tribe of the Ibos of West Africa. On Ireland, see Joseph R. Peden, "Stateless Societies: Ancient Ireland," *The Libertarian Forum* (April 1971) and the references therein.

anti-statist radicals of the English revolution of the seventeenth century. These libertarian ideas were able to take firmer hold in the United States than in the mother country owing to the fact that the American colonies were largely free from the feudal land monopoly that ruled Britain.[3] But in addition to this ideology, the absence of effective central government in many of the colonies allowed the springing up of a "natural" and unselfconscious free-market society, devoid of any political government whatever. This was particularly true of three colonies. One was Albemarle, in what later became northeastern North Carolina, where no government existed for decades until the English Crown bestowed the mammoth Carolina land grant in 1663. Another, and more prominent example was Rhode Island, originally a series of anarchistic settlements founded by groups of refugees from the autocracy of Massachusetts Bay. Finally, a peculiar set of circumstances brought effective individualistic anarchism to Pennsylvania for about a decade in the 1680s and 1690s.[4]

While the purely free and *laissez-faire* society arises unselfconsciously where people are given free rein to exert their creative energies, statism has been the dominant principle throughout history. Where State despotism already exists, then liberty can only arise from a self-conscious ideological movement that wages a protracted struggle against statism, and reveals to the mass of the public the grave flaw in its acceptance of the propaganda of the ruling classes The role of this "revolutionary" movement is to mobilize the various ranks of the oppressed masses, and to desanctify and delegitimize the rule of the State in their eyes.

It is the glory of Western civilization that it was in Western Europe, in the seventeenth and eighteenth centuries, where, for the first time in history, a large-scale, determined, and at least partially successful self-conscious movement arose to liberate men from the

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[3]On the ideological inheritance from Britain, see Bernard Bailyn, *The Ideological Origins of the American Revolution* (Cambridge, Mass.: Harvard University Press, 1967).

[4]See Murray N. Rothbard, "Individualist Anarchism in the United States: The Origins," *Libertarian Analysis* (Winter, 1970): 14–28.

restrictive shackles of statism. As Western Europe became progressively enmeshed in a coercive web of feudal and guild restrictions, and of state monopolies and privileges with the king functioning as the feudal overlord, the liberating movement arose with the conscious aim of freeing the creative energies of the individual, of enabling a society of free men to replace the frozen repression of the old order. The Levellers and the Commonwealthmen and John Locke in England, the *philosophes* and the physiocrats in France, inaugurated the Modern Revolution in thought and action that finally culminated in the American and the French Revolutions of the late eighteenth century.

This Revolution was a movement on behalf of individual liberty, and all of its facets were essentially derivations from this fundamental axiom. In religion, the movement stressed separation of Church and State, in other words the end of theocratic tyranny and the advent of religious liberty. In foreign affairs, this was a revolution on behalf of international peace and the end to ceaseless wars on behalf of State conquest and glory to the ruling elite. Politically, it was a movement to divest the ruling class of its absolute power, to reduce the scope of government altogether and to put whatever government remained under the checks of democratic choice and frequent elections. Economically, the movement stressed the freeing of man's productive energies from governmental shackles, so that men could be allowed to work, invest, produce, and exchange where they wished. The famous cry to power was *laissez faire*: let us be, let us work, produce, trade, move from one jurisdiction or country to another. Let us live and work and produce unhampered by taxes, control, regulations, or monopoly privileges. Adam Smith and the classical economists were only the most economically specialized group of this broad liberating movement.

It was the partial success of this movement that freed the market economy and thereby gave rise to the Industrial Revolution, probably the most decisive and most liberating event of modern times. It was no accident that the Industrial Revolution in England emerged, not in guild-ridden and State-controlled London, but in the new industrial towns and areas that arose in the previously rural and therefore unregulated north of England. The Industrial Revolution could not come to France until the French Revolution freed the economy from the fetters of feudal landlordism and innumerable

local restrictions on trade and production. The Industrial Revolution freed the masses of men from their abject poverty and hopelessness—a poverty aggravated by a growing population that could find no employment in the frozen economy of pre-industrial Europe. The Industrial Revolution, the achievement of free-market capitalism, meant a steady and rapid improvement in the living conditions and the quality of life for the broad masses of people, for workers and consumers alike, wherever the impact of the market was felt.

An undeveloped and sparsely populated area originally, America did not begin as the leading capitalist country. But after a century of independence it achieved this eminence, and why? *Not*, as the common myth has it, because of superior natural resources. The resources of Brazil, of Africa, of Asia, are at least as great. The difference came because of the relative freedom in the United States, because it was here that the free-market economy more than in any other country was allowed its head. We began free of a feudal or monopolizing landlord class, and we began with a strongly individualist ideology that permeated much of the population. Obviously, the market in the United States was never completely free or unhampered, but its relatively greater freedom (relative to other countries or centuries) resulted in the enormous release of productive energies, the massive capital equipment, and the unprecedentedly high standard of living that the mass of Americans not only enjoy but take blithely for granted. Living in the lap of a luxury that could not have been dreamed of by the wealthiest emperor of the past, we are all increasingly acting like the man who murdered the goose that laid the golden egg.

And so we have a mass of intellectuals who habitually sneer at "materialism" and "material values," who proclaim absurdly that we are living in a "post-scarcity age" that permits an unlimited cornucopia of production without requiring anyone to work or produce, who attack our undue affluence as somehow sinful in a perverse recreation of a new form of Puritanism. The idea that our capital machine is automatic and self-perpetuating, that whatever is done to it or not done for it does not matter because it will go on perpetually—this is the farmer blindly destroying the golden goose. Already we are beginning to suffer from the decay of capital equipment, from the restrictions and taxes and special privileges that have increasingly been imposed on the industrial machine in recent decades.

We are unfortunately making ever more relevant the dire warning of the Spanish philosopher Ortega y Gasset, who analyzed modern man as:

> finding himself in a world so excellent, technically and socially, he believes that it has been produced by nature, and never thinks of the personal efforts of highly-endowed individuals which the creation of this new world presupposed. Still less will he admit the notion that all these facilities still require the support of certain difficult human virtues, the least failure of which would cause the rapid disappearance of the whole magnificent edifice.

Ortega held the "mass man" to have one fundamental trait: "his radical ingratitude towards all that has made possible the ease of his existence." This ingratitude is the basic ingredient in the "psychology of the spoiled child." As Ortega declares:

> Heir to an ample and generous past . . . the new commonality has been spoiled by the world around it . . . the new masses find themselves in the presence of a prospect full of possibilities, and furthermore, quite secure, with everything ready to their hands, independent of any previous efforts on their part, just as we find the sun in the heavens. . . . And these spoiled masses are unintelligent enough to believe that the material and social organization, placed at their disposition like the air, is of the same origin, since apparently it never fails them, and is almost as perfect as the natural scheme of things. . . .
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> As they do not see, behind the benefits of civilization, marvels of invention and construction that can only be maintained by great effort and foresight, they imagine that their role is limited to demanding these benefits peremptorily, as if they were natural rights. In the disturbances caused by scarcity of food, the mob goes in search of bread, and the means it employs is generally to wreck the bakeries. This may serve as a symbol of the attitude adopted, on a greater and more complicated scale, by the masses of today towards the civilization by which they are supported.[5]

In an era when countless numbers of irresponsible intellectuals call for the destruction of technology and the return to a primitive

[5] José Ortega y Gasset, *The Revolt of the Masses* (New York: W.W. Norton, 1932), pp. 63–65.

"nature" that could only result in the death by starvation of the overwhelmingly greatest part of the world's population, it is instructive to recall Ortega's conclusion:

> Civilization is not "just there," it is not self-supporting. It is artificial and requires the artist or the artisan. If you want to make use of the advantages of civilization, but are not prepared to concern yourself with the upholding of civilization—you are done. In a trice you find yourself left without civilization. . . . The primitive forest appears in its native state, just as if curtains covering pure Nature had been drawn back.[6]

The steady decline in the underpinnings of our civilization began in the late nineteenth century, and accelerated during the World Wars I and II and the 1930s. The decline consisted of an accelerating retreat back from the Revolution, and of a shift back to the old order of mercantilism, statism, and international war. In England, the *laissez-faire* capitalism of Price and Priestly, of the Radicals and of Cobden and Bright and the Manchester school, was replaced by a Tory statism driving toward aggressive Empire and war against other imperial powers. In the United States the story was the same, as businessmen increasingly turned to the government to impose cartels, monopolies, subsidies, and special privileges. Here as in Western Europe, the advent of World War I was the great turning point—in aggravating the imposition of militarism and government—business economic planning at home, and imperial expansion and intervention overseas. The medieval guilds have been re-established in a new form—that of labor unions with their network of restrictions and their role as junior partners of government and industry in the new mercantilism. All the despotic trappings of the old order have returned in a new form. Instead of the absolute monarch, we have the President of the United States, wielding far more power than any monarch of the past. Instead of a constituted nobility, we have an Establishment of wealth and power that continues to rule us regardless of which political party is technically in power. The growth of a bipartisan civil service, of a bipartisan domestic and foreign policy, the advent of cool technicians of power who seem to sit in positions of command regardless of how we vote (the Achesons, the Bundys, the Baruchs, the McCloys, the J. Edgar Hoovers), all underscore our

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[6]Ibid., p. 97.

increasing domination by an elite that grows ever fatter and more privileged on the taxes that they are able to extract from the public hide.

The result of the aggravated network of mercantilist burdens and restrictions has been to place our economy under greater and greater strain. High taxes burden us all, and the military-industrial complex means an enormous diversion of resources, of capital, technology, and of scientists and engineers, from productive uses to the overkill waste of the military machine. Industry after industry has been regulated and cartelized into decline: the railroads, electric power, natural gas, and telephone industries being the most obvious examples. Housing and construction have been saddled with the blight of high property taxes, zoning restrictions, building codes, rent controls, and union featherbedding. As free-market capitalism has been replaced by state capitalism, more and more of our economy has begun to decay and our liberties to erode.

In fact, it is instructive to make a list of the universally acknowledged problem areas of our economy and our society, and we will find running through that list a common glaring leitmotif: government. In all the high problem areas, government operation or control has been especially conspicuous.

Let us consider:

Foreign policy and war: Exclusively governmental.

Conscription: Exclusively governmental.

Crime in the streets: The police and the judges are a monopoly of government, and so are the streets.

Welfare system: The problem is in government welfare; there is no special problem in the private welfare agencies.

Water pollution: Municipally owned garbage is dumped in government owned rivers and oceans.

Postal service: The failings are in the government owned Post Office, not, for example, among such highly successful private competitors as bus-delivered packages and the Independent Postal System of America, for third-class mail.

The military—industrial complex: Rests entirely on government contracts.

Railroads: Subsidized and regulated heavily by government for a century.

Telephone: A government-privileged monopoly.

Gas and electric: A government-privileged monopoly.

Housing: Bedeviled by rent controls, property taxes, zoning laws, and urban renewal programs (all government).

Excess highways: All built and owned by government.

Union restrictions and strikes: The result of government privilege, notably in the Wagner Act of 1935.

High taxation: Exclusively governmental.

The schools: Almost all governmental, or if not directly so, heavily government-subsidized and regulated.

Wiretapping and invasion of civil liberties: Almost all done by government.

Money and inflation: The money and banking system is totally under the control and manipulation of government.

Examine the problem areas, and everywhere, like a red thread, there lies the overweening stain of government. In contrast, consider the frisbee industry. Frisbees are produced, sold, and purchased without headaches, without upheavals, without mass breakdowns or protests. As a relatively free industry, the peaceful and productive frisbee business is a model of what the American economy once was and can be again—if it is freed of the repressive shackles of big government.

In *The Affluent Society*, written in the late 1950s, John Kenneth Galbraith pinpointed the fact that the governmental areas are our problem areas. But his explanation was that we have "starved" the public sector and that therefore we should be taxed more heavily in order to enlarge the public sector still further at the expense of the private. But Galbraith overlooked the glaring fact that the proportion of national income and resources devoted to government has been expanding enormously since the turn of the century. If the problems did not appear before, and have appeared increasingly in precisely the expanded governmental sector, the judicious might well conclude that perhaps the problem lies in the public sector itself. And that is precisely the contention of the free-market libertarian.

Problems and breakdowns are inherent in the operations of the public sector and of government generally. Deprived of a profit-and-loss test to gauge productivity and efficiency, the sphere of government shifts decision-making power from the hands of every individual and cooperating group, and places that power in the hands of an overall governmental machine. Not only is that machine coercive and inefficient; it is necessarily dictatorial because whichever decision it may make, there are always minorities or majorities whose desires and choices have been overridden. A public school must make one decision in each area: it must decide whether to be disciplined or progressive or some blend of the two; whether to be pro-capitalist or pro-socialist or neutral; whether to be integrated or segregated, elitist or egalitarian, and so on. Whatever it decides, there are citizens who are permanently deprived. But in the free market, parents are free to patronize whatever private or voluntary schools they wish, and different groups of parents will then be able to exercise their choice unhampered. The free market enables every individual and group to maximize its range of choice, to make its own decisions and choices and to put them into effect.

It is ironic that Professor Galbraith does not seem to be very happy about the public sector as it has lately been manifesting itself: in the military-industrial complex, in the war in Vietnam, in what Galbraith has himself properly derided as President Nixon's "Big Business Socialism." But if the glorious public sector, if expanded government, has brought us to this pretty pass, perhaps the answer is to roll government back, to return to the truly revolutionary path of dismantling the Big State.

Indeed, American liberals—who for decades have been the main heralds and apologists for big government and the welfare state—have increasingly become unhappy at the results of their own efforts. For just as in the days of oriental despotism, state rule cannot endure for long without a corps of intellectuals to spin the arguments and the rationale to gain the support and the sense of legitimacy among the public, and the liberals (the overwhelming majority of American intellectuals) have served since the New Deal as the celebrants of big government and the welfare state. But many liberals are coming to realize that they have been in power, have fashioned American society, for four decades now, and it is clear to them that something has gone radically wrong. After four decades of the welfare state at home

and "collective security" abroad, the consequences of New Deal liberalism have clearly seen aggravated breakdowns and conflicts at home and perpetual war and intervention abroad. Lyndon Johnson, with whom liberals became extremely unhappy, correctly referred to Franklin Roosevelt as his "Big Daddy"—and the parentage on all foreign and domestic fronts was quite clear. Richard Nixon is scarcely distinguishable from his predecessor. If many liberals have become strangers and afraid in a world *they* have made, then perhaps the fault lies precisely in liberalism itself.

If, then, there is to be a rollback of statism, there will have to be another ideological revolution to match the rise of the classical radicals of the seventeenth and eighteenth centuries. Intellectuals will have to shift, in large part, back from their role as apologists for the State to resume their function as upholders of the standards of truth and reason as against the *status quo*. In the last several years, there have been signs of disenchantment by the intellectuals, but the shift has been largely a wrongheaded one. As a result, in the current split between liberals and radicals among the *intelligentsia*, *neither* side provides us with the requisites of civilization, with the requisites for maintaining a prosperous and free industrial order. The liberals have offered us the spurious rationality of technocratic service to the Leviathan State of fitting in as manipulated cogs in the bureaucratic government-industrial machinery. Liberalism's solution to every domestic problem is to tax and inflate more and to allocate more federal funds; its solution for foreign crises is to "send the Marines" (accompanied, of course, by politico-economic planners to alleviate the destruction that the Marines cause). Surely we cannot continue to accept the proffered solutions of a liberalism that has manifestly failed. But the tragedy is that the radicals have taken the liberals at their face value: identifying reason, technology, and industry with the current liberal-mercantilist order, the radicals, in order to reject the current system, have turned their backs on the former necessary virtues as well.

In short, the radicals, feeling themselves forced into a visceral rejection of the world of liberalism, of Vietnam and the public-school systems have adopted the liberals' own identification of their own system with reason, industry, and technology. Hence the radicals raise the cry for the rejection of reason on behalf of emotions and vague mysticism, of rationality for inchoate and capricious spontaneity, of

work and foresight for hedonism and dropping out, of technology and industry for the return to "nature" and the primitive tribe. In doing so, in adopting this pervasive nihilism, the radicals are offering us even less of a viable solution than their liberal enemies. For the murder of millions in Vietnam they would, in effect, substitute the death by starvation of the vast bulk of the world's population. The radicals' vision cannot be accepted by sane peoples and the bulk of Americans, their ignorance or errors otherwise, are astute enough to recognize this fact and to make loud, clear, and sometimes brutal their rejection of the radicals and their alternative ethic, society, and life-style.

The point of this essay is that the public need not be forced to choose between the alternative of repressive and stifling welfare-warfare state monopoly liberalism on the one hand, or the irrational and nihilistic return to tribal primitivism on the other. The radical alternative is evidently not compatible with a prosperous life and industrial civilization; this much is crystal clear. But less clear is the fact that corporate state liberalism is in the long run also not compatible with an industrial civilization. The one route offers our society a quick suicide; the other a slow and lingering murder.

There is, then, a third alternative—one that has still gone unheeded amid the great debate between liberals and radicals. That alternative is to return to the ideals and to the structure that generated our industrial order and that is needed for that order's long-run survival—to return to the system that will bring us industry, technology, and rapidly advancing prosperity *without* war, militarism, or stifling governmental bureaucracy. That system is *laissez-faire* capitalism, what Adam Smith called "the natural system of liberty," a system that rests on an ethic that encourages individual reason, purpose, and achievement. The nineteenth-century libertarian theorists—men like the Frenchmen of the Restoration era, Charles Comte and Charles Dunoyer, and the Englishman Herbert Spencer—saw clearly that militarism and statism are relics and throwbacks of the past, that they are incompatible with the functioning of an industrial civilization. That is why Spencer and the others contrasted the "military" with the "industrial" principle, and judged that one or the other would have to prevail.

What I am suggesting, in short, in the oversimplified categories made popular by Charles Reich, is a return to "Consciousness I"—a

Consciousness that is brusquely dismissed by Reich and his readers as they proceed to take sides in the great debate between Consciousness II and III. To Reich, Consciousness I was made obsolete by the growth of modern technology and mass production, which made the turn to the corporate state inevitable. But here Reich is not being radical *enough*; he is simply adopting the conventional liberal historiography that big government was made necessary by the growth of large-scale industry. If he were familiar with economics, Reich would realize that it is precisely advanced industrial economies that require a free market to survive and flourish; on the contrary, an agricultural society can plod along indefinitely under despotism provided that the peasants are left enough of their produce to survive. The Communist countries of Eastern Europe have discovered this fact in recent years; hence, the more they industrialize, the greater and more inexorable their movement away from socialism and central planning and toward a free-market economy. The rapid shift of the East European countries toward the free market is one of the most heartening and dramatic developments in the last two decades; yet the trend has gone almost unnoticed, for the left finds the shift away from statism and egalitarianism in Yugoslavia and the other East European countries extremely embarrassing, while the conservatives are reluctant to concede that there may be *anything* hopeful about the Communist nations.

Furthermore, Reich is clearly unaware of the finds of Gabriel Kolko and other recent historians that completely revise our picture of the origins of the current welfare-warfare state. Far from large-scale industry forcing the knowledge that regulation and big government were inevitable, it was precisely the *effectiveness* of free-market competition that led big businessmen seeking monopoly to turn to the government to provide such privileges. There was nothing in the economy that objectively required a shift from Consciousness I to Consciousness II: only the age-old desire of men for subsidy and special privilege created the "counter revolution" of statism. In fact, as we have seen, this development only cripples and hampers the workings of modern industry; objective reality would require a return to Consciousness I. In this world of remarkably swift changes in values and ideologies, such a change in consciousness cannot be ruled out as impossible; far stranger things have been happening.

In one sense, the adoption of libertarian values and institutions would be a return; in another, it would be a profound and radical advance. For while the older libertarians were essentially revolutionary, they allowed partial successes to turn themselves strategically and tactically into seeming defenders of the *status quo*, mere resisters of change. In taking this stance, the earlier libertarians lost their radical perspective; for libertarianism has never come fully that into being. What they must do is become "radicals" once again, as Jefferson and Price and Cobden and Thoreau were before them. To do this they must hold aloft the banner of their ultimate goal, the ultimate triumph of the age-old logic of the concepts of free market, liberty, and private property rights. That ultimate goal is the dissolution of the State into the social organism, the privatizing of the public sector. In contrast to the dysfunctional vision of the New Left, this is a goal wholly compatible with the functioning of an industrial society—and with peace and freedom as well. All too many of the older libertarians lacked the intellectual courage to press on—to call for total victory rather than settle for partial triumph—to apply their principles to the fields of money, police, the courts, the State itself. They failed to heed the injunction of William Lloyd Garrison that "gradualism in theory is perpetuity in practice." For if the pure theory is never held aloft, how can it ever be achieved?

# 36

# A Future of Peace and Capitalism

In order to discuss the "future of capitalism," we must first decide what the meaning of the term "capitalism" really is. Unfortunately, the term "capitalism" was coined by its greatest and most famous enemy, Karl Marx. We really can't rely upon him for correct and subtle usage. And, in fact, what Marx and later writers have done is to lump together two extremely different and even contradictory concepts and actions under the same portmanteau term. These two contradictory concepts are what I would call "free-market capitalism" on the one hand, and "state capitalism" on the other.

The difference between free-market capitalism and state capitalism is precisely the difference between, on the one hand, peaceful, voluntary exchange, and on the other, violent expropriation. An example of a free-market exchange is my purchase of a newspaper on the corner for a dime; here is a peaceful, voluntary exchange beneficial to both parties. I buy the newspaper because I value the newspaper more highly than the dime that I give up in exchange; and the newsdealer sells me the paper because, he, in turn, values the dime more highly than the newspaper. Both parties to the exchange benefit. And what we are both doing in the exchange is the swapping of titles of ownership: I relinquish the ownership of my dime in exchange for the paper, and the newsdealer performs the exact opposite change of title. This simple exchange of a dime for a newspaper is an example of a unit free-market act; it is the market at work.

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This essay appeared in James H. Weaver, ed., *Modern Political Economy* (Boston: Allyn and Bacon, 1973), pp. 419–30, as chapter 28; it followed an essay by Professor Robert T. Averitt, to which Rothbard refers once or twice in his piece. One footnote supplied by the original editor has been removed. This essay has been published under the title "The Future of Capitalism."

In contrast to this peaceful act, there is the method of violent expropriation. Violent expropriation occurs when I go to the newsdealer and seize his newspapers or his money at the point of a gun. In this case, of course, there is no mutual benefit; I gain at the expense of the victimized newsdealer. Yet the difference between these two transactions—between voluntary mutual exchange, and the holdup at gunpoint—is precisely the difference between free market capitalism and state capitalism. In both cases we obtain something—whether it be money or newspapers—but we obtain them in completely different ways, ways with completely different moral attributes and social consequences.

Here I can't resist the temptation of pointing out that I have an entirely different interpretation of Jefferson and Hamilton from that of Professor Averitt. I don't regard Jefferson as some sort of early Franz Boas type, an early Left-Wing anthropologist. He wasn't. My reading of Jefferson is completely different; on my reading, Jefferson was very precisely in favor of *laissez-faire,* or free-market, capitalism. And that was the real argument between them. It wasn't really that Jefferson was against factories or industries *per se*; what he was against was coerced development, that is, taxing the farmers through tariffs and subsidies to build up industry artificially, which was essentially the Hamilton program.

Jefferson, incidentally, along with other statesmen of his time, was a very learned person. He read Adam Smith, he read Ricardo, he was very familiar with *laissez-faire* classical economics. And so his economic programs far from being the expression of bucolic agrarian nostalgia, was a very sophisticated application of classical economics to the American scene. We must not forget that *laissez-faire* classicists were also against tariffs, subsidies, and coerced economic development.

Furthermore, the term "equality," as used by Jefferson and Jeffersonians, was employed in the same sense as Jefferson's friend and colleague George Mason used when he framed the Virginia Declaration of Rights shortly before Jefferson wrote the Declaration of Independence: "that all men are by nature equally free and independent." In other words, "equality" did not then mean what we often mean by equality now: equality of condition or uniformity. "Equality" meant that each person has the right to be equally free and independent, to enjoy the right to "equal liberty," as Herbert Spencer would phrase it

a century later. In other words, again what I am saying is that the Jeffersonian wing of the Founding Fathers was essentially free-market, *laissez-faire* capitalists.

To return to the market: the free market is really a vast network, a latticework, of these little, unit exchanges which I mentioned before: such as exchanging a dime for a newspaper. At each step of the way, there are two people, or two groups of people, and these two people or groups exchange two commodities, usually money and another commodity; at each step, each benefits by the exchange, otherwise they wouldn't be making it in the first place. If it turns out that they were mistaken in thinking that the exchange would benefit them then they quickly stop, and they don't make the exchange again.

Another common example of a free market is the universal practice of children swapping baseball cards—the sort of thing where you swap "two Hank Aaron[s]" for "one Willie Mays." The "prices" of the various cards, and the exchanges that took place, were based on the relative importance that the kids attached to each baseball player. As one way of annoying liberals we might put the case this way: liberals are supposed to be in favor of any voluntary actions performed, as the famous cliché goes, by "two consenting adults." Yet it is peculiar that while liberals are in favor of any sexual activity engaged in by two consenting adults, when these consenting adults engage in trade or exchange, the liberals step in to harass, cripple, restrict, or prohibit that trade. And yet both the consenting sexual activity and the trade are similar expressions of liberty in action. Both should be favored by any consistent libertarian. But the government, especially a liberal government, habitually steps in to regulate and restrict such trade.

It is very much as though I were about to exchange two Hank Aarons for one Willie Mays, and the government, or some other third party, should step in and say: "No, you can't do that; that's evil; it's against the common good. We hereby outlaw this proposed exchange; any exchange of such baseball cards must be one for one, or three for two"—or whatever other terms the government, in its wisdom and greatness, arbitrarily wishes to impose. By what right do they do this? The libertarian claims, by no right whatsoever.

In general, government intervention can be classified in two ways: either as prohibiting or partially prohibiting an exchange

between two people—between two consenting adults, an exchange beneficial to both parties; or forcing someone to make an "exchange" with the government unilaterally, in which the person yields something up to the government under the threat of coercion. The first may include outright prohibition of an exchange, regulating the terms—the price—of the exchange, or preventing certain people from making the exchange. As an example of the last intervention, in order to be a photographer in most states, one must be a duly licensed photographer—proving that one is of "good moral character" and paying a certain amount of moolah to the state apparatus. This in order to have the right to take somebody's picture! The second kind of intervention is a forced "exchange" between us and the government, an "exchange" that benefits only the government and not ourselves. Of course, taxation is the obvious and evident example of that. In contrast to voluntary exchange, taxation is a matter of leaping in and coercively seizing people's property without their consent.

It is true that many people seem to believe that taxation is not imposed without our consent. They believe, as the great economist Joseph Schumpeter once said, that taxes are something like club dues, where each person voluntarily pays his share of the expenses of the club. But if you really think that, try not paying your taxes sometime and see what happens. No "club" that I know of has the power to come and seize your assets or jail you if you don't pay its dues. In my view, then, taxes are exploitation—taxes are a "zero-sum" game. If there's anything in the world that's a zero-sum game, it's taxation. The government seizes money from one set of people, gives it to another set of people, and in the meanwhile of course lops off a large chunk for its own "handling expenses." Taxation, then, is purely and pristinely robbery. Period.

As a matter of fact, I challenge any of you to sit down and work out a definition of taxation that would not also be applicable to robbery. As the great libertarian writer H.L. Mencken once pointed out, among the public, even if they are not dedicated libertarians, robbing the government is never considered on the same moral plane as robbing another person. Robbing another person is generally deplored; but if the government is robbed all that happens, as Mencken put it, "is that certain rogues and loafers have less money to play with than they had before."

The great German sociologist Franz Oppenheimer, who wrote a magnificent little book called *The State*, put the case brilliantly. In essence, he said, there are only two ways for men to acquire wealth. The first method is by producing a good or a service and voluntarily exchanging that good for the product of somebody else. This is the method of exchange, the method of the free market; it's creative and expands production; it is not a zero-sum game because production expands and both parties to the exchange benefit. Oppenheimer called this method the "economic means" for the acquisition of wealth. The second method is seizing another person's property without his consent, i.e., by robbery, exploitation, looting. When you seize someone's property without his consent, then you are benefiting at his expense, at the expense of the producer; here is truly a zero-sum "game"—not much of a "game," by the way, from the point of view of the victim. Instead of expanding production, this method of robbery clearly hobbles and restricts production. So in addition to being immoral while peaceful exchange is moral, the method of robbery hobbles production because it is parasitic upon the effort of the producers. With brilliant astuteness, Oppenheimer called this method of obtaining wealth "the political means." And then he went on to define the state, or government, as "the organization of the political means," i.e., the regularization, legitimation, and permanent establishment of the political means for the acquisition of wealth.

In other words, the state is organized theft, organized robbery, organized exploitation. And this essential nature of the state is highlighted by the fact that the state ever rests upon the crucial instrument of taxation.

I must here again comment on Professor Averitt's statement about "greed." It's true: greed has had a very bad press. I frankly don't see anything wrong with greed. I think that the people who are always attacking greed would be more consistent with their position if they refused their next salary increase. I don't see even the most Left-Wing scholar in this country scornfully burning his salary check. In other words, "greed" simply means that you are trying to relieve the nature-given scarcity that man was born with. Greed will continue until the Garden of Eden arrives, when everything is superabundant, and we don't have to worry about economics at all. We haven't of course reached that point yet; we haven't reached the point where everybody is burning his salary increases, or salary

checks in general. So the question then becomes: what kind of greed are we going to have, "productive greed," where people produce and voluntarily exchange their products with others? Or exploitative greed, organized robbery and predation, where you achieve your wealth at the expense of others? These are the two real alternatives.

Returning to the state and taxation, I would point out incidentally that Saint Augustine, who is not famous for being a libertarian, did however set forth an excellent libertarian parable. He wrote that Alexander the Great had seized some pirate, and asked the pirate what he meant by seizing possession of the sea. And the pirate boldly replied: "What you mean by seizing the whole earth; but because I do it with a little ship, I am called a robber, while you, because you do it with a great fleet are called an emperor." Here Augustine highlights the fact that the state is simply robbery writ large, on an enormous scale, but robbery legitimated by intellectual opinion.

Take, for another example, the Mafia, which also suffers from a bad press. What the Mafia does on a local scale, the state does on an enormous scale, but the state of course has a much better press.

In contrast to the age-old institution of statism, of the political means, free-market capitalism arrived as a great revolutionary movement in the history of man. For it came into a world previously marked by despotism, by tyranny, by totalitarian control. Emerging first in the Italian city states, free market capitalism arrived full scale with the Industrial Revolution in Western Europe, a revolution that brought about a remarkable release of creative energy and productive ability, an enormous increase of production. You can call that "greed" if you wish; you can attack as "greed" the desire of someone on a poverty level who wishes to better his lot.

This reminds me of an interesting point on "greed" that cuts across the usual "Left-Right" continuum. I remember when Russell Kirk first launched the contemporary conservative movement in this country, in the mid-1950s. One of the leading young conservatives of that era addressed a rally, and opined that the whole trouble with the world, and the reason for the growth of the Left, is that everyone is "greedy," the masses of Asia are "greedy," and so on. Here was a person who owned half of Montana, attacking the mass of the world population, who were trying to rise above the subsistence level, to better their lot a bit. And yet they were "greedy."

At any rate, free-market capitalism, the Industrial Revolution, saw an enormous outpouring of productive energies, an outpouring that constituted a revolution against the mercantilist system of the seventeenth and eighteenth centuries In fact the mercantilist system is essentially what we've got right now. There is very little difference between state monopoly capitalism, or corporate state capitalism, whatever you want to call it, in the United States and Western Europe today, and the mercantilist system of the pre-Industrial Revolution era. There are only two differences; one is that their major activity was commerce and ours is industry. But the essential *modus operandi* of the two systems is exactly the same: monopoly privilege, a complete meshing in what is now called the "partnership of government and industry," a pervasive system of militarism and war contracts, a drive toward war and imperialism; the whole shebang characterized the seventeenth and eighteenth centuries. The really key difference is that they didn't have a gigantic P.R. apparatus; they did not have a fleet of intellectuals trumpeting to all and sundry the wonders of the system: how it promotes the common good and the general welfare, how this is Liberalism In Action. They said, "We're out to shaft the public and we're doing it!" They were very honest in those days. It's really refreshing, by the way, to go back and read the material before 1914 and bask in the honesty of the period.

One of the concepts important in this connection is that of Albert Jay Nock, a great libertarian thinker and follower of Franz Oppenheimer. Nock coined two concepts: what he called "social power" on the one hand, and "state power" on the other. Social power is essentially what I have been talking about: the productive energies released by the free market, by voluntary exchanges, people interacting voluntarily and peacefully. "State power" is parasitism, exploitation, and the state apparatus in general—organized taxes, regulation, etc. And Nock saw history as essentially a race between social power and state power. In the Industrial Revolution period, for example, from various circumstances state power was minimal, and this allowed social power to take a tremendous burst upward. And what has happened in the twentieth century is essentially that state power has caught up; they've moved in on society and started crippling it once again.

What, then, is my view of the "future of capitalism"—our topic for today? My view of the future is highly optimistic. I really think

that free-market capitalism, even though it is supposed to be a reactionary, Neanderthal institution, is the wave of the future. For one thing, it was the wave of the future a hundred and two hundred years ago, and what we have now is only a reactionary reversion to the previous system.

The present system is not really "progressive" at all. Second, it was discovered by Ludwig von Mises back in 1920 that socialism—the other polar alternative to our present neo-mercantilism—cannot run an industrial system.

An agricultural system can be run indefinitely by almost anyone, as long as you leave the peasants alive. You can have almost any kind of tyrannical system over the peasants. But in an industrial system you need much more than that: you need a market, you need profit-and-loss tests, you can't run the system haphazardly. And Mises proved that a socialist system cannot calculate economically, because it doesn't have a price system for capital goods, and therefore socialism will not be able to run an industrial system.

All the textbooks say that Mises was quickly refuted by Oskar Lange and others, but he really wasn't refuted. I haven't got time to go into the theoretical argument. But in practice what has happened is that, in response to industrialization, there has been a tremendous shift in the last fifteen years in the socialist countries of Eastern Europe away from socialism and toward a free market. For a believer in freedom and the free market, this shift is one of the most exciting developments of the past two decades. Now there are only two interpretations of this development: either you have to say, as the Chinese do, that the Yugoslavs, the Poles, the Czechs, the Slovaks, the Hungarians have all sold out to capitalism—they've gone in secret to the American Embassy and received their pay. Or you have to say that something deeper is happening, that what is essentially happening is that they tried socialism and it didn't work, especially as the economies began to industrialize. They found in practice, pragmatically, without reading Mises (though there's evidence that they've read Mises by this time) and Hayek and others, that socialism can't calculate, they came to that conclusion themselves. Lenin, indeed, came to that conclusion very early, when "War Communism" was scrapped in 1921.

"War Communism" was an attempt, shortly after the Bolshevik Revolution, to leap into full communism, into an economy without

money and without prices, in which everyone was supposed to—and in practice was forced to—present his goods to the common heap, and withdraw from that heap to satisfy his needs.

The system of War Communism proved to be a total disaster—not because of the Civil War (that rationalization only came much later), but because of the communist system itself.[1] Lenin soon realized what was happening, and quickly instituted the New Economic Policy, which was essentially a return to a quasi-free market system.

Now the Eastern European countries, especially Yugoslavia, have been moving very rapidly since the 1950s away from socialism and central planning and toward a free-market system. In Yugoslavia, for example, agriculture, still the main industry, is almost completely private; a flourishing private sector exists in trade and small manufacturing; and the "public sector" has been turned over in fact as well as in law by the state to the ownership of the workers in the various plants—essentially functioning as producers' cooperatives. Furthermore, there is substantially a free market between these producers' co-ops, with a flourishing price system, stern profit and loss tests (when a firm loses enough money, it goes bankrupt). Moreover, the most recent Yugoslav economic reform which began in 1967 and is still underway, saw a tremendous drop in the rate of taxation of their co-ops—a drop from the previous approximately 70 per cent income tax rate to about 20 per cent. This means that, the central Yugoslav government no longer exercises complete control over investment: investment, too, has been decentralized and destatized. As a matter of fact, if one reads the Communist economists in Yugoslavia—especially in the relatively industrialized areas of Croatia and Slovenia—they sound very much like Barry Goldwater or Ronald Reagan. "Why should we productive Croats or Slovenes," they ask, "be taxed in order to subsidize those lazy slobs down in Montenegro?" And: "why should we build uneconomic ("political") factories? Everyone should stand on their own feet," etc. The next step in Yugoslavia is that the banks—which, incidentally, are largely competitive private co-ops owned by their business clients—are agitating for a stock market in

[1]On War Communism, see the important article by Paul Craig Roberts, "War Communism: A Re-examination," *Slavic Review* (June 1970): 237–61.

a Communist country, which would have been considered incredible ten or twenty years ago. And what they are proposing to call this system—literally—is "socialist people's capitalism."

On this point, a few years ago I was teaching a course in Comparative Economic Systems. Naturally, I spent the term praising the free market, and attacking socialism and central planning. Finally, I invited an exchange professor from Hungary—an eminent Communist economist—to give a guest lecture, and the kids felt: "Ah, at least we're going to get the other side of the picture." And what did the Hungarian economist do? He spent the entire lecture praising the free market and attacking central planning. He said almost exactly what I had been saying up till then.

In Eastern Europe, then, I think that the prospects for the free market are excellent—I think we're getting free-market capitalism and that its triumph there is almost inevitable. In the United States, the prospects are a little more cloudy, but here too we see the "New Left" picking up a lot of the positions that we "extreme Right-Wingers" used to have. Much of the position that used to be called "extreme Right-Wing" twenty years ago is now considered quite leftish. As a result, I, with the same position I had then, have been shifted bodily from extreme right to left without any effort on my part at all. Decentralization; community control; attack on Leviathan government, on bureaucracy, on government interference with each person's life; attack on the state-ridden educational system; criticism of unionism, which is tied up with the state; opposition to militarism, war, imperialism, and conscription; all these things that the Left is now beginning to see, is precisely what we "extreme Right-Wingers" have been saying all along. And, as far as "decentralization" goes, there is nothing that is so decentralized as the free market, and perhaps this too will come to the attention of the public.

And so, I'm very optimistic about the future of free-market capitalism. I'm not optimistic about the future of state capitalism—or rather, I am optimistic, because I think it will eventually come to an end. State capitalism inevitably creates all sorts of problems which become insoluble; as Mises again has pointed out, one intervention into the system to try to solve problems only creates other problems, which then demand further interventions, etc., and so the whole process keeps snowballing until you have a completely collectivist, totalitarian system. It's very much like the escalation in Vietnam, by

the way; the principle, as we all know by this time, is that government intervention in Vietnam creates problems which demand further escalation, etc. The same thing happens in domestic intervention, the farm program being a splendid example of this process. Both in Vietnam and in domestic government intervention, each escalating step only creates more problems which confront the public with the choice: either press on further with more interventions, or repeal them—in Vietnam, withdraw from the country. Now in Yugoslavia and the rest of Eastern Europe, they have taken the opposite path: of progressive de-escalation, of continuing repeal of one intervention after another, and on toward the free market. In the United States we have so far taken the path of accelerating interventions, of ever greater hobbling of tile free market. But it is beginning to become evident that the mixed system is breaking down, that it doesn't work. It's beginning to be seen, for example, that the Welfare State does not tax the rich and give to the poor; it taxes the poorer to give to the richer, and the poor in essence pay for the Welfare State. It is beginning to be seen that foreign intervention is essentially a method of subsidizing favored American corporations instead of helping out the poor in the undeveloped countries. And it is now becoming evident that the Keynesian policies only succeeded in bringing us to the present impasse of inflation-cum-recession, and that our Olympian economists have no way of getting out of the present mess at all, except to cross their fingers and their econometric models and pray. And, of course, we can look forward to another balance-of-payments crisis in a couple of years, another episode of inflationary crisis in a couple of years, another episode of gold-outflow hysteria.

Thus, we have a lot of crises looming in America, some on their way, others imminent or already here. All of these crises are the products of intervention, and none of them can really be solved by more intervention. Again, I believe that we will eventually reverse our present course—perhaps taking Yugoslavia as our paradigm. Incidentally, Professor Averitt mentioned the Great Depression. The Great Depression has always been considered as the product of free-market capitalism of the 1920s. It was the result of very heavy government intervention in the 1920s, an intervention, by the way, that is very similar to the current intervention. In the 1920s, we had the newly imposed Federal Reserve System, which all the Establishment economists of the day assured us would eliminate all future depressions; the

Federal Reserve System would henceforth manipulate prices and the money supply and iron out business cycles forever. Nineteen twenty-nine and the Great Depression were the results of that manipulation guided by the wise hands of Establishment economics—they were not the results of anything like free-market capitalism.

In short, the advent of industrialism and the Industrial Revolution has irreversibly changed the prognosis for freedom and statism. In the pre-industrial era, statism and despotism could peg along indefinitely, content to keep the peasantry at subsistence levels and to live off their surplus. But industrialism has broken the old tables; for it has become evident that socialism cannot run an industrial system, and it is gradually becoming evident that neomercantilism, interventionism, in the long run cannot run an industrial system either. Free-market capitalism, the victory of social power and the economic means, is not only the only moral and by far the most productive system; it has become the only viable system for mankind in the industrial era. Its eventual triumph is therefore virtually inevitable.

## Section Six

# Money, Banking, and Calculation

# 37
# The Austrian Theory of Money

The Austrian theory of money virtually begins and ends with Ludwig von Mises's monumental *Theory of Money and Credit*, published in 1912.[1] Mises's fundamental accomplishment was to take the theory of marginal utility, built up by Austrian economists and other marginalists as the explanation for consumer demand and market price, and apply it to the demand for and the value, or the price, of money. No longer did the theory of money need to be separated from the general economic theory of individual action and utility, of supply, demand, and price; no longer did monetary theory have to suffer isolation in a context of "velocities of circulation," "price levels," and "equations of exchange."

In applying the analysis of supply and demand to money, Mises used the Wicksteedian concept: supply is the total stock of a commodity at any given time; and demand is the total market demand to gain and hold cash balances, built up out of the marginal-utility rankings of units of money on the value scales of individuals on the market. The Wicksteedian concept is particularly appropriate to money for several reasons: first, because the supply of money is either extremely durable in relation to current production, as under the gold standard, or is determined exogenously to the market by government authority; and, second and most important, because money, uniquely among commodities desired and demanded on the market,

Originally appeared as a chapter in *The Foundations of Modern Austrian Economics*, Edwin Dolan, ed. (Kansas City: Sheed Andrews and McMeel, 1976), pp. 160–84.

[1]Ludwig von Mises, *Theorie des Geldes und der Umlaufsmittel* (1912); see the third English edition, *The Theory of Money and Credit* (New Haven, Conn.: Yale University Press, 1953).

is acquired not to be consumed, but to be held for later exchange. Demand-to-hold thereby becomes the appropriate concept for analyzing the uniquely broad monetary function of being held as stock for later sale. Mises was also able to explain the demand for cash balances as the resultant of marginal utilities on value scales that are strictly ordinal for each individual. In the course of his analysis Mises built on the insight of his fellow Austrian Franz Cuhel to develop a marginal utility that was strictly ordinal, lexicographic, and purged of all traces of the error of assuming the measurability of utilities.

The relative utilities of money units as against other goods determine each person's demand for cash balances, that is, how much of his income or wealth he will keep in cash balances as against how much he will spend. Applying the law of diminishing (ordinal) marginal utility of money and bearing in mind that money's "use" is to be held for future exchange, Mises arrived implicitly at a falling demand curve for money in relation to the purchasing power of the currency unit. The purchasing power of the money unit, which Mises also termed the "objective exchange-value" of money, was then determined, as in the usual supply-and-demand analysis, by the intersection of the money stock and the demand for cash balance schedule. We can see this visually by putting the purchasing power of the money unit on the y-axis and the quantity of money on the x-axis of the conventional two-dimensional diagram corresponding to the price of any good and its quantity. Mises wrapped up the analysis by pointing out that the total supply of money at any given time is no more or less than the sum of the individual cash balances at that time. No money in a society remains unowned by someone and is therefore outside some individual's cash balances.

While, for purposes of convenience, Mises's analysis may be expressed in the usual supply-and-demand diagram with the purchasing power of the money unit serving as the price of money, relying solely on such a simplified diagram falsifies the theory. For, as Mises pointed out in a brilliant analysis whose lessons have still not been absorbed in the mainstream of economic theory, the purchasing power of the money unit is not simply the inverse of the so-called price level of goods and services. In describing the advantages of money as a general medium of exchange and how such a general medium arose on the market, Mises pointed out that the currency unit serves as unit of account and as a common denominator of all

other prices, but that the money commodity itself is still in a state of barter with all other goods and services. Thus, in the pre-money state of barter, there is no unitary "price of eggs"; a unit of eggs (say, one dozen) will have many different "prices": the "butter" price in terms of pounds of butter, the "hat" price in terms of hats, the "horse" price in terms of horses, and so on. Every good and service will have an almost infinite array of prices in terms of every other good and service. After one commodity, say gold, is chosen to be the medium for all exchanges, every other good except gold will enjoy a unitary price, so that we know that the price of eggs is one dollar a dozen; the price of a hat is ten dollars, and so on. But while every good and service except gold now has a single price in terms of money, money itself has a virtually infinite array of individual prices in terms of every other good and service. To put it another way, the price of any good is the same thing as its purchasing power in terms of other goods and services. Under barter, if the price of a dozen eggs is two pounds of butter, the purchasing power of a dozen eggs is, *inter alia*, two pounds of butter. The purchasing power of a dozen eggs will also be one-tenth of a hat, and so on. Conversely, the purchasing power of butter is its price in terms of eggs; in this case the purchasing power of a pound of butter is a half-dozen eggs. After the arrival of money, the purchasing power of a dozen eggs is the same as its money price, in our example, one dollar. The purchasing power of a pound of butter will be fifty cents, of a hat ten dollars, and so forth.

What, then, is the purchasing power, or the price, of a dollar? It will be a vast array of all the goods and services that can be purchased for a dollar, that is, of all the goods and services in the economy. In our example, we would say that the purchasing power of a dollar equals one dozen eggs, or two pounds of butter, or one-tenth of a hat, and so on, for the entire economy. In short, the price, or purchasing power, of the money unit will be an array of the quantities of alternative goods and services that can be purchased for a dollar. Since the array is heterogeneous and specific, it cannot be summed up in some unitary price-level figure.

The fallacy of the price-level concept is further shown by Mises's analysis of precisely how prices rise (that is, the purchasing power of money falls) in response to an increase in the quantity of money (assuming, of course, that the individual demand schedules for cash balances or, more generally, individual value scales remain constant).

In contrast to the hermetic neoclassical separation of money and price levels from the relative prices of individual goods and services, Mises showed that an increased supply of money impinges differently upon different spheres of the market and thereby ineluctably changes relative prices.

Suppose, for example, that the supply of money increases by 20 percent. The result will not be, as neoclassical economics assumes, simply an across-the-board increase of 20 percent in all prices. Let us assume the most favorable case—what we might call the Angel Gabriel model—that the Angel Gabriel descends and overnight increases everyone's cash balance by precisely 20 percent. Now all prices will not simply rise by 20 percent; for each individual has a different value scale, a different ordinal ranking of utilities, including the relative marginal utilities of dollars and of all the other goods on his value scale. As each person's stock of dollars increases, his purchases of goods and services will change in accordance with their new position on his value scale in relation to dollars. The structure of demand will therefore change, as will relative prices and relative incomes in production. The composition of the array constituting the purchasing power of the dollar will change.

If relative demands and prices change in the Angel Gabriel model, they will change much more in the course of real-world increases in the supply of money. For, as Mises showed, in the real world an inflation of money is alluring to the inflators precisely because the injection of new money does not follow the Angel Gabriel model. Instead, the government or the banks create new money to be spent on specific goods and services. The demand for these goods thereby rises, raising these specific prices. Gradually, the new money ripples through the economy, raising demand and prices as it goes. Income and wealth are redistributed to those who receive the new money early in the process, at the expense of those who receive the new money late in the day and of those on fixed incomes who receive no new money at all. Two types of shifts in relative prices occur as the result of this increase in money: (1) the redistribution from late receivers to early receivers that occurs during the inflation process and; (2) the permanent shifts in wealth and income that continue even after the effects of the increase in the money supply have worked themselves out. For the new equilibrium will reflect a changed pattern of wealth, income, and demand resulting from the

changes during the intervening inflationary process. For example, the fixed income groups permanently lose in relative wealth and income.[2]

If the concept of a unitary price level is a fallacious one, still more fallacious is any attempt to measure changes in that level. To use our previous example, suppose that at one point in time the dollar can buy one dozen eggs, or one-tenth of a hat, or two pounds of butter. If, for the sake of simplicity, we restrict the available goods and services to just these three, we are describing the purchasing power of the dollar at that time. But suppose that at the next point in time, perhaps because of an increase in the supply of dollars, prices rise, so that butter costs one dollar a pound, a hat twelve dollars, and eggs three dollars a dozen. Prices rise but not uniformly, and all that we can now say quantitatively about the purchasing power of the dollar is that it is four eggs, or one-twelfth of a hat, or one pound of butter. It is impermissible to try to group the changes in the purchasing power of the dollar into a single average index number. Any such index conjures up some sort of totality of goods whose relative prices remain unchanged, so that a general averaging can arrive at a measure of changes in the purchasing power of money itself. But we have seen that relative prices cannot remain unchanged, much less the valuations that individuals place upon these goods and services.[3]

Just as the price of any good tends to be uniform, so the price, or purchasing power of money, as Mises demonstrated, will tend to be uniform throughout its trading area. The purchasing power of the dollar will tend to be uniform throughout the United States. Similarly, in the era of the gold standard, the purchasing power of a unit of gold tended to be uniform throughout those areas where gold was

[2]On the changes in relative prices attendant on an increase in the money supply, see Mises, *Theory of Money and Credit*, pp. 139–45.

[3]For more on the fallacies of measurement and index numbers, see Mises, *Theory of Money and Credit*, pp. 187–94; idem, *Human Action: A Treatise on Economics* (New Haven, Conn.: Yale University Press, 1949), pp. 221–24; Murray N. Rothbard, *Man, Economy, and State* (Princeton, N.J.: D. Van Nostrand, 1962), vol. 2, pp. 737–40; Bassett Jones, *Horses and Apples: A Study of Index Numbers* (New York: John Day, 1934); and Oskar Morgenstern, *On the Accuracy of Economic Observations*, 2nd rev. ed. (Princeton, N.J.: Princeton University Press, 1963).

in use. Critics who point to persistent tendencies for differences in the price of money between one location and another fail to understand the Austrian concept of what a good or a service actually is. A good is not defined by its technological properties but by its homogeneity in relation to the demands and wishes of the consumers. It is easy to explain, for example, why the price of wheat in Kansas will not be the same as the price of wheat in New York. From the point of view of the consumer in New York, the wheat, while technologically identical in the two places, is in reality two different commodities: one being "wheat in Kansas" and the other "wheat in New York." Wheat in New York, being closer to his use, is a more valuable commodity than wheat in Kansas and will have a higher price on the market. Similarly, the fact that a technologically similar apartment will not have the same rental price in New York City as in rural Ohio does not mean that the price of the same apartment commodity differs persistently; for the apartment in New York enjoys a more valuable and more desirable location and hence will be more highly priced on the market. The "apartment in New York" is a different and more valuable good than the "apartment in rural Ohio," since the respective locations are part and parcel of the good itself. At all times, a homogeneous good must be defined in terms of its usefulness to the consumer rather than by its technological properties.

To extend the analysis, the fact that the cost of living may be persistently higher in New York than in rural Ohio does not negate the tendency for a uniform purchasing power of the dollar throughout the country. For the two locations constitute a different set of goods and services, New York providing a vastly wider range of goods and services to the consumer. The higher costs of living in New York are the reflection of the greater locational advantages, of the more abundant range of goods and services available.[4]

In his valuable history of the theory of international prices, C.Y. Wu emphasized the Mises contribution and pointed out that Mises's explanation was in the tradition of Ricardo and Nassau Senior, who

> was the first economist to give a clear explanation of the meaning of the classical doctrine that the value of money was everywhere

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[4]See Mises, *Theory of Money and Credit*, pp. 170–78.

> the same and to demonstrate that differences in the prices of goods of similar composition in different places were perfectly reconcilable with the assumption of an equality of the value of money.[5]

Pointing out that Mises arrived at this concept independently of Senior, Wu then developed Mises's application to the alleged locational differences in the cost of living. As Wu stated,

> To him [Mises] those who believe in national differences in the value of money have left out of account the positional factor in the nature of economic goods; otherwise they should have understood that the alleged differences are explicable by differences in the quality of the commodities offered and demanded.

Wu concluded with a quote from Mises's *Theory of Money and Credit*:

> The exchange-ratio between commodities and money is everywhere the same. But men and their wants are not everywhere the same, and neither are commodities.[6]

If the tendency of the purchasing power of money is to be everywhere the same, what happens if one or more moneys coexist in the world? By way of explanation, Mises developed the Ricardian analysis into what was to be called the purchasing-power-parity theory of exchange rates, namely, that the market exchange rate between two independent moneys will tend to equal the ratio of their purchasing powers. Mises showed that this analysis applies both to the exchange rate between gold and silver—whether or not the two circulate side by side within the same country—and to independent fiat currencies issued by two nations. Wu explained the difference between Mises's theory and the unfortunately better-known version of the purchasing-power-parity theory set forth a bit later by Gustav Cassel. The Cassel version ignores the Austrian emphasis on locational differences in accounting for differences in value of technologically similar goods, and this in turn complements the broader Austrian and

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[5]Chi-Yuen Wu, *An Outline of International Price Theories* (London: George Routledge and Sons, 1939), p. 126.

[6]Ibid., p. 234; Mises, *Theory of Money and Credit*, p. 178. Mises's development of the theory was independent of Senior's because the latter was only published in 1928 in *Industrial Efficiency and Social Economy* (New York, 1928), pp. 55–56; see Wu, *Outline of International Price Theories*, p. 127*n*.

classical position that the purchasing power of money is an array of specific goods. This contrasts with Cassel and the neoclassicists, who think of the purchasing power of money as the inverse of a unitary price level. Thus Wu stated:

> The purchasing power parity theory is that the rate of exchange would be in equilibrium when the "purchasing power of the moneys" is equal in all trading countries. If the term *purchasing power* refers to the power of purchasing commodities, which are not only similar in technological composition, but also in the same geographical situation, the theory becomes the classical doctrine of comparative value of moneys in different countries and is a sound doctrine. But unfortunately the term purchasing power in connection with the theory sometimes implies the reciprocal of the general price level in a country. While so interpreted the theory becomes that the equilibrium point of the foreign exchanges is to be found at the quotient between the price levels of the different countries. That is . . . an erroneous version of the purchasing power parity theory.[7]

Unfortunately, Cassel, instead of correcting the error in his concept of purchasing power, soon abandoned the full-parity doctrine in favor of a different and highly attenuated contention that only changes in exchange rates reflect changes in respective purchasing power—perhaps because of his desire to use measurement and index numbers in applying the theory.[8]

When he set out to apply the theory of marginal utility to the price of money, Mises confronted the problem that was later to be called "the Austrian circle." In short, when someone ranks eggs or beef or shoes on his value scale, he values these goods for their direct use in consumption. Such valuations are, of course, independent of and prior to pricing on the market. But people demand money to hold in their cash balances, not for eventual direct use in consumption, but precisely in order to exchange those balances for other goods that will be used directly. Thus, money is not useful in itself but because it has a prior exchange value, because it has been and therefore presumably will be exchangeable in terms of other goods. In

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[7]Ibid., p. 250; Mises's formulation is in *Theory of Money and Credit*, pp. 179–88.

[8]See Wu, *Outline of International Price Theories*, pp. 251–60.

short, money is demanded because it has a pre-existing purchasing power; its demand not only is not independent of its existing price on the market but is precisely due to its already having a price in terms of other goods and services. But if the demand for, and hence the utility of, money depends on its pre-existing price or purchasing power, how then can that price be explained by the demand? It seems that any Austrian attempt to apply marginal utility theory to money is inextricably caught in a circular trap. For that reason mainstream economics has not been able to apply marginal utility theory to the value of money and has therefore gone off in multi-causal (or *non*-causal) Walrasian directions.

Mises, however, succeeded in solving this problem in 1912 in developing his so-called regression theorem. Briefly, Mises held that the demand for money, or cash balances, at the present time—say day X—rests on the fact that money on the previous day, day X –1, had a purchasing power. The purchasing power of money on day X is determined by the interaction on day X of the supply of money on that day and that day's demand for cash balances, which in turn is determined by the marginal utility of money for individuals on day X. But this marginal utility, and hence this demand, has an inevitable historical component: the fact that money has prior purchasing power on day X –1, and that therefore individuals know that this commodity has a monetary function and will be exchangeable on future days for other goods and services. But what then determined the purchasing power of money on day X –1? Again, that purchasing power was determined by the supply of, and demand for, money on day X –1, and that in turn depended on the fact that the money had purchasing power on day X –2. But are we not caught in an infinite regression, with no escape from the circular trap and no ultimate explanation? No. What we must do is to push the temporal regression to that point when the money commodity was not used as a medium of indirect exchange but was demanded purely for its own direct consumption use. Let us go back logically to the second day that a commodity, say gold, was used as a medium of exchange. On that day, gold was demanded partly because it has a pre-existing purchasing power as a money, or rather as a medium of exchange, on the first day. But what of that first day? On that day, the demand for gold again depended on the fact that gold had a previous purchasing power, and so we push the analysis back to the last day of barter. The

demand for gold on the last day of barter was purely a consumption use and had no historical component referring to any previous day; for under barter, every commodity was demanded purely for its current consumption use, and gold was no different. On the first day of its use as a medium of exchange, gold began to have two components in its demand, or utility: first, a consumption use as had existed in barter and, second, a monetary use, or use as a medium of exchange, which had a historical component in its utility. In short, the demand for money can be pushed back to the last day of barter, at which point the temporal element in the demand for the money commodity disappears, and the causal forces in the current demand and purchasing power of money are fully and completely explained.

Not only does the Mises regression theorem fully explain the current demand for money and integrate the theory of money with the theory of marginal utility, but it also shows that money must have originated in this fashion—on the market—with individuals on the market gradually beginning to use some previously valuable commodity as a medium of exchange. No money could have originated either by a social compact to consider some previously valueless thing as a "money" or by sudden governmental fiat. For in those cases, the money commodity could not have a previous purchasing power, which could be taken into account in the individual's demands for money. In this way, Mises demonstrated that Carl Menger's historical insight into the way in which money arose on the market was not simply a historical summary but a theoretical necessity. On the other hand, while money had to originate as a directly useful commodity, for example, gold, there is no reason, in the light of the regression theorem, why such direct uses must continue afterward for the commodity to be used as money. Once established as a money, gold or gold substitutes can lose or be deprived of their direct use function and still continue as money; for the historical reference to a previous day's purchasing power will already have been established.[9]

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[9]Mises's regression theorem may be found in *Theory of Money and Credit*, pp. 97–123. For an explanation and a diagrammatic representation of the regression theorem, see Rothbard, *Man, Economy, and State*, pp. 231–37. Menger's insight into the origin of money on the market may be found in Carl Menger, *Principles of Economics* (Glencoe, Ill.: The Free Press,

In his comprehensive 1949 treatise, *Human Action*, Mises successfully refuted earlier criticisms of the regression theorem by Anderson and Ellis.[10] Subsequently criticisms were leveled at the theory by J.C. Gilbert and Don Patinkin. Gilbert asserted that the theory fails to explain how a new paper money can be introduced when the previous monetary system breaks down. Presumably he was referring to such examples as the German *Rentenmark* after the runaway inflation of 1923. But the point is that the new paper was not introduced *de novo*; gold and foreign currencies had existed previously, and the *Rentenmark* could and did undergo exchange in terms of these previously existing moneys; furthermore, it was introduced at a fixed relation to the previous, extremely depreciated mark.[11]

Patinkin criticized Mises for allegedly claiming that the marginal utility of money refers to the marginal utility of the goods for which money is exchanged rather than the marginal utility of holding money itself; he also charged Mises with inconsistently holding the latter view in the other parts of *The Theory of Money and Credit*. But Patinkin was mistaken; Mises's concept of the marginal utility of money always refers to the utility of holding money. Mises's point in the regression theorem is a different one, namely, that the marginal utility-to-hold is itself based on the prior fact that money can be exchanged for goods, that is, on the prior purchasing power of money in terms of goods. In short, money prices of goods, the purchasing power of money, has first to exist in order for money to have a marginal utility to hold, hence the need for the regression theorem to break out of the circularity.[12]

Modern orthodox economics has abandoned the quest for causal explanation in behalf of a Walrasian world of "mutual determination"

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1950), pp. 257–62. On the relationship between Menger's approach and the regression theorem, see Mises, *Human Action*, pp. 402–04.

[10]Mises, *Human Action*, pp. 405–07. The regression analysis was either adopted by or arrived at independently by William A. Scott in *Money and Banking,* 6th ed. (New York: Henry Holt, 1926), pp. 54–55.

[11]J.C. Gilbert, "The Demand for Money: The Development of an Economic Concept," *Journal of Political Economy* 61 (April 1953): 149.

[12]Don Patinkin, *Money, Interest, and Prices* (Evanston, Ill.: Row, Peterson, 1956), pp. 71–72, 414.

suitable for the current fashion of mathematical economics. Patinkin himself feebly accepted the circular trap by stating that in analyzing the market ("market experiment") he began with utility while in analyzing utility he began with prices ("individual experiment"). With characteristic arrogance, Samuelson and Stigler each attacked the Austrian concern with escaping circularity in order to analyze causal relations. Samuelson fell back on Walras, who developed the idea of "general equilibrium in which all magnitudes are simultaneously determined by efficacious interdependent relations," which he contrasted to the "fears of literary writers" (that is, economists who write in English) about circular reasoning.[13]

Stigler dismissed Böhm-Bawerk for his

> failure to understand some of the most essential elements of modern economic theory, the concepts of mutual determination and equilibrium (developed by the use of the theory of simultaneous equations). Mutual determination . . . is spurned for the older concept of cause and effect.

Stigler added the snide note that "Böhm-Bawerk was not trained in mathematics."[14]

Thus, orthodox economists reflect the unfortunate influence of the mathematical method in economics. The idea of mutual functional determination—so adaptable in mathematical presentation—is appropriate in physics, which tries to explain the unmotivated motions of physical matter. But in praxeology, the study of human action, of which economics is the best elaborated part, the cause is known: individual purpose. In economics, therefore, the proper method is to proceed from the causing action to its consequent effects.

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[13]Paul A. Samuelson, *Foundations of Economic Analysis* (Cambridge, Mass.: Harvard University Press, 1947), pp. 117–18.

[14]George Stigler, *Production and Distribution Theories: The Formative Period* (New York: Macmillan, 1946), p. 181; also see the similar, if more polite, attack on Menger by Frank H. Knight, "Introduction," in Menger, *Principles*, p. 23. For a contrasting discussion by the mathematical economist son of Menger, Karl Menger, see "Austrian Marginalism and Mathematical Economics," in *Carl Menger and the Austrian School of Economics*, John R. Hicks and Wilhelm Weber, eds. (Oxford: Clarendon Press, 1973), pp. 54–60.

In *Human Action*, Mises advanced the Austrian theory of money by delivering a shattering blow to the very concept of Walrasian general equilibrium. To arrive at that equilibrium, the basic data of the economy—values, technology, and resources—must all be frozen and understood by every participant in the market to be frozen indefinitely. Given such a magical freeze, the economy would sooner or later settle into an endless round of constant prices and productions, with each firm earning a uniform rate of interest (or, in some construction, a zero rate of interest). The idea of certainty and fixity in what Mises called "the evenly rotating economy" is absurd, but what Mises went on to show is that in such a world of fixity and certainty no one would hold cash balances. For since everyone would have perfect foresight and knowledge of his future sales and purchases, there would be no point in holding any cash balance at all. Thus, the man who knew he would be spending $5,000 on 1 January 1977 would lend out all his money to be returned at precisely that date. As Mises stated:

> Every individual knows precisely what amount of money he will need at any future date. He is therefore in a position to lend all the funds he receives in such a way that the loans fall due on the date he will need them. . . . When the equilibrium of the evenly rotating economy is finally reached, there are no more cash holdings.[15]

But if no one holds cash and the demand for cash balances falls to zero, all prices rise to infinity, and the entire general equilibrium system of the market, which implies the continuing existence of monetary exchange, falls apart. As Mises concluded:

> In the imaginary construction of an evenly rotating economy, indirect exchange and the use of money are tacitly implied. . . . Where there is no uncertainty concerning the future, there is no need for any cash holding. As money must necessarily be kept by people in their cash holdings, there cannot be any money. . . . But the very notion of a market economy without money is self-contradictory.[16]

The very notion of a Walrasian general equilibrium is not simply totally unrealistic, it is conceptually impossible, since money and

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[15]Mises, *Human Action*, p. 250.

[16]Ibid., pp. 249–50, 414.

monetary exchange cannot be sustained in that kind of system. Another corollary contribution of Mises in this analysis was to demonstrate that, far from being only one of many "motives" for holding cash balances, uncertainty is crucial to the holding of any cash at all.

That such problems are now troubling mainstream economics is revealed by F.H. Hahn's demonstration that Patinkin's well-known model of general equilibrium can only establish the existence of a demand for money by appealing to such notions as an alleged uncertainty of the exact moments of future sales and purchases, and to "imperfections" in the credit market—neither of which, as Hahn pointed out, is consistent with the concept of general equilibrium.[17]

With respect to the supply of money, Mises returned to the basic Ricardian insight that an increase in the supply of money never confers any general benefit upon society. For money is fundamentally different from consumers' and producers' goods in at least one vital respect. Other things being equal, an increase in the supply of consumers' goods benefits society since one or more consumers will be better off. The same is true of an increase in the supply of producers' goods, which will be eventually transformed into an increased supply of consumers' goods; for production itself is the process of transforming natural resources into new forms and locations desired by consumers for direct use. But money is very different: money is not used directly in consumption or production but is exchanged for such directly usable goods. Yet, once any commodity or object is established as a money, it performs the maximum exchange work of which it is capable. An increase in the supply of money causes no increase whatever in the exchange service of money; all that happens is that the purchasing power of each unit of money is diluted by the increased supply of units. Hence there is never a social need for increasing the supply of money, either because of an increased supply of goods or because of an increase in population. People can acquire an increased proportion of cash balances with a fixed supply of money by spending less and thereby increasing the purchasing power

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[17]F.H. Hahn, "On Some Problems of Proving the Existence of an Equilibrium in a Monetary Economy," in *The Theory of Interest Rates*, F.H. Hahn and F.P.R. Breckling, eds. (London: Macmillan, 1956), pp. 128–32.

of their cash balances, thus raising their real cash balances overall. As Mises wrote:

> The services money renders are conditioned by the height of its purchasing power. Nobody wants to have in his cash holding a definite number of pieces of money or a definite weight of money; he wants to keep a cash holding of a definite amount of purchasing power. As the operation of the market tends to determine the final state of money's purchasing power at a height at which the supply of and the demand for money coincide, there can never be an excess or a deficiency of money. Each individual and all individuals together always enjoy fully the advantages which they can derive from indirect exchange and the use of money, no matter whether the total quantity of money is great or small. Changes in money's purchasing power generate changes in the disposition of wealth among the various members of society. From the point of view of people eager to be enriched by such changes, the supply of money may be called insufficient or excessive, and the appetite for such gains may result in policies designed to bring about cash-induced alterations in purchasing power. However, the services which money renders can be neither improved nor impaired by changing the supply of money. . . . The quantity of money available in the whole economy is always sufficient to secure for everybody all that money does and can do.[18]

A world of constant money supply would be one similar to that of much of the eighteenth and nineteenth centuries, marked by the successful flowering of the Industrial Revolution with increased capital investment increasing the supply of goods and with falling prices for those goods as well as falling costs of production.[19] As demonstrated by the notable Austrian theory of the business cycle, even an inflationary expansion of money and credit merely offsetting the secular fall in prices will create the distortions of production that bring about the business cycle.

In the face of overwhelming arguments against inflationary expansion of the money supply (including those not detailed here),

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[18]Mises, *Human Action*, p. 418.

[19]On the advantages of a secularly falling price "level," see C.A. Phillips, T.F. McManus, and R.W. Nelson, eds., *Banking and the Business Cycle* (New York: Macmillan, 1937), pp. 186–88, 203–07.

what accounts for the persistence of the inflationary trend in the modern world? The answer lies in the way new money is injected into the economy, in the fact that it is most definitely not done according to the Angel Gabriel model. For example, a government does not multiply the money supply tenfold across the board by issuing a decree adding another zero to every monetary number in the economy. In any economy not on a 100 percent commodity standard, the money supply is under the control of government, the central bank, and the controlled banking system. These institutions issue new money and inject it into the economy by spending it or lending it out to favored debtors. As we have seen, an increase in the supply of money benefits the early receivers, that is, the government, the banks, and their favored debtors or contractors, at the expense of the relatively fixed income groups that receive the new money late or not at all and suffer a loss in real income and wealth. In short, monetary inflation is a method by which the government, its controlled banking system, and favored political groups are able to partially expropriate the wealth of other groups in society. Those empowered to control the money supply issue new money to their own economic advantage and at the expense of the remainder of the population. Yield to government the monopoly over the issue and supply of money, and government will inflate that supply to its own advantage and to the detriment of the politically powerless. Once we adopt the distinctively Austrian approach of "methodological individualism," once we realize that government is not a superhuman institution dedicated to the common good and the general welfare, but a group of individuals devoted to furthering their economic interests, then the reason for the inherent inflationism of government as money monopolist becomes crystal clear.

As the Austrian analysis of money shows, however, the process of generated inflation cannot last indefinitely, for the government cannot in the final analysis control the pace of monetary deterioration and the loss of purchasing power. The ultimate result of a policy of persistent inflation is runaway inflation and the total collapse of the currency. As Mises analyzed the course of runaway inflation (both before and after the first example of such a collapse in an industrialized country, in post-World War I Germany), such inflation generally proceeds as follows: At first the government's increase of the money supply and the subsequent rise in prices are regarded by

the public as temporary. Since, as was true in Germany during World War I, the onset of inflation is often occasioned by the extraordinary expenses of a war, the public assumes that after the war conditions including prices will return to the pre-inflation norm. Hence the public's demand for cash balances rises as it awaits the anticipated lowering of prices. As a result, prices rise less than proportionately and often substantially less than the money supply, and the monetary authorities become bolder. As in the case of the Assignats during the French Revolution, here is a magical panacea for the difficulties of government: pump more money into the economy, and prices will rise only a little! Encouraged by the seeming success, the authorities apply more of what has worked so well, and the monetary inflation proceeds apace. In time, however, the public's expectations and views of the economic present and future undergo a vitally important change. They begin to see that there will be no return to the pre-war norm, that the new norm is a continuing price inflation—that prices will continue to go up rather than down. Phase two of the inflationary process ensues, with a continuing fall in the demand for cash balances based on this analysis: "I'd better spend my money on X, Y, and Z now, because I know full well that next year prices will be higher." Prices begin to rise more than the increase in the supply of money. The critical turning point has arrived.

At this point, the economy is regarded as suffering from a money shortage as evidenced by the outstripping of monetary expansion by the rise in prices. What is now called a liquidity crunch occurs on a broad scale, and a clamor arises for greater increases in the supply of money. As the Austrian school economist Bresciani-Turroni wrote in his definitive study of the German hyperinflation:

> The rise of prices caused an intense demand for the circulating medium to arise, because the existing quantity was not sufficient for the volume of transactions. At the same time the State's need of money increased rapidly . . . the eyes of all were turned to the Reichsbank. The pressure exercised on it became more and more insistent and the increase of issues, from the central bank, appeared as a remedy. . . .
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> The authorities therefore had not the courage to resist the pressure of those who demanded ever greater quantities of paper money, and to face boldly the crisis which . . . would be, undeniably, the result of a stoppage of the issue of notes. They preferred to continue the convenient method of continually increasing the

> issues of notes, thus making the continuation of business possible, but at the same time prolonging the pathological state of the German economy. The Government increased salaries in proportion to the depreciation of the mark, and employers in their turn granted continual increases in wages, to avoid disputes, on the condition that they could raise the prices of their products. . . .
>
> Thus was the vicious circle established; the exchange depreciated; internal prices rose; note-issues were increased; the increase of the quantity of paper money lowered once more the value of the mark in terms of gold; prices rose once more; and so on. . . .
>
> For a long time the Reichsbank—having adopted the fatalistic idea that the increase in the note-issues was the inevitable consequence of the depreciation of the mark—considered as its principal task, not the regulation of the circulation, but the preparation for the German economy of the continually increasing quantities of paper money, which the rise in prices required. It devoted itself especially to the organization, on a large scale, of the production of paper marks.[20]

The sort of thinking that gripped the German monetary authorities at the height of the hyperinflation may be gauged from this statement by the president of the Reichsbank, Rudolf Havenstein:

> The wholly extraordinary depreciation of the Mark has naturally created a rapidly increasing demand for additional currency, which the Reichsbank has not always been able fully to satisfy. A simplified production of notes of large denominations enabled us to bring ever greater amounts into circulation. But these enormous sums are barely adequate to cover the vastly increased demand for the means of payment, which has just recently attained an absolutely fantastic level. . . .

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[20]Costantino Bresciani-Turroni, *The Economics of Inflation* (London: George Allen and Unwin, 1937), pp. 80–82; also see Frank D. Graham, *Exchange, Prices, and Production in Hyper-inflation: Germany 1920–23* (New York: Russell and Russell, 1930), pp. 104–07. For an analysis of hyperinflation see Mises, *Theory of Money and Credit*, pp. 227–30; and idem, *Human Action*, pp. 423–25.

> The running of the Reichsbank's note-printing organization, which has become absolutely enormous, is making the most extreme demands on our personnel.[21]

The United States seems to be entering phase two of inflation (1975), and it is noteworthy that economists such as Walter Heller have already raised the cry that the supply of money must be expanded in order to restore the real cash balances of the public, in effect to alleviate the shortage of real balances. As in Germany in the early 1920s, the argument is being employed that the quantity of money cannot be the culprit for inflation since prices are rising at a greater rate than the supply of money.[22]

Phase three of the inflation is the ultimate runaway stage: the collapse of the currency. The public takes panicky flight from the money into real values, into any commodity whatever. The public's psychology is not simply to buy now rather than later but to buy anything immediately. The public's demand for cash balances hurtles toward zero.

The reason for the enthusiasm of Mises and other Austrian economists for the gold standard, the purer and less diluted the better, should now be crystal clear. It is not that this "barbaric relic" has any fetishistic attraction. The reason is that a money under the control of the government and its banking system is subject to inexorable pressures toward continuing monetary inflation. In contrast, the supply of gold cannot be manufactured *ad libitum* by the monetary authorities; it must be extracted from the ground, by the same costly process as governs the supply of any other commodities on the market. Essentially the choice is: gold or government. The choice of gold rather than other market commodities is the historical experience of centuries that gold (as well as silver) is uniquely suitable as a monetary commodity—for reasons once set forth in the first chapter of every money-and-banking textbook.

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[21]Rudolf Havenstein, Address to the Executive Committee of the Reichsbank, 25 August 1923, translated in *The German Inflation of 1923*, Fritz K. Ringer, ed. (New York: Oxford University Press, 1969), p. 96.

[22]See Denis S. Karnofsky, "Real Money Balances: A Misleading Indicator of Monetary Actions," *Federal Reserve Bank of St. Louis Review* 56 (February 1974): 2–10.

The criticism might be made that gold, too, can increase in quantity, and that this rise in supply, however limited, would also confer no benefit upon society. Apart from the gold versus government choice, however, there is another important consideration: an increase in the supply of gold improves its availability for nonmonetary uses, an advantage scarcely conferred by the fiat currencies of government or the deposits of the banking system.

In contrast to the Misesian "monetary overinvestment" theory of business cycles, on which considerable work has been done by F.A. Hayek and other Austrian economists, almost nothing has been done on the theory of money proper except by Mises himself. There are three cloudy and interrelated areas that need further elaboration. One is the route by which money can be released from government control. Of primary importance would be the return to a pure gold standard. To do so would involve, first, raising the "price of gold" (actually, lowering the definition of the weight of the dollar) drastically above the current pseudo-price of $42.22 an ounce and, second, a deflationary transformation of current bank deposits into nonmonetary savings certificates or certificates of deposit. What the precise price or the precise mix should be is a matter for research. Initially, the Mises proposal for a return to gold at a market price and the proposal of such Austrian monetary theorists as Jacques Rueff and Michael Heilperin for a return at a deliberately doubled price of $70 an ounce seemed far apart. But the current (1975) market price of approximately $160 an ounce brings the routes of a deliberately higher price and the market price much closer together.[23]

A second area for research is the matter of free banking as against 100 percent reserve requirements for bank deposits in relation to gold. Mises's *Theory of Money and Credit* was one of the first works to develop systematically the way in which the banks create money through an expansion of credit. It was followed by Austrian economist C.A. Phillips's famous distinction between the expansionary powers of individual banks and those of the banking system as a

[23]Mises's proposal is in *Theory of Money and Credit*, pp. 448–57; also see Michael A. Heilperin, *Aspects of the Pathology of Money* (Geneva: Michael Joseph, 1968); and Jacques Rueff, *The Monetary Sin of the West* (New York: Macmillan, 1972).

whole. However, one of Mises's arguments has remained neglected: that under a regime of free banking, that is, where banks are unregulated but held strictly to account for honoring their obligations to redeem notes or deposits in standard money, the operations of the market check monetary expansion by the banks. The threat of bank runs, combined with the impossibility of one bank's expanding more than a competitor, keeps credit expansion at a minimum. Perhaps Mises underestimated the possibility of a successful bank cartel for the promotion of credit expansion; it seems clear, however, that there is less chance for bank-credit expansion in the absence of a central bank to supply reserves and to be a lender of last resort.[24]

Finally, there is the related question, which Mises did not develop fully, of the proper definition of the crucial concept of the money supply. In current mainstream economics, there are at least four competing definitions, ranging from M1 to M4. Of one point an Austrian is certain: the definition must rest on the inner essence of the concept itself and not on the currently fashionable but question-begging methodology of statistical correlation with national income. Leland Yeager was trenchantly critical of such an approach:

> One familiar approach to the definition of money scorns any supposedly *a priori* line between money and near-moneys. Instead, it seeks the definition that works best with statistics. One strand of that approach . . . seeks the narrowly or broadly defined quantity that correlates most closely with income in equations fitted to historical data. . . . But it would be awkward if the definition of money accordingly had to change from time to time and country to country. Furthermore, even if money defined to include certain near-moneys does correlate somewhat more closely with income than money narrowly defined, that fact does not necessarily impose the broad definition. Perhaps the amount of these near-moneys depends on the level of money-income and in turn on the amount of medium of exchange. . . . More generally, it is not obvious why the magnitude with which some other magnitude correlates most closely deserves overriding attention. . . . The number of bathers at a beach may correlate more closely with the number of cars parked there than with either the temperature or the price of admission, yet the former correlation may be less interesting or useful than either of the latter. The correlation with national

[24]See Mises, *Human Action*, pp. 431–45.

> income might be closer for either consumption or investment than for the quantity of money.[25]

Money is the medium of exchange, the asset for which all other goods and services are traded on the market. If a thing functions as such a medium, as final payment for other things on the market, then it serves as part of the money supply. In his *Theory of Money and Credit*, Mises distinguished between standard money (money in the narrow sense) and money substitutes, such as bank notes and demand deposits, which function as an additional money supply. It should be noted, for example, that in Irving Fisher's non-Austrian classic, *The Purchasing Power of Money*, written at about the same time (1913), M consisted of standard money only, while M1 consisted of money substitutes in the form of bank demand deposits redeemable in standard at par. Today no economist would think of excluding demand deposits from the definition of money. But if we ponder the problem, we see that if a bank begins to fail, its deposits are no longer equivalent to money; they no longer serve as money on the market. They are only money until a bank's imminent collapse.

Furthermore, in the same way that M1 (currency plus demand deposits) is broader than the narrowest definition, we can establish even broader definitions by including savings deposits of commercial banks, and cash surrender values of life insurance companies, which are all redeemable on demand at par in standard money, and therefore all serve as money substitutes and as part of the money supply until the public begins to doubt that they are redeemable. Partisans of M1 argue that commercial banks are uniquely powerful in creating deposits and, further, that their deposits circulate more actively than the deposits of other banks. Let us suppose, however, that in a gold-standard country, a man has some gold coins in his bureau and others locked in a bank vault. His stock of gold coins at home will circulate actively and the ones in his vault sluggishly, but surely both are part of his stock of cash. And, if it also be objected that the deposits of savings banks and similar institutions pyramid on top of commercial bank deposits, it should also be noted that the latter in turn pyramid on top of reserves and standard money.

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[25]Leland B. Yeager, "Essential Properties of the Medium of Exchange," *Kyklos* (1968), reprinted in *Monetary Theory*, R.W. Clower, ed. (London: Penguin Books, 1969), p. 38.

Another example will serve to answer the common objection that a savings bank deposit is not money because it cannot be used directly as a medium of exchange but must be redeemed in that medium. (This is apart from the fact that savings banks are increasingly being empowered to issue checks and open up checking accounts.) Suppose that, through some cultural quirk, everyone in the country decided not to use five-dollar bills in actual exchange. They would only use ten-dollar and one-dollar bills, and keep their longer-term cash balances in five-dollar bills. As a result, five-dollar bills would tend to circulate far more slowly than the other bills. If a man wanted to spend some of his cash balance, he could not spend a five-dollar bill directly; instead, he would go to a bank and exchange it for five one-dollar bills for use in trade. In this hypothetical situation, the status of the five-dollar bill would be the same as that of the savings deposit today. But while the holder of the five-dollar bill would have to go to a bank and exchange it for dollar bills before spending it, surely no one would say that his five-dollar bills were not part of his cash balance or of the money supply.

A broad definition of the money supply, however, excludes assets not redeemable on demand at par in standard money, that is, any form of genuine time liability, such as savings certificates, certificates of deposit whether negotiable or nonnegotiable, and government bonds. Savings bonds, redeemable at par, are money substitutes and hence are part of the total supply of money. Finally, just as commercial bank reserves are properly excluded from the outstanding supply of money, so those demand deposits that in turn function as reserves for the deposits of these other financial institutions would have to be excluded as well. It would be double counting to include both the base and the multiple of any of the inverted money pyramids in the economy.

# 38

# Money, the State, and Modern Mercantilism

Money is the nerve center of any economy above the most primitive level. An economy consists of a vast and intricate network of two-person exchanges, and money constitutes one side of every exchange. Money is the medium by which producers of goods and services (sold for money) proceed to become consumers of goods and services (bought for money). If any one person or organization manages to obtain control over the supply of money—over its quality, its quantity, or its use—he or it has thereby taken a long step toward gaining complete control of the entire economic system. Similarly, it is difficult to see how complete economic control could be achieved without domination of the supply of money.

## Money on the Free Market

In the purely free market, no one person or group can have control over money. Money arises, on the free market, when one or more commodities, in particularly intense demand and possessing such other qualities as durability, portability, and divisibility, are chosen by individuals to serve as media of exchange. Once a commodity begins to be used as a medium, the process accelerates as this makes the good all the more valuable, until it finally comes to be used as a general medium for exchanges—as a money. Over the centuries of civilization, gold and silver have been the leading commodities to be thus established as moneys. On the free market, then, money arises as another—and highly important—use for a commodity on the

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market; in the civilized era, these chosen commodities have been gold and silver.[1]

On the free market, a person can obtain money in only three ways: (a) by producing a good or service and exchanging it ("selling it") for the money-commodity; (b) by someone else's free gift; or (c) by producing the money-commodity itself. Route (b) will not be dominant in the economy and, at any rate, it reduces back to the other two methods, since at some point backward in time the gift process must come to an end. But a good will not be chosen on the market as money unless it is in long-lasting and great demand, and it cannot be in such demand unless it is relatively scarce. Therefore, route (c) for the acquisition of money involves the complicated production of a scarce commodity; in the case of gold and silver, it means finding new reserves of ore and extracting them from the ground. All businesses, all industries on the market, tend, in the long run, to yield about the same rate of return; if not, then capital and resources will flow out of the poorer earning and into the better earning industry until rates of return are equalized. Consequently, the gold-mining business will not provide any lasting bonanza on the market; it will tend to earn about the same rate of return as other industries. There will then be no *a priori* inducement to enter the gold- or silver-mining industry as compared to any other industry. Furthermore, gold and silver are so durable that the proportion of new gold or silver mined each year will generally be negligible compared to the existing stock.

The overwhelmingly important route to obtaining money on the market, then, will be route (a), the sale of goods and services for someone else's stock of money. No one will be able to obtain money unless he either produces goods or services for exchange or enters the gold-mining

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[1]Professor Mises has demonstrated that money can only originate in this way—as a commodity on the free market—and that it cannot originate by government fiat. See Ludwig von Mises, *The Theory of Money and Credit*, 2nd ed. (New Haven, Conn.: Yale University Press, 1953), pp. 97–123. For a further discussion, see Murray N. Rothbard, *Man, Economy, and State* (Princeton, N.J.: D. Van Nostrand, 1962), vol. 1, pp. 231–37. See also Rothbard, "The Case for a 100 Per Cent Gold Dollar," in *In Search of a Monetary Constitution*, Leland B. Yeager, ed. (Cambridge, Mass.: Harvard University Press, 1962).

business. Apart from voluntary gifts, he will receive gold or silver in proportion to the value that other exchangers put on his services to them.

It should be evident that, in the free-market economy, no one person or group will be able to control any aspect of society's money. All money is extracted from the ground by private individuals, and there is no issue of currency by the State. The total supply of money is determined by the state of natural resources and by people freely and voluntarily entering the gold- or silver-mining business. How much money each person gets is determined solely by every individual's free and voluntary decision on how much he will buy and sell, or not buy and sell, of any given product or service. The aggregate result of these individual choices determines a person's total sales and income. A free and uncontrolled money, and a free and uncontrolled market, go necessarily hand in hand.

And yet, curiously enough, so far has the world gone from a truly free money that even the most "conservative" economists, often champions of the free market in other areas, do not contemplate a return to free-market money. Milton Friedman and the economists of the "Chicago School" advocate, indeed, a totally fiat paper money, manufactured by government and cut loose entirely from any vestigial connection with gold and silver. The United States Chamber of Commerce, in its textbook series on economics, simply concedes: "Money is what the government says it is."[2] But surely no free market can endure when control over the vital supply of money is thus granted permanently to government.

## Money and the State

In the *laissez-faire* revolution of the nineteenth century, money was one of the crucial areas where this revolution scarcely made headway. Government retained not only a mintage monopoly, legal tender laws, and the power to fix arbitrary exchange rates between gold and silver, but, particularly important, it retained its Central Bank, and thereby its virtual control over the banking system. Since the liabilities of the banking system, nominally redeemable in gold or silver, increasingly became the bulk of each country's money supply,

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[2]Economic Research Department, Chamber of Commerce of the United States, *The Mystery of Money* (Washington, D.C.: Chamber of Commerce, 1953), p. 1.

governmental protection and domination of the banking system loomed as an ever more vital problem. The British classical liberals never even thought of disturbing the hallowed status of the Bank of England; the United States struggled intermittently with central banking. At other times, money was subject to other variants of government control. Having relinquished little of its monetary control in the nineteenth century, the State has, in the twentieth, moved to take over absolute control of the monetary system, seizing its subjects' gold and silver and preventing them from using these commodities as their money. In this way, in most countries, the State has arrogated to itself a monopoly of monetary issue; the "paper" standard, which forms the nation's money and on which the government-controlled and manipulated banking system issues its liabilities, is *government*-issued paper.

There is no mystery as to why the State clung to its control of money even while temporarily relinquishing its grip on other areas of the economy. For one thing, as we have seen, control over a nation's money is a prerequisite for dictation over the rest of the economy. Another reason for the State's vital interest in money is that only through such control can it break the production—income nexus of the free market. We have seen that, on the free market, the only way to obtain money is to produce and sell goods or services to those who wish to buy; thus, the only way to acquire money from other people is to provide them, *pari passu*, with services they desire. But there is one way to break the requirement of producing desired goods and services to obtain money; and that is to gain control of the means of *creating* money. If one can create new money simply and easily, then he can enter the market to consume goods and services without first having to produce any himself. On the market, private individuals cannot do this, since this constitutes the crime of "counterfeiting." The State, however, has the unique attribute of being able to perform actions which would be considered criminal on the part of private individuals ("taxation" as against "robbery"; "war" as against "murder"; "inflation" as against "counterfeiting"). If the State controls the money supply, then it can create new money and use it to increase its own expenditures on goods and services, as well as the expenditures of its favored, subsidized groups in society. The "legalized counterfeiting" of "monetary issue" permits the State to break the production—monetary income chain to its own advantage. Necessarily, this

also means to the detriment of the actual producers in society, who must yield resources to the bidding of those who come to the marketplace equipped with this newly issued money. This is why "inflation"—the increase of paper money or bank liabilities—is a hidden, and therefore particularly insidious, form of taxation. Being hidden, an inflation of money is not likely to arouse the opposition that may be stirred by overt taxation. And since monetary inflation is hidden even while its consequence in rising prices becomes generally evident, the government can join the public in denouncing rising prices, while conveniently overlooking its own total responsibility for them. Indeed, it may go a step further; it may denounce any and all groups in the population, whose selling prices naturally rise during an inflation, for wickedly *causing* the price rise. Foreigners, speculators, businessmen (big or little), laborers—whichever scapegoats may be convenient are denounced, and then the government may go on to use these very attacks as a *point d'appui* for extending its controls and dictates over the society.

In short, the State may obtain its revenues—may break the production—income link of the market—in two ways. It may impose taxation, which is overt, evidently coercive, and likely to stir opposition if pressed too hard. Or, on the other hand, it may obtain control of the monetary system, and then create new money to spend for itself or to use for rewarding the groups it favors. Moreover, as we said above, this latter inflationary process is hidden and subtle, and thus not likely to arouse the general public; indeed the State can turn inflation to its own advantage by taking the lead in denouncing groups it happens to oppose for causing inflation and may then use this as an excuse to extend its own power. The State then emerges before the public, not as a predator heavily taxing the public, but as society's diligent protector against "inflation."

We may see now the irony in the doctrine that the State should "protect society against inflation" or "stabilize the price level." For inflation is the health of the State; it is the natural tendency of the State; and it is largely to enable it to inflate for its own benefit that the State is so determined to secure absolute control over the monetary mechanism.[3] Any group, in fact, that is given the exclusive

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[3]As Wilhelm Röpke says, "Inflation is as old as the power of government over money." See his *A Humane Economy* (Chicago: Regnery, 1960),

power to create new money may be expected to use that power to its own advantage—and the State is surely no exception. It is curious how differently persons' motives are analyzed and judged when they are private individuals and when they are members of the State apparatus. When a man enters business or joins the labor force, few people assume that his prime motivation is the public weal rather than private profit or income, nor are they shocked that this is so. And yet, while personal gain is considered a natural motive in private enterprise, the moment a man enters the State apparatus he is assumed to be motivated purely by altruistic striving for the "public good," and any other motivation is considered "corrupt." Perhaps this is because the public realizes instinctively that, on the free market, private gain is earned by serving others, so that the private gain of one is consistent with, and indeed advances, the private gain of all. The public may also instinctively feel, on the other hand, that the State apparatus earns its gains only *at the expense* of others. In contrast to the harmony of interests on the market, there is an inherent conflict of interest implicit in State actions. Therefore, to believe that State officials confiscate and rule the property of others for their own private gain would be intolerable. To cloak the actions of the State in morally and aesthetically respectable forms, then, the public must believe that these actions are motivated by zeal for the "common good." Let the public see the fallacy of these assumptions, and view the State as a group of people battening off the production of others, and they are much more likely to see the State as a natural inflator than as an ideal instrument for "stabilizing the price level."

## Central Banking

No institution is more necessary for State control and manipulation of a modern economy than the Central Bank, and no institution is more venerated. Most conservative economists believe themselves to be daring when they advocate independence of the Central Bank from the Treasury—a vain pretense that an organ of the State like

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p. 196. All manner of groups, at any given time or place, may become favorites or allies of the State; business, farm, labor, religious groups, and so on. The point is that (1) any group may try to use the State apparatus as a way of obtaining wealth or power for itself; and (2) the full-time rulers of the State will try to secure subsidized allies among the public.

the Central Bank can somehow be transformed into a wise and beneficent institution, "above politics." The wisdom of Federal Reserve manipulation of the American economy, for example, goes virtually unchallenged. The Chamber of Commerce, for one, has no doubt:

> It . . . is . . . an important function of the central banking authorities to determine the proper size of the money supply for the effective functioning of the economy and to try to pursue policies which will keep the money supply from either being over—or under—expanded.
>
> During recession and depression periods, the Federal Reserve should lower reserve requirements, buy U.S. Government securities and lower rediscount rates. This will provide commercial banks with excess reserves and tend to increase the supply of money. . . . During periods of prosperity and in the latter stages of recovery, the Federal Reserve should pursue the opposite of its depression policies: namely, it should raise reserve requirements, sell U.S. Government bonds, and raise rediscount rates. This puts a definite curb on the amount of credit which can be created and can act as a lever to prevent a boom from getting out of hand and can curb rising prices. . . .
>
> The power to prevent inflation (and to some extent deflation) unquestionably is now at hand in the U.S. Treasury and the Federal Reserve System. Enlightened public support on the side of reasonable price stability is indispensable to strengthen the hand of these monetary authorities.[4]

It is a generally accepted myth that the Federal Reserve System—as in the case of other central banks—was established to stabilize the economy and check inflation. Actually, it was designed to

[4]*The Mystery of Money*, p. 17; Economic Research Department, Chamber of Commerce of the United States, *Control of the Money Supply* (Washington, D.C.: Chamber of Commerce, 1953), pp. 15, 21. The enthusiasm for Federal Reserve control by leading members of the gold standard group, the Economists' National Committee on Monetary Policy, is a case in point. See also the remarks of Professors Niehaus, Wiegand, and Spahr in *A Proper Monetary and Banking System for the United States*, James Washington Bell and Walter Earl Spahr, eds. (New York: Ronald Press, 1960), pp. 51, 106, 165.

*promote* inflation under the aegis of the central government. Individual banks by themselves, not artificially bolstered by central banks, have a tendency to collapse before they can inflate very far: either from each expanding bank's losing cash (gold or paper) to other banks, or from runs on the banks. The Central Bank can make sure that all banks expand together, can furnish needed reserves to banks throughout the country and lend to banks in trouble, and can thereby bring about a much greater, and centrally coordinated, expansion of the money supply.[5]

In refreshing contrast to the plethora of conservative economists who concede the need for the absolute control of the Federal Reserve over our money is a perceptive and unequivocating article of Oscar B. Johannsen. Beginning with a critique of a report by the Economic Policy Commission of the American Banker's Association, Mr. Johannsen continues:

> the Commission apparently accepts without question the fundamental principle that money, banking and credit revolve around the State and that the State must, therefore, control monetary affairs through political action. . . . It is no more a function of the State to regulate money and banking than it is a function of the State to regulate growing and marketing of onions. . . . In keeping with the trend to intervene in the social sciences, the State has, to the limit that it could, gathered money, banking and credit together into one centralized banking system controlled by itself. But a governmentally centralized banking system is a socialized banking system, as the essence of socialism is the control and direction by the government of that which should be private enterprise.
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> It should be apparent now that with the inception of the Federal Reserve System, America adopted a system dealing with a phase of private enterprise totally different from that under which most other businesses are conducted. Manufacturing, mining,

[5]For an excellent discussion of the inflationary nature of the Federal Reserve System, as well as its further inflationary policies and their disastrous consequences, see C.A. Phillips, T.F. McManus, and R.W. Nelson, *Banking and the Business Cycle* (New York: Macmillan, 1937), pp. 21ff.; also O.K. Burrell, "The Coming Crisis in External Convertibility in U.S. Gold," *The Commercial and Financial Chronicle* (April 23, 1959): 5.

> trade are carried on by private individuals all seeking to make a profit with the customer as King. No arbitrary commission, or group of men, or bureaucrats determines who shall make cars, what cars shall be made, what prices shall be asked. . . . This is all done by private individuals, and they are guided by King Customer, who directs them by buying or not buying. Unfortunately, in banking, which has as its principal raw material the most important of all commodities—money—we have adopted socialism. This is an alarming fact upon which private enterprise cannot look with equanimity, as a socialized banking system is the precursor of socialism in all business.[6]

## Inflationism and Mercantilism in America: Five Case Studies in Historical Revision

If inflation is the health of the State, how and in what way has government generated inflation in the history of the United States? The following case studies illustrate this process, as well as the important connection between inflation and centralized State control of the economy. They illustrate also the connection of inflation with mercantilism—the use of economic regulation and intervention by the State to create special privileges for a favored group of merchants or businessmen. Until very recently, conservative as well as left-wing historians have accepted the neo-Marxian myth that struggles over inflation and hard money in America have all been "class struggles" of the farmers and workers ("debtor classes") in favor of inflation, as against merchant-creditors on behalf of hard money. The case studies indicate how recent historical scholarship has refuted this widely accepted thesis.

### *The Massachusetts Land Bank of 1740*

One inflationist paper-money scheme, the Massachusetts Land Bank of 1740, has generally been regarded by historians as a plan instituted by a mass of small farmer-debtors, over the opposition of the merchant-creditors of Boston. This stereotype was first fashioned by the contemporary opponents of the plan, who dismissed

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[6]Oscar B. Johannsen, "Advocates Unrestricted Private Control Over Money and Banking," *The Commercial and Financial Chronicle* (June 12, 1958): 2622.

the proponents of the bank as "plebeians"; it was systematized by such conservative economic historians as Andrew M. Davis, writing at a time when agrarian Populist inflationism was a threat to sound finance, and then taken over by neo-Marxist historians in the 1930s, to become established in the history textbooks. Actually, as Dr. Billias has shown in an important paper, the major proponents of the plan were as wealthy and as connected with business as its opponents; merchants were debtors too, and the chief advocates of a land bank "were all businessmen, politicians, or professional men residing in Boston"; the leading proponent of the plan was John Colman, a prominent Boston merchant and the founder of the Massachusetts Land Bank. Colman, indeed, tried to stir up support among the farmers by promising them that the inflation arising from the establishment of the bank would raise the prices of farm products. Businessmen were particularly eager for inflation after 1720, because after that date the Massachusetts government adopted a policy of granting unsettled frontier land to speculators, who then sold these lands to the actual settlers at far higher prices. Expanded bank credit was wanted to finance business speculation in government land grants as well as to raise land prices. Joined with inflation was another mercantilist feature: a subsidy to home manufacturing, through permitting repayment of bank debts in certain specified manufactured commodities.[7]

### *Nicholas Biddle, Planner and Central Banker*

The famous Bank War between Andrew Jackson and the Second Bank of the United States has also suffered grievous misinterpretation by historians. Jackson has been considered a wild-eyed agrarian inflationist, out to wreck conservative "sound finance," as represented by Nicholas Biddle, head of the Bank. Here, again, this interpretation began with Jackson's contemporary enemies, was forged amidst conservative battles with agrarian Populists in the late nineteenth century, and then was adopted—with heroes and villains, of course, reversed—by the neo-Marxist historians of the 1920s and 1930s. Actually, as recent historians have pointed out, the true ancestor of the New Deal was not Andrew Jackson but his opponents, including

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[7]George Athan Billias, "The Massachusetts Land Bankers of 1740," *University of Maine Bulletin* (April 1959).

Nicholas Biddle. Biddle, son of a leading merchant of Philadelphia, enthusiastically embraced the mercantilist "American System" of the Whigs. Biddle's mercantilist views emerge clearly from the eulogistic biography by Professor Govan, who writes:

> Biddle's study of political economy led him to reject the doctrines of the classical liberals. . . . He had seen too clearly during the course of the War of 1812 and its aftermath how business activity responded to the expansion and contraction of the money supply to believe that economic activity was governed by natural laws with which men interfered at their peril. He advocated a protective tariff for national reasons, primarily to free the country from economic domination by England. . . . Wages and profits of workers and factory owners could be maintained at higher levels than the world outside, and farmers and merchants would receive recompense in the large and constantly increasing home market. . . . Internal improvements and a national bank were essential elements in such a program. The construction of roads and canals and the improvement of rivers and harbors would facilitate the movement of goods and people, and the Bank of the United States, by providing a uniform currency and regulating the rates of domestic exchange, would similarly facilitate the pecuniary aspects of these same transactions.
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> No single mind created this concept of a predominantly private economy which was directed, supported, and controlled in the public interest by responsible national authorities. Its origin was the state papers of Alexander Hamilton.[8]

### *Stephen Colwell, Conservative Socialist*

The neglected mercantilistic affinities of conservatism and socialism have never been better illustrated than in the case of a leading protectionist ideologue of the first half of the nineteenth century, Stephen Colwell.[9] Colwell was an important Pennsylvania ironmaster and was

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[8]Thomas Payne Govan, *Nicholas Biddle: Nationalist and Public Banker, 1786–1844* (Chicago: University of Chicago Press, 1959), pp. 70–71; cf. pp. 50, 65.

[9]For an illuminating discussion of Colwell, see Joseph Dorfman, *The Economic Mind in American Civilization* (New York: Viking Press, 1946), vol. 2, pp. 809–26.

prominent in railroad investments. Iron manufacture, of course, was always a leading beneficiary of the protective tariff and of bank credit expansion as well.[10] In a series of articles published during the 1840s in the Presbyterian Biblical Repertory and Princeton Review, Colwell "attempted to weld together in the name of Christianity the pro-slavery, the high-tariff, pro-bank, and anti-democratic forces of the nation."[11] Colwell fulminated against the "moneyed power" (commerce), which "must be regulated by a judicious tariff or it will consult its own greedy interest, regardless of the sufferings it imposes on labor in the process," the laborer, "crushed, starved, and cast aside by bitter competition," is a worse "slave" than the slave in the South.[12] In fact, the slave benefits from slavery and would benefit still more from high tariffs. A wise and proper protective tariff would also enable men to fix prices not cheaply, but with reference to the quantity of labor expended on the product. *Laissez-faire* was denounced by Colwell as abstract and as emphasizing selfishness and materialism rather than religion, morals, history, and the well-being of the whole man The *laissez-faire* theorists, in fact, wickedly placed the "claims of free trade" higher than the "claims of labor," which include the protection and discipline of the slave system.[13] Colwell also wrote "The government alone can survey the whole field of national industry and ascertain the condition of all the laborers how many are suffering from the influx of foreign products."

In the 1850s Colwell concentrated on denunciation of hard money, a call for a central bank to regulate the currency, and demand for inconvertible paper money. In fact, under Colwell's scheme, banks would not have to redeem their notes, being obligated only to receive their own notes in repayments of debt. Colwell denied that

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[10]The first prominent political leader of the organized protectionist movement in America, Representative Henry Baldwin, was a prominent Pittsburgh iron manufacturer. Baldwin, indeed, was dubbed the "Father of the American System." See Murray N. Rothbard, *The Panic of 1819: Reactions and Policies* (New York: Columbia University Press, 1962), pp. 164ff.

[11]Dorfman, *The Economic Mind in American Civilization*, p. 811.

[12]Ibid., pp. 811–12.

[13]Cf. Stephen Colwell, *The Claims of Labor and Their Precedence to the Claims of Free Trade* (1861).

his contemplated inflation would increase prices greatly: the quantity theory of money was the product of "theorists" and was disproved by statistics. And anyway, high prices, even if they do follow, are beneficial, especially if joined with a high tariff to ensure that foreign competition will not disturb the idyll of high prices and high wages. Colwell denounced the banking system, with notes payable in specie, as "falsely predicated upon the assumption that whenever our importers, in consequence of having overtraded, must meet a heavily adverse balance, the business community as a whole should be denied its usual bank accommodation."[14]

### *Inflation and Protectionism in the Reconstruction Period*

Another myth that has dominated the ranks of historians until very recently is the neo-Marxist Beard-Beale concept of the Reconstruction period as the exploitation of the defeated South by the "rising capitalist class" of the North. The "exploitation" was supposed to have been imposed largely through sound money and the protective tariff. Here again, historians were guilty of reading back ideological and political conditions that had been obtained only after 1890. In fact, as a few historians have recently demonstrated, the Northern capitalists were split in their opinion of the Reconstruction program, and the Radical Republicans themselves were split on the issues of sound money and the tariff. Of the two famous leaders of the Radicals, Senator Charles Sumner favored hard money and free trade, while Representative Thaddeus Stevens, Pennsylvania iron-master, favored protection and the greenbacks. Once again, the Pennsylvania iron and steel industry was in the forefront of the battle for protection and for greenback inflationism. The Pennsylvanians realized that, in a period of inconvertible greenback money, inflation—and the consequent depreciation of greenbacks compared to gold and foreign exchange—was the equivalent of a protective tariff, in its artificial cheapening of American exports and making dear of American imports. Representative William D. ("Pig Iron") Kelley of Pennsylvania was another leading devotee of greenback inflation and a protective tariff.

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[14]Harry E. Miller, *Banking Theories in the United States Before 1860* (Cambridge, Mass.: Harvard University Press, 1927), p. 138; cf. pp. 135–38.

The Pennsylvania iron and steel interests feared the lower-cost competition of Great Britain. They were joined in backing protection and greenbacks by the marginal Pennsylvania coal industry, which feared the import of low-cost, Nova Scotia coal, and by stock speculators such as Henry Clews, who desired inflationary credit for the financing of stock speculation and the raising of stock prices. Nor were the wealthy mercantilist partisans above the use of anti-capitalist rhetoric.

Stephen Colwell was again active in the cause. And Representative Daniel J. Morrell, a leading iron manufacturer from Pennsylvania, attacked the hard-money forces as "enemies of the workingman" and as "money men, who wish to give their money more power over labor and its products."[15] Joseph Wharton, of the Bethlehem Iron Company, accused the hard-money Treasury policy of resuming specie payment as being engineered "by our English enemies."[16] The cause of protection and inflation was also persistently backed by the American Iron and Steel Association, the Union Meeting of American Iron Masters, the American Industrial League (composed largely of Pennsylvania ironmasters) and its organ Industrial Bulletin, as well as the magazines *The American Manufacturer* (Pittsburgh) and *Iron Age*.

One of the leading advocates of cheap money during this period was the prominent banker Jay Cooke. Cooke, a recipient of government land grants in his railroad ventures, benefited from inflation and credit expansion that drove up the price of land. Incidentally, Cooke had been a driving force behind the creation of the National Banking System during the Civil War, an innovation which brought federal control over the banking system for the first time since Jackson's abolition of the Second Bank of the United States. Cooke was hired by the North to be the leading underwriter of government bonds, and he thereupon worked for the establishment of a national banking system whose reserves would rest on government bonds, thus forcing the banks to invest heavily in (Cooke's) bonds.[17]

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[15]Robert P. Sharkey, *Money, Class, and Party* (Baltimore, Maryland: Johns Hopkins University Press, 1959), p. 159*n*.

[16]Irwin Unger, "Business Men and Specie Resumption," *Political Science Quarterly* (March 1959): 53.

[17]Sharkey, *Money, Class, and Party*, pp. 245ff. For other works of historical revision on this topic, see, in addition to Unger, "Business Men and

### *Paul Warburg, the Acceptance Market and the Federal Reserve System*

From its inception the Federal Reserve System, curiously enough, set out to create a market for acceptance paper, a form of credit that scarcely existed in this country (in contrast to Europe). It was uneconomical in the United States, where credit channels preferred another form entirely: single-name promissory notes. Yet the "Fed" granted an enormous subsidy to the acceptance market by standing ready to buy any acceptances offered by the market—and at a specially favorable price, cheaper than the Federal Reserve's ordinary rediscounts. This policy of unconditional support and subsidy of the acceptance market proved disastrous in the boom of the late 1920s, several times preventing the Federal Reserve from halting its expansion of credit. During the late 1920s the Federal Reserve, purchasing acceptances in this way directly from private acceptance banks, came to hold almost half of the bankers' acceptances outstanding in the country.[18] Furthermore, it confined its generous subsidy policy to a few large acceptance houses. It refused to buy acceptances directly from business, insisting on purchasing them from intermediary acceptance houses, and from only those with a capital of over $1 million. It also granted a few large dealers "repurchase agreements"—the option to buy back the acceptances at the current price.

What was the reason for this policy, which proved highly inflationary, failed in the ultimate attempt to create a permanent and widespread acceptance market, and constituted a flagrant form of subsidy and special privilege to the major acceptance banks? Perhaps the reason centers around the leading role played in the creation of

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Specie Resumption," pp. 46–70; Stanley Coben, "Northeastern Business and Radical Reconstruction: A Re-examination," *Mississippi Valley Historical Review* (June 1959): 67–90; Irwin Unger, "Review of Robert P. Sharkey, *Money, Class and Party*," *Political Science Quarterly* (June 1960); and Julius Grodinsky, "Review of Robert P. Sharkey," *Mississippi Valley Historical Review* (June 1960).

[18]See Charles O. Hardy, *Credit Policies of the Federal Reserve System* (Washington, D.C.: Brookings Institution, 1932), pp. 243–63. Hardy was certainly correct in concluding (p. 263) that "Nothing has been gained by forcing the acceptance form of credit into uses in which it cannot compete on its own merits."

the Federal Reserve System by Paul M. Warburg, one of the system's founders. Warburg came from Germany, where central banking was well established, to become a partner in the investment banking house of Kuhn, Loeb, and Company, and promptly embarked on a campaign on behalf of central banking in the United States.

Warburg was named first chairman of the Federal Reserve Board. After the war and during the 1920s he continued to be chairman of the influential Federal Advisory Council, a statutory group of bankers advising the Federal Reserve System. Interestingly enough, Warburg also became one of the nation's leading acceptance bankers, thus benefiting greatly from the system he helped found and whose course he helped set. He was Chairman of the Board of International Acceptance Bank of New York, the world's largest acceptance bank, was a director of the important Westinghouse Acceptance Bank and of several other acceptance houses, and was chief founder and chairman of the Executive Committee of the American Acceptance Council, a trade association organized in 1919. To write of Warburg's influence is not far-fetched speculation, for he himself boasted of his success in persuading the Federal Reserve to loosen eligibility rules for purchase of acceptances and to establish its policy of buying all acceptances offered at a subsidized rate.[19] Furthermore, Warburg had considerable influence on Benjamin Strong, head of the Federal Reserve Bank of New York, which in these years virtually set the policy of the Federal Reserve.[20]

In these case studies we have seen that inflationism and State control of the monetary system have, in many critical periods of

[19]In his presidential address before the American Acceptance Council, January 19, 1923. See Paul M. Warburg, *The Federal Reserve System* (New York: Macmillan, 1930), vol. 2, p. 822.

[20]Strong assumed his post only at the insistence of Warburg and of Henry Davison of J.P. Morgan and Co., his former employer. See Lester V. Chandler, *Benjamin Strong, Central Banker* (Washington, D.C.: Brookings Institution, 1958), p. 39. Chandler, a eulogizer of Strong, finds that a "major interest of Strong and many of his colleagues, *especially Paul Warburg* [italics mine], during the 1914–17 period was in promoting the creation and use of dollar acceptances—especially bankers' acceptances" (p. 86); see also pp. 91ff. For a critical treatment see Lawrence E. Clark, *Central Banking Under the Federal Reserve System* (New York: Macmillan, 1935), pp. 242–48; 376–78.

American history, been proposed and established, not by "workers and farmers" nor even by disaffected intellectuals, but by groups of merchants, manufacturers, and other businessmen eager to acquire special privilege, to use the State for their own advantage—in short, by men who were essentially modern mercantilists. This mercantilist drive has played a much greater role in the general movement toward statism and central planning than is generally recognized.

# 39

# Austrian Definitions of the Supply of Money

## The Definition of the Supply of Money

The concept of the supply of money plays a vitally important role, in differing ways, in both the Austrian and the Chicago Schools of economics. Yet, neither school has defined the concept in a full or satisfactory manner; as a result, we are never sure to which of the numerous alternative definitions of the money supply either school is referring.

The Chicago School definition is hopeless from the start. For, in a question-begging attempt to reach the conclusion that the money supply is the major determinant of national income, and to reach it by statistical rather than theoretical means, the Chicago School *defines* the money supply as that entity which correlates most closely with national income. This is one of the most flagrant examples of the Chicagoite desire to avoid essentialist concepts, and to "test" theory by statistical correlation; with the result that the supply of money is not really defined at all. Furthermore, the approach overlooks the fact that statistical correlation cannot establish causal connections; this can only be done by a genuine theory that works with definable and defined concepts.[1]

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Originally appeared as a chapter in *New Directions in Austrian Economics*, edited by Louis M. Spadaro (Kansas City: Sheed Andrews and McMeel, 1978), pp. 143–56.

[1]In a critique of the Chicago approach, Leland Yeager writes:

> But it would be awkward if the definition of money accordingly had to change from time to time and country to country. Furthermore, even if money defined to include certain near-moneys does correlate somewhat more closely with income than money

In Austrian economics, Ludwig von Mises set forth the essentials of the concept of the money supply in his *Theory of Money and Credit*, but no Austrian has developed the concept since then, and unsettled questions remain (e.g., are savings deposits properly to be included in the money supply?).[2] And since the concept of the supply of money is vital both for the theory and for applied historical analysis of such consequences as inflation and business cycles, it becomes vitally important to try to settle these questions, and to demarcate the supply of money in the modern world. In *The Theory of Money and Credit*, Mises set down the correct guidelines: money is the general medium of exchange, the thing that all other goods and services are traded for, the final payment for such goods on the market.

In contemporary economics, definitions of the money supply range widely from cash + demand deposits (M1) up to the inclusion of virtually all liquid assets (a stratospherically high M). No contemporary economist excludes demand deposits from his definition of money. But it is useful to consider exactly why this should be so. When Mises wrote *The Theory of Money and Credit* in 1912, the inclusion of demand deposits in the money supply was not yet a settled question in economic thought. Indeed, a controversy over the

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> narrowly defined, that fact does not necessarily impose the broad definition. Perhaps the amount of these near-moneys depends on the level of money-income and in turn on the amount of medium of exchange. . . . More generally, it is not obvious why the magnitude with which some other magnitude correlates most closely deserves overriding attention. . . . The number of bathers at a beach may correlate more closely with the number of cars parked there than with either the temperature or the price of admission, yet the former correlation may be less interesting or useful than either of the latter. (Leland B. Yeager, "Essential Properties of the Medium of Exchange," *Kyklos* [1968], reprinted in *Monetary Theory*, ed. R.W. Glower [London: Penguin Books, 1969], p. 38)

Also see, Murray N. Rothbard, "The Austrian Theory of Money," in Edwin Dolan, ed., *The Foundations of Modern Austrian Economics* (Kansas City, Kansas: Sheed and Ward, 1976), pp. 179–82; included in this volume as chapter 37, see pp. 704–06.

[2]Ludwig von Mises, *The Theory of Money and Credit*, 3rd ed. (New Haven, Conn.: Yale University Press, 1953).

precise role of demand deposits had raged throughout the nineteenth century. And when Irving Fisher wrote his *Purchasing Power of Money* in 1913, he still felt it necessary to distinguish between M (the supply of standard cash) and M1, the total of demand deposits.[3] Why then did Mises, the developer of the Austrian theory of money, argue for including demand deposits as part of the money supply "in the broader sense"? Because, as he pointed out, bank demand deposits were *not* other goods and services, other assets exchangeable for cash; they were, instead, redeemable for cash at par on demand. Since they were so redeemable, they functioned, not as a good or service exchanging for cash, but rather as a warehouse receipt for cash, redeemable on demand at par as in the case of any other warehouse. Demand deposits were therefore "money-substitutes" and functioned as equivalent to money in the market. Instead of exchanging cash for a good, the owner of a demand deposit and the seller of the good would both treat the deposit *as if* it were cash, a surrogate for money. Hence, receipt of the demand deposit was accepted by the seller as final payment for his product. And *so long* as demand deposits *are* accepted as equivalent to standard money, they will function as part of the money supply.

It is important to recognize that demand deposits are not automatically part of the money supply by virtue of their very existence; they continue as equivalent to money only so long as the subjective estimates of the sellers of goods on the market *think* that they are so equivalent and accept them as such in exchange. Let us hark back, for example, to the good old days before federal deposit insurance, when banks were liable to bank runs at any time. Suppose that the Jonesville Bank has outstanding demand deposits of $1 million; that million dollars is then its contribution to the aggregate money supply of the country. But suppose that suddenly the soundness of the Jonesville Bank is severely called into question; and Jonesville demand deposits are accepted only at a discount, or even not at all. In that case, as a run on the bank develops, its demand deposits no longer function as part of the money supply, certainly not at par. So

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[3]Irving Fisher, *The Purchasing Power of Money* (New York: Macmillan, 1913).

that a bank's demand deposit only functions as part of the money supply so long as it is treated as an equivalent substitute for cash.[4]

It might well be objected that since, in the era of fractional reserve banking, demand deposits are not *really* redeemable at par on demand, that then only standard cash (whether gold or fiat paper, depending upon the standard) can be considered part of the money supply. This contrasts with 100 percent reserve banking, when demand deposits are *genuinely* redeemable in cash, and function as genuine, rather than pseudo, warehouse receipts to money. Such an objection would be plausible, but would overlook the Austrian emphasis on the central importance in the market of *subjective* estimates of importance and value. Deposits are not *in fact* all redeemable in cash in a system of fractional reserve banking; but so long as individuals on the market *think* that they are so redeemable, they continue to function as part of the money supply. Indeed, it is precisely the expansion of bank demand deposits beyond their reserves that accounts for the phenomena of inflation and business cycles. As noted above, demand deposits must be included in the concept of the money supply so long as the market *treats* them as equivalent; that is, so long as individuals *think* that they are redeemable in cash. In the current era of federal deposit insurance, added to the existence of a central bank that prints standard money and functions as a lender of last resort, it is doubtful that this confidence in redeemability can ever be shaken.

All economists, of course, include standard money in their concept of the money supply. The justification for including demand deposits, as we have seen, is that people believe that these deposits are redeemable in standard money on demand, and therefore treat them as equivalent, accepting the payment of demand deposits as a surrogate for the payment of cash. But if demand deposits are to be included in the money supply for this reason, then it follows that any other entities that follow the same rules must also be included in the supply of money.

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[4]Even now, in the golden days of federal deposit insurance, a demand deposit is not always equivalent to cash, as anyone who is told that it will take 15 banking days to clear a check from California to New York can attest.

Let us consider the case of savings deposits. There are several common arguments for *not* including savings deposits in the money supply: (1) they are not redeemable on demand, the bank being legally able to force the depositors to wait a certain amount of time (usually 30 days) before paying cash; (2) they cannot be used directly for payment. Checks can be drawn on demand deposits, but savings deposits must first be redeemed in cash upon presentation of a passbook; (3) demand deposits are pyramided upon a base of total reserves as a multiple of reserves, whereas savings deposits (at least in savings banks and savings and loan associations) can only pyramid on a one-to-one basis on top of demand deposits (since such deposits will rapidly "leak out" of savings and into demand deposits).

Objection (1), however, fails from focusing on the legalities rather than on the economic realities of the situation; in particular, the objection fails to focus on the *subjective* estimates of the situation on the part of the depositors. In reality, the power to enforce a thirty-day notice on savings depositors is never enforced; hence, the depositor invariably thinks of his savings account as redeemable in cash on demand. Indeed, when, in the 1929 depression, banks tried to enforce this forgotten provision in their savings deposits, bank runs promptly ensued.[5]

Objection (2) fails as well, when we consider that, even within the stock of standard money, some part of one's cash will be traded more actively or directly than others. Thus, suppose someone holds part of his supply of cash in his wallet, and another part buried under the floorboards. The cash in the wallet will be exchanged and turned over rapidly; the floorboard money might not be used for decades. But surely no one would deny that the person's floorboard hoard is just as much part of his money stock as the cash in his wallet. So that mere lack of activity of part of the money stock in no way negates its inclusion as part of his supply of money. Similarly, the fact that passbooks must be presented before a savings deposit can be used in

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[5]On the equivalence of demand and savings deposits during the Great Depression, and on the bank runs resulting from attempts to enforce the 30-day wait for redemption, see Murray N. Rothbard, *America's Great Depression*, 3rd ed. (Kansas City, Kansas: Sheed and Ward, 1975), pp. 84, 316. Also see Lin Lin, "Are Time Deposits Money?" *American Economic Review* (March 1937): 76–86.

exchange should not negate its inclusion in the money supply. As I have written elsewhere, suppose that for some cultural quirk—say widespread revulsion against the number "5"—no seller will accept a five-dollar bill in exchange, but only ones or tens. In order to use five-dollar bills, then, their owner would first have to go to a bank to exchange them for ones or tens, and then use those ones or tens in exchange. But surely, such a necessity would not mean that someone's stock of five-dollar bills was not part of his money supply.[6]

Neither is Objection (3) persuasive. For while it is true that demand deposits are a multiple pyramid on reserves, whereas savings bank deposits are only a one-to-one pyramid on demand deposits, this distinguishes the sources or volatility of different forms of money, but should not exclude savings deposits from the supply of money. For demand deposits, in turn, pyramid on top of cash, and yet, while each of these forms of money is generated quite differently, so long as they exist each forms part of the total supply of money in the country. The same should then be true of savings deposits, whether they be deposits in commercial or in savings banks.

A fourth objection, based on the third, holds that savings deposits should not be considered as part of the money supply because they are efficiently if indirectly controllable by the Federal Reserve through its control of commercial bank total reserves and reserve requirements for demand deposits. Such control is indeed a fact, but the argument proves far too much; for, after all, demand deposits are themselves and in turn indirectly but efficiently controllable by the Fed through its control of total reserves and reserve requirements. In fact, control of savings deposits is not nearly as efficient as of demand deposits; if, for example, savings depositors would keep their money and active payments in the savings banks, instead of invariably "leaking" back to checking accounts, savings banks *would* be able to pyramid new savings deposits on top of commercial bank demand deposits by a large multiple.[7]

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[6]Rothbard, "The Austrian Theory of Money," p. 181; see p. 707 in this volume.

[7]In the United States, the latter is beginning to be the case, as savings banks are increasingly being allowed to issue checks on their savings deposits. If that became the rule, moreover, Objection (2) would then fall on this ground alone.

Not only, then, should savings deposits be included as part of the money supply, but our argument leads to the conclusion that no valid distinction can be made between savings deposits in commercial banks (included in $M_2$) and in savings banks or savings and loan associations (also included in $M_3$).[8] Once savings deposits are conceded to be part of the money supply, there is no sound reason for balking at the inclusion of deposits of the latter banks.

On the other hand, a *genuine* time deposit—a bank deposit that would indeed only be redeemable at a certain point of time in the future, would merit very different treatment. Such a time deposit, not being redeemable on demand, would instead be a credit instrument rather than a form of warehouse receipt. It would be the result of a credit transaction rather than a warehouse claim on cash; it would therefore not function in the market as a surrogate for cash.

Ludwig von Mises distinguished carefully between a *credit* and a *claim* transaction: a credit transaction is an exchange of a present good (e.g., money which can be used in exchange at any present moment) for a future good (e.g., an IOU for money that will only be available in the future). In this sense, a demand deposit, while legally designated as credit, is actually a present good—a warehouse claim to a present good that is similar to a bailment transaction, in which the warehouse pledges to redeem the ticket at any time on demand.

Thus, Mises wrote:

> It is usual to reckon the acceptance of a deposit which can be drawn upon at any time by means of notes or cheques as a type of credit transaction and juristically this view is, of course, justified; but economically, the case is not one of a credit transaction. If *credit* in the economic sense means the exchange of a present good or a present service against a future good or a future service, then it is hardly possible to include the transactions in question under the conception of credit. A depositor of a sum of money who acquires in exchange for it a claim convertible into money at any time which will perform exactly the same service for him as the

[8]Regardless of the legal form, the "shares" of formal ownership in savings and loan associations are economically precisely equivalent to the new deposits in savings banks, an equivalence that is universally acknowledged by economists.

> sum it refers to has exchanged no present good for a future good. The claim that he has acquired by his deposit is also a present good for him. The depositing of the money in no way means that he has renounced immediate disposal over the utility it commands.[9]

It might be, and has been, objected that credit instruments, such as bills of exchange or Treasury bills, can often be sold easily on credit markets—either by the rediscounting of bills or in selling old bonds on the bond market; and that therefore they should be considered as money. But many assets are "liquid," i.e., can easily be sold for money. Blue-chip stocks, for example, can be easily sold for money, yet no one would include such stocks as part of the money supply. The operative difference, then, is not whether an asset is liquid or not (since stocks are no more part of the money supply than, say, real estate) but whether the asset is redeemable at a fixed rate, at par, in money. Credit instruments, similarly to the case of shares of stock, are sold for money on the market at fluctuating rates. The current tendency of some economists to include assets as money purely because of their liquidity must be rejected; after all, in some cases, inventories of retail goods might be as liquid as stocks or bonds, and yet surely no one would list these inventories as part of the money supply. They are *other* goods sold for money on the market.[10]

One of the most noninflationary developments in recent American banking has been the emergence of *certificates of deposit* (CDs), which are genuine time and credit transactions. The purchaser of the CD, or at least the large-denomination CD, knows that he has loaned money to the bank which the bank is only bound to repay at a specific date in the future; hence, large-scale CDs are properly not included in the M2 and M3 definitions of the supply of money. The same might be said to be true of various programs of time deposits which savings banks and commercial banks have been developing in recent years: in which the depositor agrees to retain his money in the bank for a specified period of years in exchange for a higher interest return.

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[9]Mises, *Theory of Money and Credit*, p. 268.

[10]For Mises's critique of the view that endorsed bills of exchange in early nineteenth-century Europe were really part of the money supply, see ibid., pp. 284–86.

There are worrisome problems, however, that are attached to the latter programs, as well as to *small-denomination* CDs; for in these cases, the deposits *are* redeemable before the date of redemption at fixed rates, but at penalty discounts rather than at par. Let us assume a hypothetical time deposit, due in five years' time at $10,000, but redeemable at present at a penalty discount of $9,000. We have seen that such a time deposit should certainly *not* be included in the money supply in the amount of $10,000. But should it be included at the fixed, though penalty rate of $9,000, or not be included at all? Unfortunately, there is no guidance on this problem in the Austrian literature. Our inclination is to include these instruments in the money supply at the penalty level (e.g., $9,000), since the operative distinction, in our view, is not so much the par redemption as the ever-ready possibility of redemption at some fixed rate. If this is true, then we must also include in the concept of the money supply federal savings bonds, which are redeemable at fixed, though penalty rates, until the date of official maturation.

Another entity which should be included in the total money supply on our definition is *cash surrender values* of life insurance policies; these values represent the investment rather than the insurance part of life insurance and are redeemable in cash (or rather in bank demand deposits) at any time on demand. (There are, of course, no possibilities of cash surrender in other forms of insurance, such as term life, fire, accident, or medical.) Statistically, cash surrender values may be gauged by the total of policy reserves less policy loans outstanding, since policies on which money has been borrowed from the insurance company by the policyholder are not subject to immediate withdrawal. Again, the objection that policyholders are reluctant to cash in their surrender values does not negate their inclusion in the supply of money; such reluctance simply means that this part of an individual's money stock is relatively inactive.[11]

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[11]For hints on the possible inclusion of life insurance cash surrender values in the supply of money, see Gordon W. McKinley, "Effects of Federal Reserve Policy on Nonmonetary Financial Institutions," in Herbert V. Prochnow, ed., *The Federal Reserve System* (New York: Harper and Bros., 1960), p. 217*n*; and Arthur F. Burns, *Prosperity without Inflation* (Buffalo: Economica Books, 1958), p. 50.

One caveat on the inclusion of noncommercial bank deposits and other fixed liabilities into the money supply: just as the cash and other reserves of the commercial banks are not included in the money supply, since that would be double counting once demand deposits are included; in the same way, the demand deposits owned by these noncommercial bank creators of the money supply (savings banks, savings and loan companies, life insurance companies, etc.) should be deducted from the total demand deposits that are included in the supply of money. In short, if a commercial bank has demand deposit liabilities of $1 million, of which $100,000 are owned by a savings bank as a reserve for its outstanding savings deposits of $2 million, then the total money supply to be attributed to these two banks would be $2.9 million, deducting the savings bank reserve that is the base for its own liabilities.

One anomaly in American monetary statistics should also be cleared up: for a reason that remains obscure, demand deposits in commercial banks or in the Federal Reserve Banks owned by the Treasury are excluded from the total money supply. If, for example, the Treasury taxes citizens by $1 billion, and their demand deposits are shifted from public accounts to the Treasury account, the total supply of money is considered to have fallen by $1 billion, when what has really happened is that $1 billion worth of money has (temporarily) shifted from private to governmental hands. Clearly, Treasury deposits should be included in the national total of the money supply.

Thus, we propose that the money supply should be defined as all entities which are redeemable on demand in standard cash at a fixed rate, and that, in the United States at the present time, this criterion translates into:

$M_a$ (a = Austrian) = total supply of cash-cash held in the banks + total demand deposits + total savings deposits in commercial and savings banks + total shares in savings and loan associations + time deposits and small CDs at current redemption rates + total policy reserves of life insurance companies—policy loans outstanding—demand deposits owned by savings banks, saving and loan associations, and life insurance companies + savings bonds, at current rates of redemption.

$M_a$ hews to the Austrian theory of money, and, in so doing, broadens the definition of the money supply far beyond the narrow $M_1$, and yet avoids the path of those who would broaden the definition to the virtual inclusion of all liquid assets, and who thus would obliterate the uniqueness of the money phenomenon as the final means of payment for all other goods and services.

## The Money Supply and Credit Expansion to Business

In contrast to the Chicago School, the Austrian economist cannot rest content with arriving at the proper concept of the supply of money. For while the supply of money ($M_a$) is the vitally important supply side of the "money relation" (the supply of and demand for money) that determines the array of prices, and is therefore the relevant concept for analyzing price inflation, different parts of the money supply play very different roles in affecting the business cycle. For the Austrian theory of the trade cycle reveals that *only* the inflationary bank credit expansion that enters the market through new business loans (or through purchase of business bonds) generates the over-investment in higher-order capital goods that leads to the boom-bust cycle. Inflationary bank credit that enters the market through financing government deficits does *not* generate the business cycle; for, instead of causing overinvestment in higher-order capital goods, it simply reallocates resources from the private to the public sector, and also tends to drive up prices. Thus, Mises distinguished between "simple inflation," in which the banks create more deposits through purchase of government bonds, and genuine "credit expansion," which enters the business loan market and generates the business cycle. As Mises writes:

> In dealing with the [business cycle] we assumed that the total amount of additional fiduciary media enters the market system via the loan market as advances to business. . . .
>
> There are, however, instances in which the legal and technical methods of credit expansion are used for a procedure catallactically utterly different from genuine credit expansion. Political and institutional convenience sometimes makes it expedient for a government to take advantage of the facilities of banking as a substitute for issuing government fiat money. The treasury borrows from the bank, and the bank provides the funds needed by issuing additional

> banknotes or crediting the government on a deposit account. Legally the bank becomes the treasury's creditor. In fact the whole transaction amounts to fiat money inflation. The additional fiduciary media enter the market by way of the treasury as payment for various items of government expenditure. . . . They affect the loan market and the gross market rate of interest, apart from the emergence of a positive price premium, only if a part of them reaches the loan market at a time at which their effects upon commodity prices and wage rates have not yet been consummated.[12]

Mises did not deal with the relatively new post-World War II phenomenon of large-scale bank loans to consumers, but these too cannot be said to generate a business cycle. Inflationary bank loans to consumers will artificially deflect social resources to consumption rather than investment, as compared to the unhampered desires and preferences of the consumers. But they will *not* generate a boom-bust cycle, because they will not result in "over" investment, which must be liquidated in a recession. Not enough investments will be made, but at least there will be no flood of investments which will later have to be liquidated. Hence, the effects of diverting consumption investment proportions away from consumer time preferences will be asymmetrical, with the overinvestment-business cycle effects only resulting from inflationary bank loans to business. Indeed, the reason why bank financing of government deficits may be called simple rather than cyclical inflation is because government demands are "consumption" uses as decided by the preferences of the ruling government officials.

In addition to $M_a$, then, Austrian economists should be interested in *how much* of a new supply of bank money enters the market through new loans to business. We might call the portion of new $M_a$ that is created in the course of business lending, $M_b$ (standing for either business loans or business cycle). If, for example, a bank creates $1 million of deposits in a given time period, and $400,000 goes into consumer loans and government bonds, while, $600,000 goes into business loans and investments, then $M_b$ will have increased by $600,000 in that period.

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[12]Ludwig von Mises, *Human Action*, 3rd rev. ed. (Chicago: Henry Regnery, 1966), p. 570.

In examining $M_b$ on the American financial scene, we can ignore savings banks and savings and loan associations, whose assets are almost exclusively invested in residential mortgages. Savings bonds, of course, simply help finance government activity. We are left, then, with commercial banks (as well as life insurance investments). Commercial bank assets are comprised of reserves, government bonds, consumer loans, and business loans and investments (corporate bonds). Their liabilities consist of demand deposits, time deposits (omitting large CDs), large CDs, and capital. In trying to discover movements of $M_b$, with any precision, we founder on the difficulty that it is impossible in practice to decide to what extent any increases of business loans and investments have been financed by an increase of deposits, thus increasing $M_b$, and how much they have been financed by increases of capital and large CDs. Looking at the problem another way, it is impossible to determine how much of an increase in deposits (increase in $M_a$) went to finance business loans and investments, and how much went into reserves or consumer loans. In trying to determine increases in $M_b$ for any given period, then, it is impossible to be scientifically precise, and the economic historian must act as an "artist" rather than as an apodictic scientist. In practice, since bank capital is relatively small, as are bank investments in corporate bonds, the figure for commercial bank loans to business can provide a rough estimate of movements in $M_b$. With the development of the concepts of $M_a$ (total supply of money) and $M_b$ (total new money supply going into business credit), we have attempted to give more precision to the Austrian theory of money, and to the theoretical as well as historical Austrian analysis of monetary and business cycle phenomena.

# 40
# Gold vs. Fluctuating Fiat Exchange Rates

Scarcely more than a year since it was signed, the Smithsonian Agreement, the "greatest monetary agreement in the history of the world" (in the words of President Nixon) lay in shambles. And so the world vibrates, with increasing intensity, between fixed and fluctuating exchange rates, with each system providing only a different set of ills. We apparently live in a world of perpetual international monetary crises.

In this distressing situation, the last few years have seen the burgeoning of a school of economists who counsel a simple solution for the world's monetary illness. Since fixed exchange rates between currencies seem to bring only currency shortages and surpluses, black markets and exchange controls, and a chronic series of monetary crises, why not simply set all these currencies free to fluctuate with one another? This group of economists, headed by Professor Milton Friedman and the "Chicago School," claims to be speaking blunt truths in the name of the "free market." The simple and powerful case of the Friedmanites goes somewhat as follows:

Economic theory tells us the myriad evils that stem from any attempt at price controls of goods and services. Maximum price controls lead to artificially created shortages of the product; minimum controls lead to artificial unsold surpluses. There is a ready cure for these economic ills; they are caused not by processes deep within the free market economy, but by arbitrary government intervention into the market. Remove the controls, let market processes have full sway, and shortages and surpluses will disappear.

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Originally appeared in *Gold is Money*, Hans F. Sennholz, ed. (Westport, Conn.: Greenwood Press, 1975), pp. 24–40.

Similarly, the monetary crises of recent years are the product of government attempts to fix exchange rates between currencies. If the government of Ruritania fixes the "rur" at a rate higher than its free market price, then there will be a surplus of rurs looking for undervalued currencies, and a shortage of these harder currencies. The "dollar shortage" of the early postwar years was the result of the dollar being undervalued in terms of other currencies; the current surplus of dollars, as compared to West German marks or Japanese yen, is a reflection of the overvaluation of the dollar compared to these other currencies. Allow all of these currencies to fluctuate freely on the market, and the currencies will find their true levels, and the various currency shortages and surpluses will disappear. Furthermore, there will be no need to worry any longer about deficits in any country's "balance of payments." Under the pre-1971 system, when dollars were at least theoretically redeemable in gold, an excess of imports over exports led to a piling up of dollar claims and an increasingly threatening outflow of gold. Eliminate gold redeemability and allow the currencies to fluctuate freely, and the deficit will automatically correct itself as the dollar suppliers bid up the prices of marks and yen, thereby making American goods less expensive and German and Japanese goods more expensive in the world market.

Such is the Friedmanite case for the freely fluctuating exchange rate solution to the world monetary crisis. Any objection is met by a variant of the usual case for a free market. Thus, if critics assert that changing exchange rates introduce unwelcome uncertainty into world markets and thereby hinder international trade, particularly investment, the Friedmanites can reply that uncertainty is always a function of a free price system, and most economists support such a system. If the critics point to the evils of currency speculation, then Friedmanites can reply by demonstrating the important economic functions of speculation on the free commodity markets of the world. All this permits the Friedmanites to scoff at the timidity and conservatism of the world's bankers, journalists, and a dwindling handful of economists. Why not try freedom? These arguments, coupled with the obvious and increasingly evident evils of such fixed exchange rate systems as Bretton Woods (1945–1971) and the Smithsonian (1971–1973), are bringing an increasing number of economists into the Friedmanite camp.

The Friedmanite program cannot be fully countered in its details; it must be considered at the level of its deepest assumptions. Namely, are currencies really fit subjects for "markets"? Can there be a truly "free market" between pounds, dollars, francs, and so on?

Let us begin by considering this problem: suppose that someone comes along and says, "The existing relationship between pounds and ounces is completely arbitrary. The *government* has decreed that 16 ounces are equal to 1 pound. But this is arbitrary government intervention; let us have a free market between ounces and pounds, and let us see what relationship the market will establish between ounces and pounds. Perhaps we will find that the market will decide that 1 pound equals 14 or 17 ounces." Of course, everyone would find such a suggestion absurd. But why is it absurd? Not from arbitrary government edict, but because the pound is universally *defined* as consisting of 16 ounces. Standards of weight and measurement are established by common definition, and it is precisely their fixity that makes them indispensable to human life. Shifting relationships of pounds to ounces or feet to inches would make a mockery of any and all attempts to measure. But it is precisely the contention of the gold standard advocates that what we know as the *names* for different national currencies are not independent entities at all. They are not, in essence, different commodities like copper or wheat. They are, or they should be, simply names for different *weights* of gold or silver, and hence should have the same status as the fixed definition for any set, of weights and measures.

Let us bring our example a bit closer to the topic of money. Suppose that someone should come along and say, "The existing relationship between nickels and dimes is purely arbitrary. It is only the government that has decreed that two nickels equal one dime. Let us have a free market between nickels and dimes. Who knows? Maybe the market will decree that a dime is worth 7 cents or 11 cents. Let us try the market and see." Again, we would feel that such a suggestion would be scarcely less absurd. But again, why? What precisely is wrong with the idea? Again the point is that cents, nickels, and dimes are defined units of currency. The dollar is defined as equal to 10 dimes and 100 cents, and it would be chaotic and absurd to start calling for day-to-day changes in such definitions. Again, fixity of definition, fixity of units of weight and measure, is vital to any sort of accounting or calculation.

To put it another way: the idea of a *market* only makes sense between *different* entities, between different goods and services, between, say, copper and wheat, or movie admissions. But the idea of a market makes no sense whatever between different units of the *same* entity: between, say, ounces of copper and pounds of copper. Units of measure must, to serve any purpose, remain as a fixed yardstick of account and reckoning.

The basic gold standard criticism of the Friedmanite position is that the Chicagoites are advocating a free market between entities that are in essence, and should be once more, different units of the *same* entity, that is, different weights of the commodity gold. For the implicit and vital assumption of the Friedmanites is that every national currency—pounds, dollars, marks, and the like—is and should be an independent entity, a commodity in its own right, and therefore should fluctuate freely with one another.

Let us consider: what *are* pounds, francs, dollars? Where do they come from? The Friedmanites take them at face value as things or entities issued at will by different central governments. The British government defines something as a "pound" and issues or controls the issue of whatever number of pounds it decides upon (or controls the supply of bank credit redeemable in these "pounds"). The United States government does the same for "dollars," the French government the same for "francs," and so on.

The first thing we can say, then, is that this is a very curious kind of "free market" that is being advocated here. For it is a free market in things, or entities, which are issued entirely by and are at the complete mercy of each respective government. Here is already a vital difference from other commodities and free markets championed by the Chicago school. Copper, steel, wheat, movies are all, in the Friedman scheme, issued by private firms and organizations, and subject to the supply and demand of private consumers and the free market. Only money, only these mysterious "dollars," "marks," and so on, are to be totally under the control and dictation of every government. What sort of "free" market is this? To be *truly* analogous with free markets in other commodities, the supply of money would have to be produced only by private firms and persons in the market, and be subject only to the demand and supply forces of private consumers and producers. It should be clear that the governmental fiat currencies of the

Friedmanite scheme cannot possibly be subject only to private and therefore to free market forces.

Is there any way by which the respective national moneys can be subject solely to private market forces? Is such a thing at all possible? Not only is the answer yes, but it is still true that the *origin* of all these currencies that the Friedmanites take at face value as independent entities, was, each and every one, as units of weight of gold in a truly private and free market for money.

To understand this truth, we must go back beyond the existing fiat names for money and see how they originated. In fact, we need go back only as far as the Western world before World War I. Even today, the "dollar" is not legally defined an independent fictive name; it is still legally defined by U.S. statute as a *unit of weight* of gold, now approximately one-forty-second of a gold ounce. Before 1914, the dollar was defined as approximately one-twentieth of a gold ounce. That's what a "dollar" *was*. Similarly the pound sterling was not an independent name; it was defined as a gold weight of slightly less than one-fourth of a gold ounce. Every other currency was also *defined* in terms of a weight of gold (or, in some cases, of silver). To see how the system worked, we assume the following definition for three of the numerous currencies:

1 dollar defined as one-twentieth of a gold ounce;
1 pound sterling defined as one-fourth of a gold ounce;
1 franc defined as one-hundredth of a gold ounce.

In this case, the different national currencies are different in name only. In actual fact, they are simply different units of weight of the same commodity, gold. In terms of *each other*, then, the various currencies are immediately set in accordance with their respective gold weights, namely,

1 dollar is defined as equal to one-fifth of a pound sterling, and to 5 francs;

1 franc is defined as equal to one-fifth of a dollar, and to one-twenty-fifth of a pound;

1 pound is defined as equal to 5 dollars, and to 25 francs.

We might say that the "exchange rates" between the various countries were thereby fixed. But these were not so much exchange

rates as they were various units of weight of gold, fixed ineluctably as soon as the respective definitions of weight were established. To say that the governments "arbitrarily fixed" the exchange rates of the various currencies is to say also that governments "arbitrarily" define 1 pound weight as equal to 16 ounces or 1 foot as equal to 12 inches, or "arbitrarily" define the dollar as composed of 10 dimes and 100 cents. Like all weights and measures, such definitions do not have to be imposed by government. They could, at least in theory, have been set by groups of scientists or by custom and commonly accepted by the general public.

This "classical gold standard" had numerous and considerable economic and social advantages. In the first place, the supply of money in the various countries was basically determined, *not* by government dictates, but—like copper, wheat, and so on—by the supply and demand forces of the free and private market. Gold was and is a metal that has to be discovered, and then mined, by private firms. Its supply was determined by market forces, by the demand for gold in relation to the demand and supply of other commodities and factors; by, for example, the relative cost and productivity of factors of production in mining gold and in producing other goods and services. At its base, the money supply of the world, then, was determined by free market forces rather than by the dictates of government. While it is true that governments were able to interfere with the process by weakening the links between the currency name and the weight of gold, the base of the system was still private, and hence it was always possible to return to a purely private and free monetary system. To the extent that the various currency names were kept as strictly equivalent to weights of gold, to that extent the classical gold standard worked well and harmoniously and without severe inflation or booms and busts.

The international gold standard had other great advantages. It meant that the entire world was on a single money, that *money*, with all its enormous advantages, had fully replaced the chaotic world of barter, where it is impossible to engage in economic calculation or to figure out prices, profits, or losses. Only when the world was on a single money did it enjoy the full advantage of money over barter, with its attendant economic calculation and the corollary advantages of freedom of trade, investment, and movement between the various countries and regions of the civilized world. One

of the main reasons for the great growth and prosperity of the United States, it is generally acknowledged, was that it consisted of a large free-trading area within the nation: we have always been free of tariffs and trading quotas between New York and Indiana, or California and Oregon. But not only that. We have also enjoyed the advantage of having one currency: one dollar area between all the regions of the country, East, West, North, and South. There have also been no currency devaluations or exchange controls between New York and Indiana.

But let us now contemplate instead what could happen were the Friedmanite scheme to be applied *within* the United States. After all, while a nation or country may be an important *political* unit, it is not really an economic unit. No nation could or should wish to be self-sufficient, cut off from the enormous advantages of international specialization and the division of labor. The Friedmanites would properly react in horror to the idea of high tariffs or quota walls between New York and New Jersey. But what of different currencies issued by every state? If, according to the Friedmanites, the ultimate in monetary desirability is for each nation to issue its own currency—for the Swiss to issue Swiss francs, the French their francs, and so on—then why not allow New York to issue its own "yorks," New Jersey its own "jersies," and then enjoy the benefits of a freely fluctuating "market" between these various currencies? But since we have one money, the dollar, within the United States, enjoying what the Friedmanites would call "fixed exchange rates" between each of the various states, we don't have any monetary crisis within the country, and we don't have to worry about the "balance of payments" between New York, New Jersey, and the other states.

Furthermore, it should be clear that what the Friedmanites take away with one hand, so to speak, they give back with the other. For while they are staunchly opposed to tariff barriers between geographical areas, their freely fluctuating fiat currencies could and undoubtedly would operate as crypto-tariff barriers between these areas. During the fiat money Greenback period in the United States after the Civil War, the Pennsylvania iron manufacturers, who had always been the leading advocates of a protective tariff to exclude more efficient and lower cost British iron, now realized that depreciating greenbacks functioned as a protective device: for a falling dollar

makes imports more expensive and exports cheaper.[1] In the same way, during the international fiat money periods of the 1930s (and now from March 1973 on), the export interests of each country scrambled for currency devaluations, backed up by inefficient domestic firms trying to keep out foreign competitors. And similarly, a Friedmanite world *within* the United States would have the disastrous effect of functioning as competing and accelerating tariff barriers between the states.

And if independent currencies between each of the fifty states is a good thing, why not go still one better? Why not independent currencies to be issued by each county, city, town, block, building, person? Friedmanite monetary theorist Leland B. Yeager, who is willing to push the *reductio ad absurdum* almost all the way by advocating separate moneys for each region or even locality, draws back finally at the idea of each individual or firm printing his own money. Why not? Because, Yeager concedes, "Beyond some admittedly indefinable point, the proliferation of separate currencies for ever smaller and more narrowly defined territories would begin to negate the very concept of money."[2] That it would surely do, but the point is that the breakdown of the concept of money begins to occur not at some "indefinable point" but *as soon as* any national fiat paper enters the scene to break up the world's money. For if Rothbard, Yeager, and Jones each printed his own "Rothbards," "Yeagers," and "Joneses" and these each among billions freely fluctuating on the market were the only currencies, it is clear that the world would be back in an enormously complex and chaotic form of barter and that all trade and investment would be reduced to a virtual standstill. There would in fact be no more *money*, for money *means* a general medium for all exchanges. As a result, there would be no money of account to perform the indispensable function of economic calculation in a money

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[1]On depreciating fiat currency as a protectionist device during the Greenback period, see Murray N. Rothbard, "Money, the State, and Modern Mercantilism," in *Central Planning and Neomercantilism*, Helmut Schoeck and John W. Wiggins, eds. (Princeton, N.J.: D. Van Nostrand, 1964), pp. 149–51; included in this volume as chapter 38.

[2]Leland B. Yeager, "Exchange Rates within a Common Market," *Social Research* (Winter, 1958): 436–37. See also Yeager, "An Evaluation of Freely-Fluctuating Exchange Rates" (Ph.D. dissertation, Columbia University, 1952).

and price system. But the point is that while we can see this clearly in a world of "every man his own currency," the same disastrous principle, the same breakdown of the money function, is at work in a world of fluctuating fiat currencies such as the Friedmanites are wishing upon us. The way to return to the advantages of a world money is the opposite of the Friedmanite path: it is to return to a commodity which the entire world can and does use as a money, which means in practice the commodity gold.

One critic of fluctuating exchange rates, while himself a proponent of "regional currency areas," recognizes the classical argument for one world money. Thus, Professor Mundell writes:

> It will be recalled that the older economists of the nineteenth century were internationalists and generally favored a world currency. Thus John Stuart Mill wrote in *Principles of Political Economy*, vol. 2, p. 176:
>
> . . . So much of barbarism, however, still remains in the transactions of most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own.
>
> . . . Mill, like Bagehot and others, was concerned with the costs of valuation and money changing, not stabilization policy, and it is readily seen that these costs tend to increase with the number of currencies. Any given money *qua numeraire*, or unit of account, fulfills this function less adequately if the prices of foreign goods are expressed in terms of foreign currency and must then be translated into domestic currency prices. Similarly, money in its role of medium of exchange is less useful if there are many currencies; although the costs of currency conversion are always present, they loom exceptionally larger under inconvertibility or flexible exchange rates. Money is a convenience and this restricts the optimum number of currencies. In terms of this argument alone, the optimum currency area is the world, regardless of the number of regions of which it is composed.[3]

[3]Robert A. Mundell, *International Economics* (New York: Macmillan, 1968), p. 183.

There is another reason for avoiding fiat paper currency issued by all governments and for returning instead to a commodity money produced on the private market (for example, gold). For once a money is established, whatever supply of money exists does the full amount of the "monetary work" needed in the economy. Other things being equal, an increase in the supply of steel, or copper, or TV sets is a net benefit to society: it increases the production of goods and services to the consumers. But an increase in the supply of money does no such thing. Since the usefulness of money comes from exchanging it rather than consuming it or using it up in production, an increased supply will simply lower its purchasing power; it will dilute the effectiveness of any one unit of money. An increase in the supply of dollars will merely reduce the purchasing power of each dollar, that is, will cause what is now called "inflation." If money is a scarce market commodity, such as gold, increasing its supply is a costly process and therefore the world will not be subjected to sudden inflationary additions to its supply. But fiat paper money is virtually costless: it costs nothing for the government to turn on the printing press and to add rapidly to the money supply and hence to ruinous inflation. Give government, as the Friedmanites would do, the total and absolute power over the supply of fiat paper and of bank deposits—the supply of money—and we put into the hands of government a standing and mighty temptation to use this power and inflate money and prices.

Given the inherent tendency of government to inflate the money supply when it has the chance, the absence of a gold standard and "fixed exchange rates" also means the loss of balance-of-payments discipline, one of the few checks that governments have faced in their eternal propensity to inflate the money supply. In such a system, the outflow of gold abroad puts the monetary authorities on increased warning that they must stop inflating so as not to keep losing gold. Abandon a world money and adopt fluctuating fiat moneys, and the balance-of-payments limitation will be gone; governments will have only the depreciating of their currencies as a limit on their inflationary actions. But since export firms and inefficient domestic firms tend actually to favor depreciating currencies, this check is apt to be a flimsy one indeed.

Thus, in his critique of the concept of fluctuating exchange rates, Professor Heilperin writes:

> The real trouble with the advocates of indefinitely flexible exchange rates is that they fail to take into sufficient consideration the *causes of balance-of-payments disequilibrium*. Now these, unlike Pallas Athene from Zeus' head, never spring "fully armed" from a particular economic situation. They have their causes, the most basic of which [are] internal inflations or major changes in world markets.
>
> "Fundamental disequilibria" as they are called . . . can and do happen. Often however, they can be avoided: if and when an incipient inflation is brought under control; if and when adjustments to external change are effectively and early made. Now nothing encourages the early adoption of internal correctives more than an outflow of reserves under conditions of fixed parities, always provided, of course, that the country's monetary authorities are "internationally minded" and do their best to keep external equilibrium by all internal means at their disposal.[4]

Heilperin adds that the desire to pursue national monetary and fiscal policies without regard to the balance of payments is "one of the widespread and yet very fallacious aspirations of certain governments . . . and of altogether too many learned economists, aspirations to 'do as one pleases' without suffering any adverse consequences." He concludes that the result of a fluctuating exchange rate system can only be "chaos," a chaos that "would lead inevitably . . . to a widespread readoption of exchange controls, the worst conceivable form of monetary organization."[5]

If governments are likely to use any power to inflate fiat currency that is placed in their hands, they are indeed almost as likely to use the power to impose exchange controls. It is politically naive in the extreme to place the supply of fiat money in the hands of government and then to hope and expect it to refrain from controlling exchange rates or going on to impose more detailed exchange controls. In particular, in the totally fiat economy that the world has been plunged into since March 1973, it is highly naive to expect European countries to sit forever on their accumulation of 80-odd billions of dollars—the fruits of decades of American balance-of-payments

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[4]Michael A. Heilperin, *Aspects of the Pathology of Money* (London: Michael Joseph, 1968), p. 227.

[5]Ibid., pp. 222, 293.

deficits—and expect them to allow an indefinite accumulation of such continually depreciating dollars. It is also naive to anticipate their accepting a continually falling dollar and yet do nothing to stem the flood of imports of American products or to spur their own exports. Even in the few short months since March 1973 central banks have intervened with "dirty" instead of "clean" floats to the exchange rates. When the dollar plunged rapidly downward in early July, its fall was only checked by rumors of increased "swap" arrangements by which the Federal Reserve would borrow "hard" foreign currencies with which to buy dollars.

But it should be clear that such expedients can only stem the tide for a short while. Ever since the early 1950s, the monetary policies of the United States and the West have been short-run expedients, designed to buy time, to delay the inevitable monetary crisis that is rooted in the inflationary regime of paper money and the abandonment of the classical gold standard. The difference now is that there is far less time to buy, and the distance between monetary crises grows ever shorter. All during the 1950s and 1960s the Establishment economists continued to assure us that the international regime established at Bretton Woods was permanent and impregnable, and that if the harder money countries of Europe didn't like American inflation and deficits there was nothing they could do about it. We were also assured by the same economists that the official gold price of $35 an ounce—a price which for long has absurdly undervalued gold in terms of the depreciating dollar—was graven in stone, destined to endure until the end of time. But on August 15, 1971, President Nixon, under pressure by European central banks to redeem dollars in gold, ended the Bretton Woods arrangement and the final, if tenuous, link of the dollar to redemption in gold.

We are also told, with even greater assurance (and this time by Friedmanite as well as by Keynesian economists) that when, in March 1968, the free market gold price was cut loose from official governmental purchases and sales, that gold would at last sink to its estimated nonmonetary price of approximately $10 an ounce. Both the Keynesians and the Friedmanites, equal deprecators of gold as money, had been maintaining that, despite appearances, it had been the *dollar* which had propped up *gold* in the free—gold markets of London and Zurich before 1968. And so when the "two-tier gold market" was established in March, with governments and their central banks

pledging to keep gold at $35 an ounce, but having nothing further to do with outside purchases or sales of gold, these economists confidently predicted that gold would soon disappear as a monetary force to reckon with. And yet the reverse has happened. Not only did gold never sink below $35 an ounce on the free market, but the market's perceptive valuation of gold as compared to the shrinking and depreciating dollar has now hoisted the free market gold price to something like $125 an ounce. And even the hallowed $35 an ounce figure has been devalued twice in the official American accounts, so that now the dollar—still grossly overvalued—is pegged officially at $42.22 an ounce. Thus, the market has continued to give a thumping vote of confidence to gold, and has brought gold back into the monetary picture more strongly than ever.

Not only have the detractors of gold been caught napping by the market, but so have even its staunchest champions. Thus, even the French economist Jacques Rueff, for decades the most ardent advocate of the eminently sensible policy of going back to the gold standard at a higher gold price, even he, as late as October 1971 faltered and conceded that perhaps a doubling of the gold price to $70 might be too drastic to be viable. And yet now the market itself places gold at very nearly double *that* seemingly high price.[6]

Without gold, without an international money, the world is destined to stumble into one accelerated monetary crisis after another, and to veer back and forth between the ills and evils of fluctuating in exchange rates and of fixed exchange rates without gold. Without gold as the basic money and means of payment, fixed exchange rates make even less sense than fluctuating rates. Yet a solution to the most glaring of the world's aggravated monetary ills lies near at hand, and nearer than ever now that the free-gold market points the way. That solution would be for the nations of the world to return to a classical gold standard, with the price fixed at something like the old current free market level. With the dollar, say, at $125 an ounce, there would be far more gold to back up the dollar and all other national currencies. Exchange rates would again be fixed by the gold content of each currency. While this would scarcely solve all the

[6]Jacques Rueff, *The Monetary Sin of the West* (New York: Macmillan, 1972), pp. 210–22.

monetary problems of the world—there would still be need for drastic reforms of banking and central bank inflation, for example—a giant step would have been taken toward monetary sanity. At least the world would have a *money* again, and the spectre of a calamitous return to barter would have ended. And that would be no small accomplishment.

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# The Case for a Genuine Gold Dollar

## Inflationary Fiat Paper

For nearly a half-century the United States and the rest of the world have experienced an unprecedented continuous and severe inflation. It has dawned on an increasing number of economists that the fact that over the same half-century the world has been on an equally unprecedented fiat paper standard is no mere coincidence. Never have the world's moneys been so long cut off from their metallic roots. During the century of the gold standard from the end of the Napoleonic wars until World War I, on the other hand, prices generally fell year after year, except for such brief wartime interludes as the Civil War.[1] During wartime, the central governments engaged in massive expansion of the money supply to finance the war effort. In peacetime, on the other hand, monetary expansion was small compared to the outpouring of goods and services attendant upon rapid industrial and economic development. Prices, therefore, were normally allowed to fall. The enormous expenditures of World War I forced all the warring governments to go off the gold standard,[2] and unwillingness to return to a genuine

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[1]The exception was the period 1896–1914, when a mild chronic inflation (approximately 2 percent per year) resulted from unusual gold discoveries, in Alaska and South Africa.

[2]With the exception of the United States, which entered the war in the spring of 1917, two and a half years after the other belligerents. But even the United States went informally off the gold standard by prohibiting the export of gold for the duration of the war.

gold standard eventually led to a radical shift to fiat paper money during the financial crisis of 1931–33.

It is my contention that there should be no mystery about the unusual chronic inflation plaguing the world since the 1930s. The dollar is the American currency unit (and the pound sterling, the franc, the mark, and the like, are equivalent national currency units), and since 1933, there have been no effective restrictions on the issue of these currencies by the various nation-states. In effect, each nation-state, since 1933, and especially since the end of all gold redemption in 1971, has had the unlimited right and power to create paper currency which will be legal tender in its own geographic area. It is my contention that if any person or organization ever obtains the monopoly right to create money, that person or organization will tend to use this right to the hilt. The reason is simple: Anyone or any group empowered to manufacture money virtually out of thin air will tend to exercise that right, and with considerable enthusiasm. For the power to create money is a heady and profitable privilege indeed.

The essential meaning of a fiat paper standard is that the currency unit—the dollar, pound, franc, mark, or whatever—consists of paper tickets, marked as "dollars," "pound," and so on, and manufactured by the central government of the nation-state.[3] The government (or its central bank) is able to manufacture those tickets *ad libitum* and essentially costlessly. The cost of the paper and the printing is invariably negligible compared to the value of the currency printed. And if, for some reason, such cost is not negligible, the government can always simply increase the denominations of the bills!

It should be clear that the point of the government's having the power to print money is to monopolize that power. It would simply not do to allow every man, woman, and organization the right to print dollars, and so the government invariably guards its monopoly jealously. It should be noted that government is never so zealous in

[3]In olden days, the paper tickets were issued by the central government's Treasury (e.g., Continentals in the American Revolutionary war, *Assignats* during the French Revolution, greenbacks during the American Civil War). Nowadays, in a more complex variant of the system, the tickets constituting the monetary "standard" are issued by the government's central bank.

suppressing crime as when that crime consists of direct injury to its own sources of revenue, as in tax evasion and counterfeiting of its currency. If counterfeiting of currency were not illegal, the nation's supply of dollars or francs would rise toward infinity very rapidly, and the purchasing power of the currency unit itself would be effectively destroyed.[4]

In recent years an increasing number of economists have understandably become disillusioned by the inflationary record of fiat currencies. They have therefore concluded that leaving the government and its central bank power to fine tune the money supply, but abjuring them to use that power wisely in accordance with various rules, is simply leaving the fox in charge of the proverbial henhouse. They have come to the conclusion that only radical measures can remedy the problem, in essence the problem of the inherent tendency of government to inflate a money supply that it monopolizes and creates. That remedy is no less than the strict separation of money and its supply from the state.

## Hayek's "Denationalization" of Money

The best known proposal to separate money from the state is that of F.A. Hayek and his followers.[5] Hayek's "denationalization of money" would eliminate legal tender laws, and allow every individual and organization to issue its own currency, as paper tickets with its own names and marks attached. The central government would retain its monopoly over the dollar, or franc, but other institutions would be allowed to compete in the money creation business by offering their own brand name currencies. Thus, Hayek would be able to print Hayeks, the present author to issue Rothbards, and so on. Mixed in with Hayek's suggested legal change is an entrepreneurial scheme by which a Hayek-inspired bank would issue

[4]Note that we are assuming that standard paper is legal tender, as indeed all government money now is. (That is, all creditors are compelled to accept the paper tickets in payment for money debt.) In our hypothetical scenario, all individual tickets marked "dollars" or "francs" would similarly possess legal tender power.

[5]See, in particular, F.A. Hayek, *The Denationalisation of Money* (London: Institute of Economic Affairs, 1976).

"ducats," which would be issued in such a way as to keep prices in terms of ducats constant. Hayek is confident that his ducat would easily out- compete the inflated dollar, pound, mark, or whatever.

Hayek's plan would have merit if the thing—the commodity—we call "money" were similar to all other goods and services. One way, for example, to get rid of the inefficient, backward, and sometimes despotic U.S. Postal Service is simply to abolish it; but other free market advocates propose the less radical plan of keeping the post office intact but allowing any and all organizations to compete with it. These economists are confident that private firms would soon be able to outcompete the post office. In the past decade, economists have become more sympathetic to deregulation and free competition, so that superficially denationalizing or allowing free competition in currencies would seem viable in analogy with postal services or fire-fighting or private schools.

There is a crucial difference, however, between money and all other goods and services. All other goods, whether they be postal service or candy bars or personal computers, are desired for their own sake, for the utility and value that they yield to consumers. Consumers are therefore able to weigh these utilities against one another on their own personal scales of value. Money, however, is desired not for its own sake, but precisely because it *already* functions as money, so that everyone is confident that the money commodity will be readily accepted by any and all in exchange. People eagerly accept paper tickets marked "dollars" not for their aesthetic value, but because they are sure that they will be able to sell those tickets for the goods and services they desire. They can only be sure in that way when the particular name, "dollar," is *already* in use as money.

Hayek is surely correct that a free market economy and a devotion to the right of private property requires that everyone be permitted to issue whatever proposed currency names and tickets they wish. Hayek should be free to issue Hayeks or ducats, and I to issue Rothbards or whatever. But issuance and *acceptance* are two very different matters. No one will accept new currency tickets, as they well might new postal organizations or new computers. These names will not be chosen as currencies precisely because they have not been used as money, or for any other purpose, before.

Hayek and his followers have failed completely to absorb the lesson of Ludwig von Mises's "regression theorem," one of the most

important theorems in monetary economics.[6] Mises showed, as far back as 1912, that since no one will accept any entity as money unless it had been demanded and exchanged earlier, we must therefore logically go back (regress) to the first day when a commodity became used as money, a medium of exchange. Since by definition the commodity could not have been used as money before that first day, it could only be demanded because it had been used as a nonmonetary commodity, and therefore had a preexisting price, even in the era before it began to be used as a medium. In other words, for any commodity to become used as money, it must have originated as a commodity valued for some nonmonetary purpose, so that it had a stable demand and price before it began to be used as a medium of exchange. In short, money cannot be created out of thin air, by social contract, or by issuing paper tickets with new names on them. Money has to originate as a valuable nonmonetary commodity. In practice, precious metals such as gold or silver, metals in stable and high demand per unit weight, have won out over all other commodities as moneys. Hence, Mises's regression theorem demonstrates that money must originate as a useful nonmonetary commodity on the free market.

But one crucial problem with the Hayekian ducat is that no one will take it. New names on tickets cannot hope to compete with dollars or pounds which originated as units of weight of gold or silver and have now been used for centuries on the market as the currency unit, the medium of exchange, and the instrument of monetary calculation and reckoning.[7]

Hayek's plan for the denationalization of money is Utopian in the worst sense: not because it is radical, but because it would not

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[6]For his regression theorem, see Ludwig von Mises, *The Theory of Money and Credit*, 2nd ed. (New Haven, Conn.: Yale University Press, 1953), pp. 170–86. Also see Murray N. Rothbard, *The Case for a 100 Percent Gold Dollar* (1962; Washington, D.C.: Libertarian Review Press, 1974), pp. 10–11.

[7]We might apply to Hayek's scheme the sardonic words of the nineteenth-century French economist Henri Cernuschi, which Mises approvingly cited in a slightly different context: "I want to give everybody the right to issue banknotes so that nobody should take banknotes any longer." Ludwig von Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1949), p. 443.

and could not work. Print different names on paper all one wishes, and these new tickets still would not be accepted or function as money; the dollar (or pound or mark) would still reign unchecked. Even the removal of the legal tender privilege would not work, for the new names would not have emerged out of useful commodities on the free market, as the regression theorem demonstrates they must. And since the government's own currency, the dollar and the like, would continue to reign unchallenged as money, money would not have been denationalized at all. Money would still be nationalized and a creature of the state; there would still be no separation of money and the state. In short, even though hopelessly Utopian, the Hayek plan would scarcely be radical enough, since the current inflationary and state-run system would be left intact.

Even the variant on Hayek whereby private citizens or firms issue gold coins denominated in grams or ounces would not work, and this is true even though the dollar and other fiat currencies originated centuries ago as names of units of weight of gold or silver.[8] Americans have been used to using and reckoning in "dollars" for two centuries, and they will cling to the dollar for the foreseeable future. They will simply not shift away from the dollar to the gold ounce or gram as a currency unit. People will cling doggedly to their customary names for currency; even during runaway inflation and virtual destruction of the currency, the German people clung to the "mark" in 1923 and the Chinese to the "yen" in the 1940s. Even drastic revaluations of the runaway currencies which helped end the inflation kept the original "mark" or other currency name.

Hayek brings up historical examples where more than one currency circulated in the same geographic area at the same time, but none of the examples is relevant to his "ducat" plan. Border regions may accept two *governmental* currencies,[9] but each has legal tender power, and each had been in lengthy use within its own nation.

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[8]Thus, the pound sterling originated, *pace* its name, as a definition of one pound weight of silver, and the dollar originated as an ounce coin of silver in Bohemia. Much later, the "dollar" became defined as approximately 1/20 of an ounce of gold.

[9]In Luxemburg, *three* government currencies—those of France, West Germany, and Luxemburg itself—circulate side by side.

Multicurrency circulation, then, is not relevant to the idea of one or more new private paper currencies. In addition, Hayek might have mentioned the fact that in the United States, until the practice was outlawed in 1857, foreign gold and silver coins as well as private gold coins, circulated as money side by side with official coins. The fact that the Spanish silver dollar had long circulated in America along with Austrian and English specie coins, permitted the new United States to change over easily from pound to dollar reckoning. But again, this situation is not relevant, because all these coins were different weights of gold and silver, and none was fiat government money. It was easy, then, for people to refer the various values of the coins back to their gold or silver weights. Gold and silver had of course long circulated as money, and the pound sterling or dollar were simply different weights of one or the other metals. Hayek's plan is a very different one: the issue of private paper tickets marked by new names and in the hope that they are accepted as money.

If people love and will cling to their dollars or francs, then there is only one way to separate money from the state, to truly denationalize a nation's money. And that is to denationalize the *dollar* (or the mark or franc) itself. Only privatization of the dollar can end the government's inflationary dominance of the nation's money supply.

How, then, can the dollar be privatized or denationalized? Obviously not by making counterfeiting legal. There is only one way: to link the dollar once again to a useful market commodity. Only by changing the definition of the dollar from fiat paper tickets issued by the government to a unit of weight of some market commodity, can the function of issuing money be permanently and totally shifted from government to private hands.

## The "Commodity Dollar": A Critique

If it is imperative that the dollar be defined once again as a weight of a market commodity, then what commodity (or commodities) should it be defined as, and what should be the particular weight in which it is set?

In reply, I propose that the dollar be defined as a weight of a single commodity, and that that commodity be gold. Many economists, beginning with Irving Fisher at the turn of the twentieth century, and including Benjamin Graham and an earlier F.A. Hayek, have

hankered after some form of "commodity dollar," in which the dollar is defined, not as a weight of a single commodity, but in terms of a "market basket" of two or many more commodities.[10] There are many deep-seated flaws in this approach. In the first place, such a market-basket currency has never emerged spontaneously from the workings of the market. It would have to be imposed (to use a derogatory term from Hayek himself) as a "constructivist" scheme from the top, from government to be inflicted upon the market. Second, and as a corollary, the government would be obviously in charge, since a market-basket currency does not, unlike the use of units of weight in exchange, arise from the free market itself. The government could and would, then, alter the ratios of weights, adjust the various fixed terms, and so forth. Third, the hankering for a fixed market basket is an outgrowth of a strong desire for the government to regulate the economy so as to keep the "price level" constant. As we have seen, the natural tendency of the free market is to lower prices over time, in accordance with growing productivity and increased supplies of goods. There is no good reason for the government to interfere. Indeed, if it does so, it can only create a boom-and-bust business cycle by expanding credit to keep prices artificially higher than they would be on the free market.

Furthermore, there are other grave problems with the commodity-basket approach. There is, for one thing, no such unitary entity as "the price level" which would be kept constant. The entire concept of price level is an artificial construction masking the fact that it can only consist of individual prices, each varying continually in relation to each other.

Irving Fisher's intense desire for a constant price level stemmed from his own fallacious philosophic notion that, just as science is based upon measurable standards (such as a yard comprising 36 inches), so money is supposed to be a measure of values and prices. But since there is no single price level, his very idea, far from being scientific, is a hopeless chimera. The only scientific measurement that properly applies is the currency unit as a true measure of *weight*

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[10]In fact, even Hayek's current "ducat" scheme incorporates a commodity-basket plan. His proposed bank would fine tune the supply of ducats so as to keep the "price level" in terms of ducats always constant.

of the money commodity. Furthermore, the only scientific measure is a definition which, once selected, remains eternally the same: "the pound," or "the yard." Juggling definitions of weight within a market basket violates any proper concept of definition or of measure.[11]

A final and vital flaw in a market-basket dollar is that Gresham's law would result in perpetual shortages and surpluses of different commodities within the market basket. Gresham's law states that any money overvalued by the government (in relation to its market value) will drive out of circulation money undervalued by the government. In short, control of exchange rates has consequences like any other price control: A maximum rate below the free market causes a shortage; a minimum rate set above the market will cause a surplus. From the origin of the United States, the currency was in continuing trouble because the United States was on a bimetallic rather than a gold standard, in short a market basket of two commodities, gold

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[11]For an outstanding philosophical critique of Fisher's commodity dollar, see the totally neglected work of the libertarian political theorist Isabel Paterson. Thus, Paterson writes:

> As all units of measure are determined arbitrarily in the first place, though not fixed by law, obviously they can be altered by law. The same length of cotton would be designated an inch one day, a foot the next, and a yard the next; the same quantity of precious metal could be denominated ten cents today and a dollar tomorrow. But the net result would be that figures used on different days would not mean the same thing; and somebody must take a heavy loss. The alleged argument for a "commodity dollar" was that a real dollar, of fixed quantity, will not always buy the same quantity of goods. Of course it will not. If there is no medium of value, no money, neither would a yard of cotton or a pound of cheese always exchange for an unvarying fixed quantity of any other goods. It was argued that a dollar ought always to buy the same quantity of and description of goods. It will not and cannot. That could occur only if the same number of dollars and the same quantities of goods of all kinds and in every kind were always in existence and in exchange and always in exactly proportionate demand; while if production and consumption were admitted, both must proceed constantly at an equal rate to offset one another. (Isabel Paterson, *The God of the Machine* [New York: Putnam, 1943], p. 203*n*)

and silver. As is well known, the system never worked, because at one time or another, one or the other precious metal was above or below its world market valuations, and hence one or the other coin or bullion was flowing into the country while the other would disappear. In 1873 partisans of the monometallic gold standard, seeing that silver was soon to be overvalued and hence on the point of driving out gold, put the United States on a virtual single gold standard, a system that was ratified officially in 1900.[12]

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[12]Specifically, the Coinage Act of 1792 defined the "dollar" as *both* a weight of 371.25 grains of pure silver and a weight of 24.75 grains of pure gold—a fixed ratio of 15 grains of silver to 1 grain of gold. This 15:1 ratio was indeed the world market ratio during the early 1790s, but of course the market ratio was bound to keep changing over time, and thus bring about the effects of Gresham's law. Soon an increased silver production led to a steady decline of silver, the market ratio falling to 15.75:1. As a result, silver coins flooded into the United States, and gold coins flooded out. Silver remained the sole circulating coinage, until the Jacksonians in 1834 successfully brought back gold by debasing the gold weight of the dollar to 23.2 grains, lowering the weight by 6.26 percent. At this new ratio of 16:1, gold and silver circulated side by side for two decades, when the discovery of new gold mines in California, Russia, and Australia, greatly increased gold production, and sent the market ratio down to 15.3:1. As a result, gold coin poured in and silver flowed out of the country. The United States continued on a *de facto* gold monometallic standard, but a de jure bimetallic standard from the 1850s, with the market ratio holding at about 15.5:1 while the official mint ratio was 16:1.

By 1872, however, a few knowledgeable officials at the U.S. Treasury realized that silver was about to suffer a huge decline in value, since the European nations were shifting from a silver to a gold standard, thereby decreasing their demand for silver and increasing their demand for gold, and because of the discovery of the new silver mines in Nevada and other Mountain states. To keep the *de facto* gold standard, the Treasury slipped bills through Congress in 1873 and 1874, discontinuing the minting of any further silver dollars, and ending the legal tender quality of silver dollars above the sum of $5. This demonetization of silver meant that, when, in 1874, silver began a rapid market ratio decline above 16:1 and finally to 32:1 in the 1890s, silver coins would not flow into the country and gold would not flow out. Finally, in 1900, the dollar was defined *de jure* solely in terms of gold, at 23.22 grains.

See Ron Paul and Lewis Lehrman, *The Case for Gold* (Washington, D.C.: Cato Institute, 1982), pp. 17–19, 30–32, 60–66, 100–02.

One argument used by Fisher, James M. Buchanan, and others holds that the U.S. Constitution mandates the government's using its powers to stabilize the price level. This argument rests on Article I, Section 8 of the Constitution, which gives Congress the power "to coin money, regulate the value thereof." The argument, absurd at best, disingenuous at worst, and certainly anachronistic treats the framers of the Constitution as if they were modern price-stabilizationist economists, as if they meant by "the value thereof" the purchasing power of the money unit, or its inverse, the price level. From this dubious assumption, these writers derive the alleged constitutional duty of the federal government to intervene in monetary matters so as to stabilize the level of prices. But what the framers meant by "value" was simply the weight and the fineness of coins. It is, after all, the responsibility of every firm to regulate the nature of its own product, and to the extent that the federal government mints coins, it must see to it that the weight and fineness of these coins are what the government says they are.

## The Case for a Gold Dollar

We conclude, then, that the dollar must be redefined in terms of a single commodity, rather than in terms of an artificial market basket of two or more commodities. Which commodity, then, should be chosen? In the first place, precious metals, gold and silver, have always been preferred to all other commodities as mediums of exchange where they have been available. It is no accident that this has been the invariable success story of precious metals, which can be partly explained by their superior stable nonmonetary demand, their high value per unit weight, durability, divisibility, cognizability, and the other virtues described at length in the first chapter of all money and banking textbooks published before the U.S. government abandoned the gold standard in 1933. Which metal should be the standard, then, silver or gold? There is, indeed, a case for silver, but the weight of argument holds with a return to gold. Silver's increasing relative abundance of supply has depreciated its value badly in terms of gold, and it has not been used as a general monetary metal since the nineteenth century. Gold was the monetary standard in most countries until 1914, or even until the 1930s. Furthermore, gold was the standard when the U.S. government in 1933 confiscated the gold of all American citizens and abandoned gold

redeemability of the dollar, supposedly only for the duration of the depression emergency. Still further, gold and not silver is still considered a monetary metal everywhere, and governments and their central banks have managed to amass an enormous amount of gold not now in use, but which again could be used as a standard for the dollar, pound, or mark.

This brings up an important corollary. The United States, and other governments, have in effect nationalized gold. Even now, when private citizens are allowed to own gold, the great bulk of that metal continues to be sequestered in the vaults of the central banks.[13] If the dollar is redefined in terms of gold, gold as well as the dollar can be jointly denationalized. But if the dollar is *not* defined as a weight of gold, then how can a denationalization of gold ever take place? Selling the gold stock would be unsatisfactory, since this (1) would imply that the government is entitled to the receipts from the sale and (2) would leave the dollar under the absolute fiat control of the government.

It is important to realize what a definition of the dollar in terms of gold would entail. The definition must be *real* and effective rather than nominal. Thus, the U.S. statutes define the dollar as 1/42.22 gold ounce, but this definition is a mere formalistic accounting device. To be real, the definition of the dollar as a unit of weight of gold must imply that the dollar is interchangeable and therefore redeemable by its issuer in that weight, that the dollar is a demand claim for that weight in gold.

Furthermore, once selected, the definition, whatever it is, must be fixed permanently. Once chosen, there is no more excuse for changing definitions than there is for altering the length of a standard yard or the weight of a standard pound.

Before proceeding to investigate what the new definition or weight of the dollar should be, let us consider some objections to the very idea of the government setting a new definition. One criticism holds it to be fundamentally statist and a violation of the free market for the government, rather than the market, to be responsible for fixing a new definition of the dollar in terms of gold. The problem, however, is that

[13]In the United States, the Treasury holds the gold in trust for the Federal Reserve Banks at its depositories at Fort Knox and elsewhere.

we are now tackling the problem in midstream, *after* the government has taken the dollar off gold, virtually nationalized the stock of gold, and issued dollars for decades as arbitrary and fiat money. Since government has monopolized issue of the dollar, and confiscated the public's gold, only government can solve the problem by jointly denationalizing gold and the dollar. Objection to government's redefining and privatizing gold is equivalent to complaining about the government's repealing its own price controls because repeal would constitute a governmental rather than private action. A similar charge could be leveled at government's denationalizing any product or operation. It is not advocating statism to call for the government's repeal of its own interventions.

A corollary criticism, and a favorite of monetarists, asks why gold standard advocates would have the government "fix the (dollar) price of gold" when they are generally opposed to fixing any other prices. Why leave the market free to determine all prices *except* the price of gold?

But this criticism totally misconceives the meaning of the concept of price. A "price" is the quantity exchanged of one commodity on the market in terms of another. Thus, in barter, if a package of six light bulbs is exchanged on the market for one pound of butter, then the price per light bulb is one-sixth of a pound of butter. Or, if there is monetary exchange, the price of each light bulb will be a certain weight of gold, or, these days, numbers of cents or dollars. The important point is that price is the ratio of quantities of *two commodities* being exchanged. But if money is on a gold standard, the dollar and gold will no longer be two independent commodities, whose price should be free to fluctuate on the market. They will be one commodity, one a unit of weight of the other. To call for a "free market" in the "price of gold" is as ludicrous as calling for a free market of ounces in terms of pounds, or inches in terms of yards. How many inches equal a yard is not something subject to daily fluctuations on the free or any other market. The answer is fixed eternally by definition, and what a gold standard entails is a fixed, absolute, unchanging definition as in the case of any other measure or unit of weight. The market necessarily exchanges two different commodities rather than one commodity for itself. To call for a free market in the price of gold would, in short, be as absurd as calling for a fluctuating market price for dollars in terms of cents. How many cents constitute a

dollar is no more subject to daily fluctuation and uncertainty than inches in terms of yards. On the contrary, a truly free market in money will exist only when the dollar is once again strictly defined and therefore redeemable in terms of weights of gold. After that, gold will be exchangeable, at freely fluctuating prices, for the weights of all other goods and services on the market.

In short, the very description of a gold standard as "fixing the price of gold" is a grave misinterpretation. In a gold standard, the "price of gold" is not unaccountably fixed by government intervention. Rather, the "dollar," for the past half-century a mere paper ticket issued by the government, will become defined once again as a unit of weight of gold.

## Defining the Dollar

If, then, the dollar should once again be defined as a unit of weight of gold, what should the new definition be? It is curious that the growing number of economists and writers who call for a return to the gold standard seem to display little or no interest in what precisely the new weight of the dollar should be. The question is admittedly a controversial one, but even more controversial is the very question of having a gold standard at all. Moreover, it should be realized that there is no hope of ever returning to a gold standard unless the proper weight of the dollar is first decided upon.

From the 1940s to the 1960s, the small body of advocates of a return to gold were grouped in two kindred organizations: the Economists' National Committee for Monetary Policy, and the Gold Standard League. Both were guided by Walter E. Spahr, professor of economics at New York University. In this era, and indeed from 1933 until 1971, the United States was on a fiat standard domestically, but on a curious and highly restricted form of gold standard internationally, in which the United States agreed to redeem dollars held by foreign governments and their central banks in gold at the legally defined rate of $35 per ounce. Foreign individuals or private firms could not redeem their dollar balances in gold, and neither individuals nor governments could redeem their dollars in gold coin, since such coin was no longer being issued. Instead, dollars could only be redeemed in large gold bars. However, until 1968 the U.S. Treasury stood ready to maintain the official dollar/gold rate in the free gold market of London and Zurich by purchasing dollars with gold should

the gold price threaten to rise above $35. In that way the United States informally maintained a redeemable dollar at $35 an ounce for foreign individuals and firms as well as officially for governments and central banks. As European pressure for redemption assaulted the inflated dollar, however, the United States, in 1968, sealed off the dollar from the free gold market, establishing the short-lived "two-tier" gold market. In 1971 the last vestige of international gold redemption was ended by President Nixon, and the dollar became totally fiat.

The Spahr organizations advocated a return to the classic, pre-1933, gold coin standard, with gold coin circulating as the standard money. But they sidestepped the problem of considering the proper dollar weight by simply urging the definition of the gold dollar at 1/35 a gold ounce. Their major argument was that 35 dollars to the ounce was the existing legal definition, and that this definition was effectively the redemption rate for foreign governments and central banks. (They might have added, as we have seen, that $35 was also the effective redemption rate for foreign individuals.)

The sole basis of the Spahr call for $35 was that definitions, once selected, must stand forevermore. But this stance was a weak one, considering that there was no gold standard domestically, and no gold coin redemption at all. Why stand courageously for cleaving to a gold standard at $35 an ounce, when nothing like a genuine gold standard has existed since 1933? Indeed, if the Spahr group had been consistent in wanting to maintain the old definition of the dollar, it would have urged a return to the last definition under a true gold standard, the pre-Rooseveltian $20 to the ounce.

The fact that none of the Spahr group so much as contemplated a return to $20 hinted at a growing realization that $35 and, *a fortiori*, $20, was no longer a viable weight, considering the inflation of money and prices that had proceeded steadily since the advent of World War II. The "classic" gold standard before 1933 was marked by a pyramiding of dollar claims upon a much smaller gold stock (specifically bank deposits upon bank notes and in turn upon gold). During and after World War II, the inflationary pyramiding directed by the Federal Reserve became ever more top-heavy, and a return to a $35-an-ounce dollar would have risked a massive deflationary contraction of money. For that reason, such dissident members of the Economists' National Committee as Henry Hazlitt, and other economists such as Michael

Angelo Heilperin, Jacques Rueff, and Ludwig von Mises, began calling for return to gold at a "price" much higher than $35.[14]

At any rate, at the present time, even the weak argument for a definition of the dollar at $35 no longer exists. There is no gold standard left in any sense, and the existing "definition" of the value of gold as being $42.22 an ounce is clearly only an accounting fiction, and at radical variance from its value on the gold market. In a return to the gold standard, we would begin *de novo*, and with a clear slate. In that case, we must realize that there is no moral obligation involved in framing an *initial* definition, and that a new definition of the dollar should therefore be set at whatever figure is pragmatically the most useful. What definition we choose for the new gold dollar is then dependent on what sort of monetary system we would like to achieve, as well as on what definition would assure the easiest transition to that desired system.

## Which Gold Standard?

Which definition we choose, then, depends on what kind of gold standard we would like to attain. At the very least, it must be a genuine gold standard, that is, the dollar must be tied to gold permanently at a fixed weight, and must be redeemable in gold coin at that weight. That rules out all forms of pseudo gold standards such as the 1933–1971 monetary system of the United States, or its subset, the Bretton Woods system of 1945–1971. It rules out, similarly, the pseudo gold standard advocated by the supply-side economists, who would go back to something like Bretton Woods. There would then be no gold coin redemption, and, even worse than Bretton Woods, which at least kept a fixed dollar weight in gold, the Federal Reserve

[14]These dissidents were virtually all in the Austrian tradition, and the three names in the text were all either students or followers of Ludwig von Mises.

In the light of later developments in the gold market, it is amusing to note that the Rueff-Hazlitt proposals for a gold dollar at $70 were scorned by virtually all economists as absurdly high, and that before 1968, monetarists and Keynesians alike were unanimous in predicting that if ever the dollar were cut loose from gold, the gold price would fall precipitately to its nonmonetary level, then estimated at approximately $9 per ounce. It is equally amusing to consider that most of these economists would still subscribe to the motto that "science is prediction."

would be able to manipulate the dollar definition at will, in attempting to fine tune the economy to achieve such macroeconomic goals as full employment or price level stability.

We could in fact return to the classical gold standard such as all major nations were on before World War I and the United States from the 1850s to 1933. The major advantages would be a return to fixity of weight and to genuine redeemability in gold coin. A classical gold standard would be infinitely superior to either the current or the Bretton Woods system. In this case the particular definition chosen would not matter very much, except that it should be much higher than $35 so as not to tempt an unnecessary and massive deflationary contraction that would, at the very least, turn public opinion away from the gold standard for decades to come. More important, the classical gold standard would return to the very same system that created boom-and-bust cycles and brought us 1929 and at least the first four years of the Great Depression. It would, in short, retain the Federal Reserve System, and its system of cartelized banking, special privilege, and virtually inevitable generation of inflation and contraction. Finally, while the ultimate monetary commodity, gold, would be supplied by the free market, the dollar would not be truly denationalized, and it would still be a creature of the federal government.

We can do much better, and there seems little point in going to the trouble of advocating and working for fundamental reform while neglecting to hold up the standard of the best we can achieve. If in our disillusionment with central banking, we call for abolition of the Federal Reserve and a return to some form of free banking, what route could we then take toward that goal? The closest approximation to a free banking-and-gold standard was the American economy from the 1840s to the Civil War, in which there was no form of central banking, and each bank had to redeem its notes and deposits promptly in gold. But in working toward such a system, we must realize that we now have a gold supply nationalized in the coffers of the Federal Reserve. Abolition of the Federal Reserve would mean that its gold supply now kept in Treasury depositories would have to be disgorged and returned to private hands. But this gives us the clue to the proper definition of a gold dollar. For in order to liquidate the Federal Reserve and remove the gold from its vaults, and at the same time tie gold to the dollar, the Federal Reserve's gold must be revalued and redefined so as to be able to exchange it, one for one, for dollar claims

on gold. The Federal Reserve's gold must be valued at *some* level, and it is surely absurd to cleave to the fictitious $42.22 when another definition at a much lower weight would enable the one-for-one liquidation of the Federal Reserve's liabilities as well as transferring its gold from governmental to private hands.

Let us take a specific example. At the end of December 1981, Federal Reserve liabilities totaled approximately $179 billion ($132 billion in Federal Reserve notes plus $47 billion in deposits due to the commercial banks). The Federal Reserve owned a gold stock of 265.3 million ounces. Valued at the artificial $42.22 an ounce, this yielded a dollar value to the Federal Reserve's gold stock of $11.2 billion. But what if the dollar were defined so that the Federal Reserve's gold stock equaled, dollar for dollar, its total liabilities—that is, $179 billion? In that case, gold would be defined as equal to $676 an ounce, or, more accurately, the dollar would be newly defined as equal to, and redeemable in 1/676 gold ounce. At that new weight, Federal Reserve notes would then be promptly redeemed, one for one, in gold coin, and Federal Reserve demand deposits would be redeemed in gold to the various commercial banks. The gold would then constitute those banks' reserves for their demand deposits. The abolition of Federal Reserve notes need not, of course, mean the end of all paper currency; for banks, as before the Civil War, could then be allowed to print bank notes as well as issue demand deposits.

This plan, essentially the one advocated by Congressman Ron Paul (R.-Tx), would return us speedily to something akin to the best monetary system in U.S. history, the system from the abolition of the Second Bank of the United States and the pet banks, to the advent of the Civil War. Inflation and business cycles would be greatly muted, if not eliminated altogether. Add the abolition of the Federal Deposit Insurance Corporation, the requirement of instant payment of demand liabilities on pain of insolvency, and the long overdue legalization of interstate branch banking, and we would have a system of free banking such as advocated by many writers and economists.

We could, however, go even one step further. If we were interested in going on to 100 percent reserve banking, eliminating virtually all inflation and all bank contraction forevermore, we might require 100 percent banking as part of a general legal prohibition against fraud. The substantial 100 percent gold reserve tradition (held by writers and economists ranging from David Hume, Thomas

Jefferson, and John Adams, and partly to Ludwig von Mises), considers the issuing of demand liabilities greater than reserves as equivalent to a warehouse issuing and speculating in warehouse receipts for nonexisting deposits. In short, a fraudulent violation of bailment.

How might the United States go over to a 100 percent gold system? At the end of December 1981, total demand liabilities issued by the entire commercial banking system (that is, M-1), equaled $445 billion (including Federal Reserve notes and demand, or rather checkable, deposits). To go over immediately to 100 percent gold, the dollar would be newly defined at 1/1,696 gold ounce. Total gold stock at the Federal Reserve would then be valued at $445 billion, and the gold could be transferred to the individual holders of Federal Reserve notes as well as to the banks, the banks' assets now equaling and balancing their total demand deposits outstanding. They would then be automatically on a 100 percent gold system.

From the standpoint of the free market, there is admittedly a problem with this transition to 100 percent gold. For the Federal Reserve's gold would be transferred to the commercial banks up to the value of their demand deposits by the Federal Reserve's granting a free gift of capital to the banks by that amount. Thus, overall, commercial banks, at the end of December 1981, had demand deposits of $317 billion, offset by reserves of $47 billion. A return to gold at $1,696 an ounce would have meant that gold transferred to the banks in exchange for their reserve at the Federal Reserve would also have increased their reserves from $47 to $317 billion, via a writing up of bank capital by $270 billion. The criticism would be that the banks scarcely deserve such a free gift, deserving instead to take their chances like all other firms on the free market. The rebuttal argument, however, would stress that, if a 100 percent gold requirement were now imposed on the banks, their free gift would do no more than insure the banking system against a potential holocaust of deflation, contraction, and bankruptcies.[15]

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[15]On the paths to a genuine gold standard, see Murray N. Rothbard, *The Mystery of Banking* (New York: Richardson and Snyder, 1983), pp. 254–69. On the 100 percent gold tradition, see Rothbard, *Case for a 100 Percent Gold Dollar* (from *In Search of a Monetary Constitution*, Leland B. Yeager, ed. [Cambridge, Mass.: Harvard University Press, 1962], reprinted 1991 as a monograph by the Ludwig von Mises Institute) and the neglected

At any rate, whichever of the last two paths is chosen, money and banking would at last be separated from the state, and new currencies, whether "Hayeks" or "ducats," would be free to compete on the market with the gold dollar. I would not advise anyone, however, to bet their life savings on any of these proposed new currencies getting anywhere in this competitive race.

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work by Mark Skousen, *The 100 Percent Gold Standard: Economics of a Pure Money Commodity* (Washington, D.C.: University Press of America, 1977). Also see Rothbard, "Gold vs. Fluctuating Fiat Exchange Rates," in Hans Sennholz, ed., *Gold Is Money* (Westport, Conn.: Greenwood Press, 1975), pp. 24–40; included in this volume as chapter 40.

# 42

# Inflation and the Business Cycle: The Collapse of the Keynesian Paradigm

Until the years 1973–1974, the Keynesians who had formed the ruling economic orthodoxy since the late 1930s had been riding high, wide, and handsome.[1] Virtually everyone had accepted the Keynesian view that there is something in the free-market economy that makes it subject to swings of under- and overspending (in practice, the Keynesian concern is almost exclusively with alleged *underspending*), and that hence it is the function of the government to compensate for this market defect. The government was to compensate for this alleged imbalance by manipulating its spending and deficits (in practice, to increase them). Guiding this vital "macroeconomic" function of government, of course, was to be a board of Keynesian economists (the "Council of Economic Advisors"), who would be able to "fine-tune" the economy so as to prevent either inflation or recession, and to regulate the proper amount of total spending so as to insure continuing full employment without inflation.

It was in 1973–1974 that even the Keynesians finally realized that something was very, very wrong with this confident scenario, that it was time to go back in confusion to their drawing boards. For not only had forty-odd years of Keynesian fine-tuning *not* eliminated

Originally appeared as chapter 9 in *For a New Liberty* (1973, 1978; Auburn, Ala.: Ludwig von Mises Institute, 2006), pp. 213–40.

[1]Keynesians are creators of "macroeconomics" and disciples of Lord Keynes, the wealthy and charismatic Cambridge University economist whose *General Theory of Employment, Interest, and Money* (New York: Harcourt Brace, 1936) is the cornerstone of Keynesian economics.

a chronic inflation that had set in with World War II, but it was in those years that inflation escalated temporarily into double-digit figures (to about 13 percent per annum). Not only that, it was also in 1973–1974 that the United States plunged into its deepest and longest recession since the 1930s (it would have been called a "depression" if the term hadn't long since been abandoned as impolitic by economists). This curious phenomenon of a vaunting inflation occurring *at the same time* as a steep recession was simply *not supposed to happen* in the Keynesian view of the world. Economists had always known that either the economy is in a boom period, in which case prices are rising, *or else* the economy is in a recession or depression marked by high unemployment, in which case prices are falling. In the boom, the Keynesian government was supposed to "sop up excess purchasing power" by increasing taxes, according to the Keynesian prescription—that is, it was supposed to take spending out of the economy; in the recession, on the other hand, the government was supposed to increase its spending and its deficits, in order to pump spending into the economy. But if the economy should be in an inflation *and* a recession with heavy unemployment *at the same time*, what in the world was government supposed to do? How could it step on the economic accelerator *and* brake at the same time?

As early as the recession of 1958, things had started to work peculiarly; for the first time, in the midst of a recession, consumer goods prices rose, if only slightly. It was a cloud no bigger than a man's hand, and it seemed to give Keynesians little to worry about.

Consumer prices, again, rose in the recession of 1966, but this was such a mild recession that no one worried about that either. The sharp inflation of the recession of 1969–1971, however, was a considerable jolt. But it took the steep recession that began in the midst of the double-digit inflation of 1973–1974 to throw the Keynesian economic establishment into permanent disarray. It made them realize that not only had fine-tuning failed, not only was the supposedly dead and buried cycle still with us, but now the economy was in a state of chronic inflation and getting worse—and it was also subject to continuing bouts of recession: of inflationary recession, or "stagflation." It was not only a new phenomenon, it was one that could not be explained, that could not even exist, in the theories of economic orthodoxy.

And the inflation appeared to be getting worse: approximately 1–2 percent per annum in the Eisenhower years, up to 3–4 percent during the Kennedy era, to 5–6 percent in the Johnson administration, then up to about 13 percent in 1973–1974, and then falling "back" to about 6 percent, but only under the hammer blows of a steep and prolonged depression (approximately 1973–1976).

There are several things, then, which need almost desperately to be explained: (1) Why the chronic and accelerating inflation? (2) Why an inflation even during deep depressions? And while we are at it, it would be important to explain, if we could, (3) Why the business cycle at all? Why the seemingly unending round of boom and bust?

Fortunately, the answers to these questions are at hand, provided by the tragically neglected "Austrian School" of economics and its theory of money and the business cycle, developed in Austria by Ludwig von Mises and his follower Friedrich A. Hayek and brought to the London School of Economics by Hayek in the early 1930s. Actually, Hayek's Austrian business cycle theory swept the younger economists in Britain precisely because it alone offered a satisfactory explanation of the Great Depression of the 1930s. Such future Keynesian leaders as John R. Hicks, Abba P. Lerner, Lionel Robbins, and Nicholas Kaldor in England, as well as Alvin Hansen in the United States, had been Hayekians only a few years earlier. Then, Keynes's *General Theory* swept the boards after 1936 in a veritable "Keynesian Revolution," which arrogantly proclaimed that no one before it had presumed to offer any explanation whatever of the business cycle or of the Great Depression. It should be emphasized that the Keynesian theory did *not* win out by carefully debating and refuting the Austrian position; on the contrary, as often happens in the history of social science, Keynesianism simply became the new fashion, and the Austrian theory was not refuted but only ignored and forgotten.

For four decades, the Austrian theory was kept alive, unwept, un-honored, and unsung by most of the world of economics: only Mises (at NYU) and Hayek (at Chicago) themselves and a few followers still clung to the theory. Surely it is no accident that the current renaissance of Austrian economics has coincided with the phenomenon of stagflation and its consequent shattering of the Keynesian paradigm for all to see. In 1974 the first conference of Austrian School economists in decades was held in South Royalton,

Vermont. Later that year, the economics profession was astounded by the Nobel Prize being awarded to Hayek. Since then, there have been notable Austrian conferences at the University of Hartford, at Windsor Castle in England, and at New York University, with even Hicks and Lerner showing signs of at least partially returning to their own long-neglected position. Regional conferences have been held on the East Coast, on the West Coast, in the Middle West, and in the Southwest. Books are being published in this field, and, perhaps most important, a number of extremely able graduate students and young professors devoted to Austrian economics have emerged and will undoubtedly be contributing a great deal in the future.

## Money and Inflation

What, then, does this resurgent Austrian theory have to say about our problem?[2] The first thing to point out is that inflation is not ineluctably built into the economy, nor is it a prerequisite for a growing and thriving world. During most of the nineteenth century (apart from the years of the War of 1812 and the Civil War), prices were falling, *and yet* the economy was growing and industrializing. Falling prices put no damper whatsoever on business or economic prosperity.

Thus, falling prices are apparently the *normal* functioning of a growing market economy. So how is it that the very idea of steadily falling prices is so counter to our experience that it seems a totally unrealistic dreamworld? Why, since World War II, have prices gone up continuously, and even swiftly, in the United States and throughout the world? Before that point, prices had gone up steeply during

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[2]A brief introduction to Austrian business cycle theory can be found in Murray N. Rothbard, *Depressions: Their Cause and Cure* (Lansing, Mich.: Constitutional Alliance, March 1969). The theory is set forth and then applied to the Great Depression of 1929–1933, and also used briefly to explain our current stagflation, in Rothbard, *America's Great Depression*, 3rd ed. (Kansas City, Kans.: Sheed and Ward, 1975).

The best source for the Austrian theory of money is still its original work: Ludwig von Mises, *Theory of Money and Credit*, 3rd ed. (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1971). For an introduction, see Rothbard, *What Has Government Done to Our Money?* 2nd ed. (Los Angeles: Libertarian Publishers, 1974).

World War I and World War II; in between, they fell slightly despite the great boom of the 1920s, and then fell steeply during the Great Depression of the 1930s. In short, apart from wartime experiences, the idea of inflation as a peacetime norm really arrived after World War II.

The favorite explanation of inflation is that greedy businessmen persist in putting up prices in order to increase their profits. But surely the quotient of business "greed" has not suddenly taken a great leap forward since World War II. Weren't businesses equally "greedy" in the nineteenth century and up to 1941? So why was there no inflation trend then? Moreover, if businessmen are so avaricious as to jack up prices 10 percent per year, why do they stop there? Why do they wait; why don't they raise prices by 50 percent, or double or triple them immediately? *What holds them back?*

A similar flaw rebuts another favorite explanation of inflation: that unions insist on higher wage rates, which in turn leads businessmen to raise prices. Apart from the fact that inflation appeared as long ago as ancient Rome and long before unions arrived on the scene, and apart from the lack of evidence that union wages go up faster than nonunion or that prices of unionized products rise faster than of nonunionized, a similar question arises: Why don't businesses raise their prices *anyway*? What is it that permits them to raise prices by a certain amount, but *not* by more? If unions are that powerful, and businesses that responsive, why don't wages and prices rise by 50 percent, or 100 percent, per year? *What holds them back?*

A government-inspired TV propaganda campaign a few years ago got a bit closer to the mark: consumers were blamed for inflation by being too "piggy," by eating and spending too much. We have here at least the beginning of an explanation of what holds businesses or unions back from demanding still higher prices: consumers won't pay them. Coffee prices zoomed upward a few years ago; a year or two later they fell sharply because of consumer resistance—to some extent from a flashy consumer "boycott"—but more importantly from a shift in consumer buying habits away from coffee and toward lower-priced substitutes. So a limit on consumer demand holds them back.

But this pushes the problem one step backward. For if consumer demand, as seems logical, is limited at any given time, how come it keeps going up, year after year, and validating or permitting price and

wage increases? And if it can go up by 10 percent, what keeps it from going up by 50 percent? In short, what enables consumer demand to keep going up, year after year, and yet keeps it from going up any further?

To go any further in this detective hunt we must analyze the meaning of the term "price." What exactly is a price? The price of any given quantity of a product is the amount of money the buyer must spend on it. In short, if someone must spend seven dollars on ten loaves of bread, then the "price" of those ten loaves is seven dollars, or, since we usually express price per unit of product, the price of bread is seventy cents per loaf. So there are two sides to this exchange: the buyer with money and the seller with bread. It should be clear that the interaction of both sides brings about the ruling price in the market. In short, if more bread comes onto the market, the price of bread will be bid down (increased supply lowers the price); while, on the other hand, if the bread buyers have more money in their wallets, the price of bread will be bid higher (increased demand raises the price).

We have now found the crucial element that limits and holds back the amount of consumer demand and hence the price: the amount of money in the consumers' possession. If the money in their pockets increases by 20 percent, then the limitation on their demand is relaxed by 20 percent, and, other things remaining equal, prices will tend to rise by 20 percent as well. We have found the crucial factor: the stock or the supply of money.

If we consider prices across-the-board for the entire economy, then the crucial factor is the total stock or supply of money in the whole economy. In fact, the importance of the money supply in analyzing inflation may be seen in extending our treatment from the bread or coffee market to the overall economy. For *all* prices are determined inversely by the supply of the good and directly by the demand for it. But the supplies of goods are, in general, going up year after year in our still growing economy. So that, from the point of view of the supply side of the equation, most prices should be *falling*, and we should right now be experiencing a nineteenth-century-style steady fall in prices ("deflation"). If chronic inflation were due to the supply side—to activities by producers such as business firms or unions—then the supply of goods overall would necessarily be falling, thereby raising prices. But since the supply of goods is manifestly increasing,

the source of inflation must be the demand side—and the dominant factor on the demand side, as we have indicated, is the total supply of money.

And, indeed, if we look at the world past and present, we find that the money supply has been going up at a rapid pace. It rose in the nineteenth century, too, but at a much slower pace, far slower than the increase of goods and services; but, since World War II, the increase in the money supply—both here and abroad—has been much faster than in the supply of goods. Hence, inflation.

The crucial question then becomes who, or what, controls and determines the money supply, and keeps increasing its amount, especially in recent decades? To answer this question, we must first consider how money arises to begin with in the market economy. For money first arises on the market as individuals begin to choose one or several useful commodities to act as a money: the best money-commodities are those that are in high demand; that have a high value per unit-weight; that are durable, so they can be stored a long time, mobile, so they can be moved readily from one place to another, and easily recognizable; and that can be readily divisible into small parts without losing their value. Over the centuries, various markets and societies have chosen a large number of commodities as money: from salt to sugar to cowrie shells to cattle to tobacco down to cigarettes in POW camps during World War II. But over all these centuries, two commodities have always won out in the competitive race to become moneys when they have been available: gold and silver.

Metals always circulate by their weight—a *ton* of iron, a *pound* of copper, etc.—and their prices are reckoned in terms of these units of weight. Gold and silver are no exception. Every one of the modern currency units originated as units of weight of either gold or silver. Thus, the British unit, the "pound sterling," is so named because it originally meant simply *one pound of silver*. (To see how the pound has lost value in the centuries since, we should note that the pound sterling is now worth two-fifths of an *ounce* of silver on the market. This is the effect of British inflation—of the *debasement* of the value of the pound.) The "dollar" was originally a Bohemian coin consisting of an ounce of silver. Later on, the "dollar" came to be defined as one-twentieth of an ounce of gold.

When a society or a country comes to adopt a certain commodity as a money, and its unit of weight then becomes the unit of currency—the unit of reckoning in everyday life—then that country is said to be on that particular commodity "standard." Since markets have universally found gold or silver to be the best standards whenever they are available, the natural course of these economies is to be on the gold or silver standard. In that case, the supply of gold is determined by market forces: by the technological conditions of supply, the prices of other commodities, etc.

From the beginning of market adoption of gold and silver as money, the State has been moving in to seize control of the money-supply function, the function of determining and creating the supply of money in the society. It should be obvious why the State should want to do so: this would mean seizing control over the money supply from the market and turning it over to a group of people in charge of the State apparatus. Why they should want to do so is clear: here would be an alternative to taxation which the victims of a tax always consider onerous.

For now the rulers of the State can simply create their own money and spend it or lend it out to their favorite allies. None of this was easy until the discovery of the art of printing; after that, the State could contrive to change the definition of the "dollar," the "pound," the "mark," etc., from units of weight of gold or silver into simply the *names* for pieces of paper printed by the central government. Then that government could print them costlessly and virtually *ad lib*, and then spend or lend them out to its heart's content. It took centuries for this complex movement to be completed, but now the stock and the issuance of money is totally in the hands of every central government. The consequences are increasingly visible all around us.

Consider what would happen if the government should approach one group of people—say the Jones family—and say to them: "Here, we give you the absolute and unlimited power to print dollars, to determine the number of dollars in circulation. And you will have an absolute monopoly power: anyone else who presumes to use such power will be jailed for a long, long time as an evil and subversive counterfeiter. We hope you use this power wisely." We can pretty well predict what the Jones family will do with this newfound power. At first, it will use the power slowly and carefully, to pay off its debts,

perhaps buy itself a few particularly desired items; but then, habituated to the heady wine of being able to print their own currency, they will begin to use the power to the hilt, to buy luxuries, reward their friends, etc. The result will be continuing and even accelerated increases in the money supply, and therefore continuing and accelerated inflation.

But this is precisely what governments—all governments—*have* done. Except that instead of granting the monopoly power to counterfeit to the Jones or other families, government has "granted" the power to *itself*. Just as the State arrogates to itself a monopoly power over legalized kidnapping and calls it *conscription*; just as it has acquired a monopoly over legalized robbery and calls it *taxation*; so, too, it has acquired the monopoly power to counterfeit and calls it increasing the supply of dollars (or francs, marks, or whatever). Instead of a gold standard, instead of a money that emerges from and whose supply is determined by the free market, we are living under a fiat paper standard. That is, the dollar, franc, etc., are simply pieces of paper with such names stamped upon them, issued at will by the central government—by the State apparatus.

Furthermore, since the interest of a counterfeiter is to print as much money as he can get away with, so too will the State print as much money as *it* can get away with, just as it will employ the power to tax in the same way: to extract as much money as it can without raising too many howls of protest.

Government control of money supply is inherently inflationary, then, for the same reason that *any* system in which a group of people obtains control over the printing of money is bound to be inflationary.

## The Federal Reserve and Fractional Reserve Banking

Inflating by simply printing more money, however, is now considered old-fashioned. For one thing, it is too *visible*; with a lot of high-denomination bills floating around, the public might get the troublesome idea that the cause of the unwelcome inflation is the government's printing of all the bills—and the government might be stripped of that power. Instead, governments have come up with a much more complex and sophisticated, and much less visible, means of doing the same thing: of organizing increases in the money supply

to give themselves more money to spend and to subsidize favored political groups. The idea was this: instead of stressing the printing of money, retain the paper dollars or marks or francs as the basic money (the "legal tender"), and then pyramid on top of that a mysterious and invisible, but no less potent, "checkbook money," or bank demand deposits. The result is an inflationary engine, controlled by government, which no one but bankers, economists, and government central bankers understands—and designedly so.

First, it must be realized that the entire commercial banking system, in the United States or elsewhere, is under the total control of the central government—a control that the banks welcome, for it permits them to create money. The banks are under the complete control of the central bank—a government institution—a control stemming largely from the central bank's compulsory monopoly over the printing of money. In the United States, the Federal Reserve System performs this central banking function. The Federal Reserve ("the Fed") then permits the commercial banks to pyramid bank demand deposits ("checkbook money") on top of their own "reserves" (deposits at the Fed) by a multiple of approximately 6:1. In other words, if bank reserves at the Fed increase by $1 billion, the banks can and do pyramid their deposits by $6 billion—that is, the banks create $6 billion worth of new money.

Why do bank demand deposits constitute the major part of the money supply? Officially, they are not money or legal tender in the way that Federal Reserve Notes are money. But they constitute a promise by a bank that it will redeem its demand deposits in cash (Federal Reserve Notes) anytime that the depositholder (the owner of the "checking account") may desire. The point, of course, is that the banks *don't have* the money; they cannot, since they owe six times their reserves, which are their own checking account at the Fed. The public, however, is induced to trust the banks by the penumbra of soundness and sanctity laid about them by the Federal Reserve System. For the Fed can and does bail out banks in trouble. If the public understood the process and descended in a storm upon the banks demanding their money, the Fed, in a pinch, if it wanted, could always *print* enough money to tide the banks over.

The Fed, then, controls the rate of monetary inflation by adjusting the multiple (6:1) of bank money creation, or, more importantly, by determining the total amount of bank reserves. In other words, if

the Fed wishes to increase the total money supply by $6 billion, instead of actually printing the $6 billion, it will contrive to increase bank reserves by $1 billion, and then leave it up to the banks to create $6 billion of new checkbook money. The public, meanwhile, is kept ignorant of the process or of its significance.

How do the banks create new deposits? Simply by lending them out in the process of creation. Suppose, for example, that the banks receive the $1 billion of new reserves; the banks will lend out $6 billion and create the new deposits in the course of making these new loans. In short, when the commercial banks lend money to an individual, a business firm, or the government, they are *not* relending existing money that the public laboriously had saved and deposited in their vaults—as the public usually believes. They lend out new demand deposits that they create in the course of the loan—and they are limited only by the "reserve requirements," by the required maximum multiple of deposit to reserves (e.g., 6:1). For, after all, they are not printing paper dollars or digging up pieces of gold; they are simply issuing deposit or "checkbook" claims upon themselves for cash—claims which they wouldn't have a prayer of honoring if the public as a whole should ever rise up at once and demand such a settling of their accounts.

How, then, does the Fed contrive to determine (almost always, to *increase*) the total reserves of the commercial banks? It can and does *lend* reserves to the banks, and it does so at an artificially cheap rate (the "rediscount rate"). But still, the banks do not like to be heavily in debt to the Fed, and so the total loans outstanding from the Fed to the banks is never very high. By far the most important route for the Fed's determining of total reserves is little known or understood by the public: the method of "open market purchases." What this simply means is that the Federal Reserve Bank goes out into the open market and buys an asset. Strictly, it doesn't matter what kind of an asset the Fed buys. It could, for example, be a pocket calculator for twenty dollars. Suppose that the Fed buys a pocket calculator from XYZ Electronics for twenty dollars. The Fed acquires a calculator; but the important point for our purposes is that XYZ Electronics acquires a check for twenty dollars from the Federal Reserve Bank. Now, the Fed is not open to checking accounts from private citizens, only from banks and the federal government itself. XYZ Electronics, therefore, can only do one thing with its twenty-dollar

check: deposit it at its own bank, say the Acme Bank. At this point, another transaction takes place: XYZ gets an increase of twenty dollars in its checking account, in its "demand deposits." In return, Acme Bank gets a check, made over to itself, from the Federal Reserve Bank.

Now, the first thing that has happened is that XYZ's money stock has gone up by twenty dollars—its newly increased account at the Acme Bank—and nobody else's money stock has changed at all. So, at the end of this initial phase—phase I—the money supply has increased by twenty dollars, the same amount as the Fed's purchase of an asset. If one asks, where did the Fed get the twenty dollars to buy the calculator, then the answer is: it created the twenty dollars *out of thin air* by simply writing out a check upon itself. No one, neither the Fed nor anyone else, *had* the twenty dollars before it was created in the process of the Fed's expenditure.

But this is not all. For now the Acme Bank, to its delight, finds it has a check on the Federal Reserve. It rushes to the Fed, deposits it, and acquires an increase of $20 in its reserves, that is, in its "demand deposits with the Fed." Now that the banking system has an increase in $20, it can and does expand credit, that is, create more demand deposits in the form of loans to business (or to consumers or government), until the total increase in checkbook money is $120. At the end of phase II, then, we have an increase of $20 in bank reserves generated by Fed purchase of a calculator for that amount, an increase in $120 in bank demand deposits, and an increase of $100 in bank loans to business or others. The total money supply has increased by $120, of which $100 was created by the banks in the course of lending out checkbook money to business, and $20 was created by the Fed in the course of buying the calculator.

In practice, of course, the Fed does not spend much of its time buying haphazard assets. Its purchases of assets are so huge in order to inflate the economy that it must settle on a regular, highly liquid asset. In practice, this means purchases of U.S. government bonds and other U.S. government securities. The U.S. government bond market is huge and highly liquid, and the Fed does not have to get into the political conflicts that would be involved in figuring out which private stocks or bonds to purchase. For the government, this process also has the happy consequence of helping to prop up the

government security market, and keep up the price of government bonds.

Suppose, however, that some bank, perhaps under the pressure of its depositors, might have to cash in some of its checking account reserves in order to acquire hard currency. What would happen to the Fed then, since its checks had created new bank reserves out of thin air? Wouldn't it be forced to go bankrupt or the equivalent? No, because the Fed has a monopoly on the printing of cash, and it could—and would—simply redeem its demand deposit by printing whatever Federal Reserve Notes are needed. In short, if a bank came to the Fed and demanded $20 in cash for its reserve—or, indeed, if it demanded $20 million—all the Fed would have to do is print that amount and pay it out. As we can see, being able to print its own money places the Fed in a uniquely enviable position.

So here we have, at long last, the key to the mystery of the modern inflationary process. It is a process of continually expanding the money supply through continuing Fed purchases of government securities on the open market. Let the Fed wish to increase the money supply by $6 billion, and it will purchase government securities on the open market to a total of $1 billion (if the money multiplier of demand deposits/reserves is 6:1), and the goal will be speedily accomplished. In fact, week after week, even as these lines are being read, the Fed goes into the open market in New York and purchases whatever amount of government bonds it has decided upon, and thereby helps decide upon the amount of monetary inflation.

The monetary history of this century has been one of repeated loosening of restraints on the State's propensity to inflate, the removal of one check after another until now the government is able to inflate the money supply, and therefore prices, at will. In 1913, the Federal Reserve System was created to enable this sophisticated pyramiding process to take place. The new system permitted a large expansion of the money supply, and of inflation to pay for war expenditures in World War I. In 1933, another fateful step was taken: the United States government took the country off the gold standard, that is, dollars, while still legally defined in terms of a weight of gold, were no longer redeemable in gold. In short, before 1933, there was an important shackle upon the Fed's ability to inflate and expand the money supply: Federal Reserve Notes themselves were payable in the equivalent weight of gold.

There is, of course, a crucial difference between gold and Federal Reserve Notes. The government cannot create new gold at will. Gold has to be dug, in a costly process, out of the ground. But Federal Reserve Notes can be issued at will, at virtually zero cost in resources. In 1933, the United States government removed the gold restraint on its inflationary potential by shifting to fiat money: to making the paper dollar itself the standard of money, with government the monopoly supplier of dollars. It was going off the gold standard that paved the way for the mighty U.S. money and price inflation during and after World War II.

But there was still one fly in the inflationary ointment, one restraint left on the U.S. government's propensity for inflation. While the United States had gone off gold domestically, it was still pledged to redeem any paper dollars (and ultimately bank dollars) held by foreign governments in gold should they desire to do so. We were, in short, still on a restricted and aborted form of gold standard *internationally*. Hence, as the United States inflated the money supply and prices in the 1950s and 1960s, the dollars and dollar claims (in paper and checkbook money) piled up in the hands of European governments. After a great deal of economic finagling and political arm-twisting to induce foreign governments not to exercise their right to redeem dollars in gold, the United States, in August 1971, declared national bankruptcy by repudiating its solemn contractual obligations and "closing the gold window." It is no coincidence that this tossing off of the last vestige of gold restraint upon the governments of the world was followed by the double-digit inflation of 1973–1974, and by similar inflation in the rest of the world.

We have now explained the chronic and worsening inflation in the contemporary world and in the United States: the unfortunate product of a continuing shift in this century from gold to government-issued paper as the standard money, and of the development of central banking and the pyramiding of checkbook money on top of inflated paper currency. Both interrelated developments amount to one thing: the seizure of control over the money supply by government.

If we have explained the problem of inflation, we have not yet examined the problem of the business cycle, of recessions, and of inflationary recession or stagflation. Why the business cycle, and why the new mysterious phenomenon of stagflation?

## BANK CREDIT AND THE BUSINESS CYCLE

The business cycle arrived in the Western world in the latter part of the eighteenth century. It was a curious phenomenon, because there seemed to be no reason for it, and indeed it had not existed before. The business cycle consisted of a regularly recurring (though not strictly periodical) series of booms and busts, of inflationary periods marked by increased business activity, higher employment, and higher prices followed sharply by recessions or depressions marked by declining business activity, higher unemployment, and price declines; and then, after a term of such recession, recovery takes place and the boom phase begins again.

*A priori*, there is no reason to expect this sort of cyclical pattern of economic activity. There will be cyclical waves in specific types of activity, of course; thus, the cycle of the seven-year locust will cause a seven-year cycle in locust-fighting activity, in the production of antilocust sprays and equipment, etc. But there is no reason to expect boom-bust cycles in the overall economy. In fact, there is reason to expect just the opposite; for usually the free market works smoothly and efficiently, and especially with no massive cluster of error such as becomes evident when boom turns suddenly to bust and severe losses are incurred. And indeed, before the late eighteenth century there were no such overall cycles. Generally, business went along smoothly and evenly until a sudden interruption occurred: a wheat famine would cause a collapse in an agricultural country; the king would seize most of the money in the hands of financiers, causing a sudden depression; a war would disrupt trading patterns. In each of these cases, there was a specific blow to trade brought about by an easily identifiable, one-shot cause, with no need to search further for explanation.

So why the new phenomenon of the business cycle? It was seen that the cycle occurred in the most economically advanced areas of each country: in the port cities, in the areas engaged in trade with the most advanced world centers of production and activity. Two different and vitally important phenomena began to emerge on a significant scale in Western Europe during this period, precisely in the most advanced centers of production and trade: industrialization and commercial banking. The commercial banking was the same sort of "fractional reserve" banking we have analyzed above, with London

the site of the world's first central bank, the Bank of England, which originated at the turn of the eighteenth century. By the nineteenth century, in the new discipline of economics and among financial writers and commentators, two types of theories began to emerge in an attempt to explain the new and unwelcome phenomenon: those focusing the blame on the existence of industry, and those centering upon the banking system. The former, in sum, saw the responsibility for the business cycle to lie deep within the free-market economy—and it was easy for such economists to call either for the abolition of the market (e.g., Karl Marx) or for its drastic control and regulation by the government in order to alleviate the cycle (e.g., Lord Keynes). On the other hand, those economists who saw the fault to lie in the fractional reserve banking system placed the blame outside the market economy and onto an area—money and banking—which even English classical liberalism had never taken away from tight government control. Even in the nineteenth century, then, blaming the banks meant essentially blaming government for the boom-bust cycle.

We cannot go into details here on the numerous fallacies of the schools of thought that blame the market economy for the cycles; suffice it to say that these theories cannot explain the rise in prices in the boom or the fall in the recession, or the massive cluster of error that emerges suddenly in the form of severe losses when the boom turns to bust.

The first economists to develop a cycle theory centering on the money and banking system were the early nineteenth-century English classical economist David Ricardo and his followers, who developed the "monetary theory" of the business cycle.[3] The Ricardian theory went somewhat as follows: the fractional-reserve banks, spurred and controlled by the government and its central bank, expand credit. As credit is expanded and pyramided on top of paper money and gold, the money supply (in the form of bank deposits or, in that historical period, bank notes) expands. The expansion of the money supply raises prices and sets the inflationary boom into motion. As the boom continues, fueled by the pyramiding of bank

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[3]For the analysis of the remainder of this chapter, see Rothbard, *Depressions: Their Cause and Cure*, pp. 13–26.

notes and deposits on top of gold, domestic prices also increase. But this means that domestic prices will be higher, and still higher, than the prices of imported goods, so that imports will increase and exports to foreign lands will decline. A deficit in the balance of payments will emerge and widen, and it will have to be paid for by gold flowing out of the inflating country and into the hard-money countries. But as gold flows out, the expanding money and banking pyramid will become increasingly top-heavy, and the banks will find themselves in increasing danger of going bankrupt. Finally, the government and banks will have to stop their expansion, and, to save themselves, the banks will have to contract their bank loans and checkbook money.

The sudden shift from bank credit expansion to contraction reverses the economic picture and bust quickly follows boom. The banks must pull in their horns, and businesses and economic activity suffer as the pressure mounts for debt repayment and contraction. The fall in the supply of money, in turn, leads to a general fall in prices ("deflation"). The recession or depression phase has arrived. However, as the money supply and prices fall, goods again become more competitive with foreign products and the balance of payments reverses itself, with a surplus replacing the deficit. Gold flows into the country, and, as bank notes and deposits contract on top of an expanding gold base, the condition of the banks becomes much sounder, and recovery gets under way.

The Ricardian theory had several notable features: It accounted for the behavior of prices by focusing on changes in the supply of bank money (which indeed always increased in booms and declined in busts). It also accounted for the behavior of the balance of payments. And, moreover, it linked the boom and the bust, so that the bust was seen to be the consequence of the preceding boom. And not only the consequence, but the salutary means of adjusting the economy to the unwise intervention that created the inflationary boom.

In short, for the first time, the bust was seen to be neither a visitation from hell nor a catastrophe generated by the inner workings of the industrialized market economy. The Ricardians realized that the major evil was the preceding inflationary boom caused by government intervention in the money and banking system, and that the recession, unwelcome though its symptoms may be, is really the necessary adjustment process by which that interventionary boom

gets washed out of the economic system. The depression is the process by which the market economy adjusts, throws off the excesses and distortions of the inflationary boom, and reestablishes a sound economic condition. The depression is the unpleasant but necessary reaction to the distortions and excesses of the previous boom.

Why, then, does the business cycle recur? Why does the next boom-and-bust cycle always begin? To answer that, we have to understand the motivations of the banks and the government. The commercial banks live and profit by expanding credit and by creating a new money supply; so they are naturally inclined to do so, "to monetize credit," if they can. The government also wishes to inflate, both to expand its own revenue (either by printing money or so that the banking system can finance government deficits) and to subsidize favored economic and political groups through a boom and cheap credit. So we know why the initial boom began. The government and the banks had to retreat when disaster threatened and the crisis point had arrived. But as gold flows into the country, the condition of the banks becomes sounder. And when the banks have pretty well recovered, they are then in the confident position to resume their natural tendency of inflating the supply of money and credit. And so the *next* boom proceeds on its way, sowing the seeds for the *next* inevitable bust.

Thus, the Ricardian theory also explained the continuing recurrence of the business cycle. But two things it did not explain. First, and most important, it did not explain the massive cluster of error that businessmen are suddenly seen to have made when the crisis hits and bust follows boom. For businessmen are trained to be successful forecasters, and it is not like them to make a sudden cluster of grave error that forces them to experience widespread and severe losses. Second, another important feature of every business cycle has been the fact that both booms and busts have been much more severe in the "capital goods industries" (the industries making machines, equipment, plant or industrial raw materials) than in consumer goods industries. And the Ricardian theory had no way of explaining this feature of the cycle.

The Austrian, or Misesian, theory of the business cycle built on the Ricardian analysis and developed its own "monetary overinvestment" or, more strictly, "monetary malinvestment" theory of the

business cycle. The Austrian theory was able to explain not only the phenomena explicated by the Ricardians, but also the cluster of error and the greater intensity of capital goods' cycles. And, as we shall see, it is the only one that can comprehend the modern phenomenon of stagflation.

Mises begins as did the Ricardians: government and its central bank stimulate bank credit expansion by purchasing assets and thereby increasing bank reserves. The banks proceed to expand credit and hence the nation's money supply in the form of checking deposits (private bank notes having virtually disappeared). As with the Ricardians, Mises sees that this expansion of bank money drives up prices and causes inflation.

But, as Mises pointed out, the Ricardians understated the unfortunate consequences of bank credit inflation. For something even more sinister is at work. Bank credit expansion not only raises prices, it also artificially lowers the rate of interest, and thereby sends misleading signals to businessmen, causing them to make unsound and uneconomic investments.

For, on the free and unhampered market, the interest rate on loans is determined solely by the "time preferences" of all the individuals that make up the market economy. For the essence of any loan is that a "present good" (money which can be used at present) is being exchanged for a "future good" (an IOU which can be used at some point in the future). Since people always prefer having money right now to the present *prospect* of getting the same amount of money at some point in the future, present goods always command a premium over future goods in the market. That premium, or "agio," is the interest rate, and its height will vary according to the degree to which people prefer the present to the future, i.e., the degree of their time preferences.

People's time preferences also determine the extent to which people will save and invest for future use, as compared to how much they will consume now. If people's time preferences should fall, i.e., if their degree of preference for present over future declines, then people will tend to consume less now and save and invest more; at the same time, and for the same reason, the rate of interest, the rate of time-discount, will also fall. Economic growth comes about largely as the result of falling rates of time preference, which bring about an

increase in the proportion of saving and investment to consumption, as well as a falling rate of interest.

But what happens when the rate of interest falls *not* because of voluntary lower time preferences and higher savings on the part of the public, but from government interference that promotes the expansion of bank credit and bank money? For the new checkbook money created in the course of bank loans to business will come onto the market as a supplier of loans, and will therefore, at least initially, lower the rate of interest. What happens, in other words, when the rate of interest falls artificially, due to intervention, rather than naturally, from changes in the valuations and preferences of the consuming public?

What happens is trouble. For businessmen, seeing the rate of interest fall, will react as they always must to such a change of market signals: they will invest more in capital goods. Investments, particularly in lengthy and time-consuming projects, which *previously* looked unprofitable, now seem profitable because of the fall in the interest charge. In short, businessmen react as they would have if savings had *genuinely* increased: they move to invest those supposed savings. They expand their investment in durable equipment, in capital goods, in industrial raw material, and in construction, as compared with their direct production of consumer goods.

Thus, businesses happily borrow the newly expanded bank money that is coming to them at cheaper rates; they use the money to invest in capital goods, and eventually this money gets paid out in higher wages to workers in the capital goods industries. The increased business demand bids up labor costs, but businesses think they will be able to pay these higher costs because they have been fooled by the government-and-bank intervention in the loan market and by its vitally important tampering with the interest-rate signal of the marketplace—the signal that determines how many resources will be devoted to the production of capital goods and how many to consumer goods.

Problems surface when the workers begin to spend the new bank money that they have received in the form of higher wages. For the time preferences of the public have not *really* gotten lower; the public doesn't *want* to save more than it has. So the workers set about to consume most of their new income, in short, to reestablish their old

consumer/saving proportions. This means that they now redirect spending in the economy back to the consumer goods industries, and that they don't save and invest enough to buy the newly produced machines, capital equipment, industrial raw materials, etc. This lack of enough saving-and-investment to buy all the new capital goods at expected and existing prices reveals itself as a sudden, sharp depression in the capital goods industries. For once the consumers reestablish their desired consumption/investment proportions, it is thus revealed that business had invested too much in capital goods (hence the term "monetary overinvestment theory"), and had also underinvested in consumer goods. Business had been seduced by the governmental tampering and artificial lowering of the rate of interest, and acted as if more savings were available to invest than were really there. As soon as the new bank money filtered through the system and the consumers reestablish their old time-preference proportions, it became clear that there were not enough savings to buy all the producers' goods, and that business had misinvested the limited savings available ("monetary malinvestment theory"). Business had overinvested in capital goods and underinvested in consumer goods.

The inflationary boom thus leads to distortions of the pricing and production system. Prices of labor, raw materials, and machines in the capital goods industries are bid up too high during the boom to be profitable once the consumers are able to reassert their old consumption/investment preferences. The "depression" is thus seen—even more than in the Ricardian theory—as the necessary and healthy period in which the market economy sloughs off and liquidates the unsound, uneconomic investments of the boom, and reestablishes those proportions between consumption and investment that are truly desired by the consumers. The depression is the painful but necessary process by which the free market rids itself of the excesses and errors of the boom and reestablishes the market economy in its function of efficient service to the mass of consumers. Since the prices of factors of production (land, labor, machines, raw materials) have been bid too high in the capital goods industries during the boom, this means that these prices must be allowed to fall in the recession until proper market proportions of prices and production are restored.

Put another way, the inflationary boom will not only increase prices in general, it will also distort relative prices, will distort relations

of one type of price to another. In brief, inflationary credit expansion will raise all prices; but prices and wages in the capital goods industries will go up faster than the prices of consumer goods industries. In short, the boom will be more intense in the capital goods than in the consumer goods industries. On the other hand, the essence of the depression adjustment period will be to lower prices and wages in the capital goods industries relative to consumer goods, in order to induce resources to move back from the swollen capital goods to the deprived consumer goods industries. All prices will fall because of the contraction of bank credit, but prices and wages in capital goods will fall more sharply than in consumer goods. In short, both the boom and the bust will be more intense in the capital than in the consumer goods industries. Hence, we have explained the greater intensity of business cycles in the former type of industry.

There seems to be a flaw in the theory, however; for, since workers receive the increased money in the form of higher wages fairly rapidly, and then begin to reassert their desired consumer/investment proportions, how is it that booms go on for years without facing retribution: without having their unsound investments revealed or their errors caused by bank tampering with market signals made evident? In short, why does it take so long for the depression adjustment process to begin its work? The answer is that the booms would indeed be very shortlived (say, a few months) *if* the bank credit expansion and the subsequent pushing of interest rates below the free-market level were just a one-shot affair. But the crucial point is that the credit expansion is *not* one shot. It proceeds on and on, never giving the consumers the chance to reestablish their preferred proportions of consumption and saving, never allowing the rise in cost in the capital goods industries to catch up to the inflationary rise in prices. Like the repeated doping of a horse, the boom is kept on its way and ahead of its inevitable comeuppance by repeated and accelerating doses of the stimulant of bank credit. It is only when bank credit expansion must finally stop or sharply slow down, either because the banks are getting shaky or because the public is getting restive at the continuing inflation, that retribution finally catches up with the boom. As soon as credit expansion stops, the piper must be paid, and the inevitable readjustments must liquidate the unsound overinvestments of the boom and redirect the economy more toward *consumer goods* production. And, of course, the longer the boom is

kept going, the greater the malinvestments that must be liquidated, and the more harrowing the readjustments that must be made.

Thus, the Austrian theory accounts for the massive cluster of error (overinvestments in capital goods industries suddenly revealed as such by the stopping of the artificial stimulant of credit expansion) and for the greater intensity of boom and bust in the capital goods than in the consumer goods industries. Its explanation for the recurrence, for the inauguration of the next boom, is similar to the Ricardian; once the liquidations and bankruptcies are undergone, and the price and production adjustments completed, the economy and the banks begin to recover, and the banks can set themselves to return to their natural and desired course of credit expansion.

What of the Austrian explanation—the only preferred explanation—of stagflation? How is it that, in recent recessions, prices continue to go up? We must amend this first by pointing out that it is particularly consumer goods prices that continue to rise during recessions, and that confound the public by giving them the worst of both worlds at the same time: high unemployment and increases in the cost of living. Thus, during the most recent 1974–1976 depression, consumer goods prices rose rapidly, but wholesale prices remained level, while industrial raw material prices fell rapidly and substantially. So how is it that the cost of living continues to rise in current recessions?

Let us go back and examine what happened to prices in the "classic," or old-fashioned boom-bust cycle (pre-World War II vintage). In the booms the money supply went up, prices in general therefore went up, but the prices of capital goods rose by *more* than consumer goods, drawing resources out of consumer and into capital goods industries. In short, abstracting from general price increases, *relative to each other*, capital goods prices rose and consumer prices *fell* in the boom. What happened in the bust? The opposite situation: the money supply went down, prices in general therefore fell, but the prices of capital goods fell by *more* than consumer goods, drawing resources back out of capital goods into consumer goods industries. In short, abstracting from general price declines, *relative to each other*, capital goods prices *fell* and consumer prices *rose* during the bust.

The Austrian point is that this scenario in relative prices in boom and bust is *still* taking place unchanged. During the booms, capital goods prices still rise and consumer goods prices still fall relative to

each other, and vice versa during the recession. The difference is that a new monetary world has arrived, as we have indicated earlier in this chapter. For now that the gold standard has been eliminated, the Fed can and does increase the money supply *all the time*, whether it be boom or recession. There hasn't been a contraction of the money supply since the early 1930s, and there is not likely to be another in the foreseeable future. So now that the money supply *always* increases, prices in general are *always* going up, sometimes more slowly, sometimes more rapidly.

In short, in the classic recession, consumer goods prices were always going up relative to capital goods. Thus, if consumer goods prices fell by 10 percent in a particular recession, and capital goods prices fell by 30 percent, consumer prices were *rising* substantially in relative terms. But, from the point of view of the consumer, the fall in the cost of living was highly welcome, and indeed was the blessed sugarcoating on the pill of recession or depression. Even in the Great Depression of the 1930s, with very high rates of unemployment, the 75–80 percent of the labor force still employed enjoyed bargain prices for their consumer goods.

But now, with Keynesian fine-tuning at work, the sugarcoating has been removed from the pill. Now that the supply of money—and hence general prices—is *never* allowed to fall, the rise in relative consumer goods prices during a recession will hit the consumer as a visible rise in nominal prices as well. His cost of living now goes up in a depression, and so he reaps the worst of both worlds; in the classical business cycle, before the rule of Keynes and the Council of Economic Advisors, he at least had to suffer only one calamity at a time.

What then are the policy conclusions that arise rapidly and easily from the Austrian analysis of the business cycle? They are the precise opposite from those of the Keynesian establishment. For, since the virus of distortion of production and prices stems from inflationary bank credit expansion, the Austrian prescription for the business cycle will be: First, if we are in a boom period, the government and its banks must cease inflating immediately. It is true that this cessation of artificial stimulant will inevitably bring the inflationary boom to an end, and will inaugurate the inevitable recession or depression. But the longer the government delays this process, the harsher the necessary readjustments will have to be. For the sooner the depression readjustment is gotten over with, the better. This also means

that the government must never try to delay the depression process; the depression must be allowed to work itself out as quickly as possible, so that real recovery can begin. This means, too, that the government must particularly avoid any of the interventions so dear to Keynesian hearts. It must never try to prop up unsound business situations; it must never bail out or lend money to business firms in trouble. For doing so will simply prolong the agony and convert a sharp and quick depression phase into a lingering and chronic disease. The government must never try to prop up wage rates or prices, especially in the capital goods industries; doing so will prolong and delay indefinitely the completion of the depression adjustment process. It will also cause indefinite and prolonged depression and mass unemployment in the vital capital goods industries. The government must not try to inflate again in order to get out of the depression. For even if this reinflation succeeds (which is by no means assured), it will only sow greater trouble and more prolonged and renewed depression later on. The government must do nothing to encourage consumption, and it must not increase its own expenditures, for this will further increase the social consumption/investment ratio—when the only thing that could speed up the adjustment process is to lower the consumption/savings ratio so that more of the currently unsound investments will become validated and become economic. The only way the government can aid in this process is to lower its own budget, which will increase the ratio of investment to consumption in the economy (since government spending may be regarded as consumption spending for bureaucrats and politicians).

Thus, what the government should do, according to the Austrian analysis of the depression and the business cycle, is absolutely nothing. It should stop its *own* inflating, and then it should maintain a strict hands-off, *laissez-faire* policy. Anything it does will delay and obstruct the adjustment processes of the market; the less it does, the more rapidly will the market adjustment process do its work and sound economic recovery ensue.

The Austrian prescription for a depression is thus the diametric opposite of the Keynesian: it is for the government to keep absolute hands off the economy, and to confine itself to stopping its own inflation, and to cutting its own budget.

It should be clear that the Austrian analysis of the business cycle meshes handsomely with the libertarian outlook toward government

and a free economy. Since the State would always like to inflate and to interfere in the economy, a libertarian prescription would stress the importance of absolute separation of money and banking from the State. This would involve, at the very least, the abolition of the Federal Reserve System and the return to a commodity money (e.g., gold or silver) so that the money-unit would once again be a unit of weight of a market-produced commodity rather than the name of a piece of paper printed by the State's counterfeiting apparatus.

# 43

# Lange, Mises, and Praxeology: The Retreat from Marxism

Most economists are familiar with the controversy on the possibility of economic calculation under socialism and with the fact that Ludwig von Mises and Oskar Lange were the two major protagonists of that debate.[1] Many are also familiar with Lange's ironic gibe that, for having posed the problem which Lange believed that socialism could readily solve, "a statue of Professor Mises ought to occupy an honorable place in the great hall of the Ministry of Socialization or of the Central Planning Board of the socialist state."[2] In the light of the rapid retreat from socialist central planning and toward a free market in the Eastern Europe of recent years, it seems that Lange's irony might well have boomeranged.

Far less known, however, is a parallel retreat from Marxist economic theory in Oskar Lange's last years, a retreat, furthermore, made in long strides toward the economic theory and the methodology of none other than his old opponent. Mises's most distinctive contribution to economics was his concept and elaboration of economic theory as *praxeology*, the formal, general logic of human

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[1]See Ludwig von Mises, *Socialism* (New Haven, Conn.: Yale University Press, 1951); F.A. Hayek, ed., *Collectivist Economic Planning* (London: George Routledge and Sons, 1935); and Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism* (New York: McGraw-Hill, 1964). For a summary and critique of the controversy, see Trygve J.B. Hoff, *Economic Calculation in the Socialist Society* (London: William Hodge, 1949).

[2]Lange and Taylor, *On the Economic Theory of Socialism*, pp. 57–58.

action, of human purposive activity using scarce means to achieve the most preferred ends.[3] As a leading Polish economist, Lange was very familiar with the praxeological theories of the distinguished contemporary Polish philosopher, Tadeusz Kotarbinski. While Kotarbinski's specific conception of praxeology differs considerably from Mises's, stressing analysis of efficient as well as hostile action, they unite in emphasizing the essence of praxeology as a general theory of rational action.[4] In his final, posthumous work, designed as the first of a multi-volume treatise on economics, Oskar Lange devoted a great deal of time to the painful acknowledgement that economics must encompass praxeology as well as Marxism. The particular irony is that Lange devoted a great amount of attention to an economic theory of his old anti-socialist rival which still remains almost unknown in conventional Western economic thought.

Lange entitled chapter 5 of his posthumous *Political Economy*, "The Principle of Economic Rationality: Political Economy and Praxeology."[5] He begins the chapter with the decidedly un-Marxist but praxeological statement that "Human economic activity is conscious and purposive activity," that "consists in the realization of given ends by the use of certain means."[6] He proceeds to point out that the capitalist market economy had not only developed gainful activity, but that this gainful activity was a rational one, quantifying ends and means through a calculation in terms of money. Here Lange is implicitly harking back to the old calculation controversy. The economic calculation made possible by money and the invention of double-entry bookkeeping in the capitalist market, enabled action

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[3]See particularly Ludwig von Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1949). For a discussion of Mises's praxeology and its relation to previous economic methodologies, see Israel M. Kirzner, *The Economic Point of View* (Princeton, N.J.: D. Van Nostrand, 1960).

[4]For Mises on Kotarbinski, see Ludwig von Mises, *The Ultimate Foundation of Economic Science* (Princeton, N.J.: D. Van Nostrand, 1962), pp. 42, 135. Most accessible of Kotarbinski's writings is his "Idée de la methodologie générale praxeologic," *Travaux du IXe Congres Internationale de Philosophie* (Paris, 1937), vol. 4, pp. 190–94.

[5]Oskar Lange, *Political Economy* (New York: Macmillan, 1963).

[6]Ibid., p. 148.

toward the maximizing of money profit and income, and thereby toward the most efficient realization of man's ends. In this way, maximization of profit under capitalism is accomplished by following the *economic principle* or principle of economic rationality, a principle enabling the maximum degree of realization of one's ends per given outlay, as well as the minimal outlay of means for a given degree of realization of one's ends. The former variant is the "principle of greatest efficiency," the latter, the "principle of minimum outlay, or economy, of means," or minimum cost.[7] The rational use of means, according to these criteria, is their *optimum* use; any other use of means Lange agrees to consider a waste. In support of these economic principles, Lange cites Kotarbinski's general praxeological concept: "The more valuable the product of a given experience the more productive is behavior; on the other hand, the less the outlay in the achievement of a given aim, the more economical is behavior."

Lange proceeds to pay tribute to the great achievement of the capitalist market economy in arriving at this rational economic principle. Despite the prevailing private rather than "social" rationality, and despite such problems as the business cycle, Lange declares that

> the rationalization of economic activity within the capitalist enterprise, the practice of proceeding according to the principle of economic rationality, and especially the consciousness of this principle in human thought, all constitute an achievement of historic significance . . . on a par with the imposing advance in material technique made within the capitalist mode of production . . . itself closely connected with the application of the principle of economic rationality in enterprise.[8]

After rather perfunctorily asserting that socialism will proceed to expand this rationality to social planning and to such areas of action as input-output analysis, technology, and military strategy and tactics,[9] Lange goes on to identify this study of the rational principles of

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[7]Lange here explicitly accepts the modern concept that the ultimate end is not cardinal or quantifiable, but rather an ordered, ordinal set of preferences. Ibid., pp. 167–68.

[8]Ibid., p. 176.

[9]Kotarbinski's early work was on praxeology as applied to the theory of hostile action. See Mises, *Ultimate Foundation*, pp. 42, 135.

action as praxeology, the logic of rational activity, and details the history of this concept. From Mises, Lange had discovered that the term "praxeology" was first used by the French historian Alfred Espinas in 1890.[10] The first work explicitly on praxeology was an article in 1926 by the eminent Russian economist Eugen Slutsky.[11]

Proceeding to the more developed praxeological work of Kotarbinski, Lange criticizes the Polish philosopher's narrow and technological treatment of the concept as the science of effective or efficient activity; instead, notes Lange, praxeology is really a broader "methodological rationality," a doing of one's best according to one's knowledge, so that it is better to define praxeology as the *science of rational activity*. In opting for this broader, more formal, and more general concept, Lange goes a long way from the Kotarbinski and toward the Misesian formulation of the theory. Praxeology, adds Lange, encompasses under this rubric of rational activity such categories as: ends and means, method, action, plan, efficiency, and economy. Praxeological principles of behavior comprise the relations between the praxeological categories, and the principle of economic rationality (or the "economic principle") is one of these praxeological principles of behavior. In this way, Lange agrees with Mises that the economic principle is itself embedded in the wider praxeological principles of general human action. Furthermore, he agrees that the praxeological principles had until now been elaborated only in the field of economics, as Mises affirms, and in ethics as well.

Lange, however, now found himself at the brink of a precarious position: the Mises thesis that praxeology had so far been elaborated only in economic theory, and that therefore economics and praxeology, while conceivably of different scope in the future, are now virtually identical. To take such a position would mean, for Lange, being close to becoming a Misesian and an Austrian School economist.

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[10]In Espinas's article, "Les Origines de la technologie," *Revue philosophique*, 15th year (July-December 1890): 114–15, and in his book with the same title, published in Paris in 1897. See Mises, *Human Action*, p. 3*n*.

[11]Eugen Slutsky, "Ein Beitrag zur formal-praxeologischen Grundlegung der Ökonomik," in *Annales de la classe des sciences sociales-economiques* (Kiev: Académie Oukranienne des Sciences, 1926), vol. 4.

Drawing back from this precipice, Lange hastens to add that praxeology includes, not only Mises-type economic theory, but also the general theory of statistical decisions, operations research, programming input—output analysis, and cybernetics. Lange did not seem to realize that by rushing to include these disciplines, along with economic theory, in the rubric of praxeology, he was returning to the very different technological concept—the technological manipulation of means to reach a given end—that Lange had already rejected in Kotarbinski.[12] Remembering suddenly to pay his respects to Marxism, Lange adds as an afterthought that dialectical materialism partly bases its cognition on the "praxeological principle" of proceeding according to the "criterion of practice."[13]

From the praxeological principles of behavior, and especially the economic principles adds Lange, a considerable edifice of economic laws can be deduced: such as a general attempt to maximize profit and investing capital at the highest rate of profit, thereby leading to a tendency toward a uniform rate of profit throughout the economy. In this way, Lange accepts the essential deductive Misesian methodology for economic theory: beginning with broadly general praxeological principles as axioms and from these elaborating necessary laws by logical deduction. While Lange attempts to qualify this agreement by stating that empirical testing is needed to see whether various economic actions are "rational" or "customary-traditional," his basic alignment with Misesian methodology still remains.

Later in the book, Lange returns to grapple with praxeology through a critique of subjective utility theory, itself a topic that usually rates little or no space in Marxian works.[14] He begins with a history of value theory and of the basis of economics in the nineteenth century that is perfectly acceptable to any modern economist: from

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[12]On the economic vs. the technological principles, see Lionel Robbins, *The Nature and Significance of Economic Science* (London: Macmillan, 1935), a work heavily under the influence of Mises, Richard Strigl and others of the Austrian School; and Kirzner, *The Economic Point of View*, pp. 108–45. Also see Rutledge Vining, *Economics in the United States of America* (Paris: UNESCO, 1956), pp. 1–37.

[13]Lange, *Political Economy*, p. 190*n*.

[14]Ibid., pp. 229ff.

the classical "economic man" to Benthamite utilitarianism and hedonism to Bastiat's exchange of services and on to the subjective, marginal utility school. The latter began with Jevonian hedonism and then developed into the Austrian, praxeological interpretation of utility not as "pleasure," but as the realization of one's aim of economic activity, *regardless* of the nature of that aim. The aim may be pleasure, money, power, health, or whatever; the Austrian view simply states that economic activity has *some* aim, or *preference*, that forms the goal of action. As Lange correctly concludes: "In this praxeological interpretation, the subjectivist trend leaves aside all psychological considerations and transforms itself into a logic of 'rational choice' aimed at the maximization of preference."[15]

Lange then proceeds to a history of the development of this general, formal theory of utility as ordinal preference. He sees that the Austrian School (Menger, Wieser, Böhm-Bawerk) was far more thoroughgoing in its application of subjective marginal utility theory than the currently far more influential Lausanne School (Walras, Pareto) or than Alfred Marshall. For the Austrians applied marginal utility theory to all gainful activity, whereas the latter applied it only to consumers. In the Austrian and praxeological view, both the consumers' aim of maximizing utility and the producers' aim of maximizing money income or profit fall under the single rubric of maximizing preferences and of marginal utility. Lange's history here is deficient in identifying Pareto partially with the Austrian approach while totally neglecting the praxeological role of Pareto's Italian opponent Benedetto Croce. Moreover, he also neglects the adoption of a general and purely ordinal concept of marginal utility by the Czech Austrian School economist Franz Cuhel, and following Cuhel by Ludwig von Mises in 1912, long before the famous Hicks and Allen article of 1934.[16]

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[15]Ibid., p. 236.

[16]Croce's decidedly praxeological contribution to economics may be found in his fascinating debate with the positivist Pareto on economic methodology, written in 1900 and 1901. See Benedetto Croce, "On the Economic Principle," in *International Economic Papers* 3 (1953): 172–79, 197–202. For an appreciation of Croce's work, see Giorgio Tagliacozzo, "Croce and the Nature of Economic Science," *Quarterly Journal of Economics* (May 1945), and Kirzner, *Economic Point of View*, pp. 155ff.

Lange is correct, however, in citing a praxeological interpretation of utility by Max Weber as early as 1908, in which Weber stated that marginal utility should be formulated, not in such psychological terms as pleasure, but in such "pragmatic" categories as *ends* and *means*.[17]

Thus far our Marxian was willing to go with praxeological economics. But here Lange confronted a precipice even steeper than before: for just as it was important for him to deny that praxeology might be confined to economics, so it was still more important for him to deny that all of economic theory is a subset of praxeology. For if that were really the case, where would that leave Marxism? And so Lange separates himself from the final step in the development of praxeological economics: the transformation of economics into a branch of praxeology. Separated now from concrete objects, economic analysis became a formal science of rational behavior, of the maximization of magnitudes. Conversely, the formal aspects of all rational behavior became analyzable by the economic principle.[18]

For this transformation of economics into a branch of praxeology, Lange cites Lionel Robbins and his well-known depiction of economics as a certain aspect of all activity, namely the relation between scarce means and alternative ends, and the choice among those ends.[19] He also devotes attention to the Austrian economist Hans

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Cuhel's great contribution was his *Zur Lehre von der Bedürfnissen* (Innsbruck: Wagner Universitäts-Buchhandlung, 1907). On Cuhel, see Eugen von Böhm-Bawerk, *Capital and Interest*, 3 vols. (South Holland, Ill.: Libertarian Press, 1959), vol. 2, pp. 191, 193–94, 423, 431–32; vol. 3, pp. 124–36, 232–33. Mises's development of Cuhel is in his *Theory of Money and Credit* (New Haven, Conn.: Yale University Press, 1953), pp. 38ff.

[17]Max Weber, "Die Grenznutzlehre mit das 'psychophysische Grundgesetz," *Gesammelte Aufsätze zur Wissenschaftslehre*, 2nd ed. (Tübingen: J.C.B. Mohr, 1951), pp. 364ff. On the Weber article, see Emil Kauder, *A History of Marginal Utility Theory* (Princeton, N.J.: Princeton University Press, 1965), pp. 116–17, 136–37.

[18]Lange, *Political Economy*, p. 237.

[19]Robbins, *The Nature and Significance of Economic Science*. On the relationship between Robbins's and Mises's views on the nature of economics, which however greatly understates their similarities, see Kirzner, *Economic Point of View*, pp. 108–86. Bracketing them more closely is Ludwig M. Lachmann, "The Science of Human Action," *Economica* (November 1951): 413.

Mayer and to Max Weber, who had originated the Robbinsian distinction between economics as the choice between ends and technology as the choice of means to realize a given end.[20] While this distinction is rather simplistic—neglecting for example, the point that economic as well as technological considerations enter even into the choice of means toward a single end—Lange is incorrect in charging that the distinction is meaningless because the hierarchy of alternative ends are all aimed toward one principal end: the maximization of utility. Lange does not realize that "utility," for the praxeological school, is not a thing or an entity in itself, but is simply the *label* placed upon the preference rankings which everyone makes among his various ends. "Maximizing utility" simply means the formal principle that a man attempts to attain his highest ranking, his most preferred rather than his less preferred end.[21]

Lange then points out that this transformation of economics into a branch of the universal science of praxeology culminated in Ludwig von Mises's *Human Action* in 1949. Classical political economy was now fully transformed into a general theory of human action, of the acts of choice. Economics becomes no longer an empirical science with "real" phenomena, but a formal logic of choice, where the only criterion of truth is agreement with the original axioms. The economic theory becomes empirically true *insofar* as any concrete action is governed by the economic principle. Lange is particularly critical because all of the laws of praxeological, subjective economics are considered by Mises and the preceding Austrians to be applicable to Crusoe economics as well as to the exchange economy. Lange's hostility to this "unrealism" stems precisely from the fact, as he points

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[20]Hans Mayer, "Untersuchungen zu dem Grundgesetz der wirtschaftlichen Wertrechnung," *Zeitschrift für Volkwirtschaft und Sozialpolitik* (Vienna: Franz Deutsche, 1921), vol. 2, p. 5; Max Weber, *The Theory of Social and Economic Organization* (New York: Oxford University Press, 1947), pp. 162, 209. For a critique of Weber's views on economic methodology, see Ludwig von Mises, *Epistemological Problems of Economics* (Princeton, N.J.: D. Van Nostrand, 1960), pp. 74–106. On Mayer, see Kauder, *A History of Marginal Utility Theory*, pp. 107ff.

[21]Kirzner falls into the same error. Kirzner, *Economic Point of View*, p. 134.

out, that application to Crusoe economics implies that the laws of economics are universal and apodictic for every time and place, regardless of the concrete content of social relations or economic activity. By means of praxeology, economics, like the natural sciences, has transcended the concrete and changing data of history and has assumed the character of a universal and apodictic science. As Lange characterizes this position: "Historically conditioned social relations may influence the concrete form in which these laws manifest themselves but they cannot change their basic character."[22] Lange is willing to concede this universal and trans-historical character to *praxeology*; he is not willing to concede economics to be only a subset of praxeology and therefore to take on the same timeless character. For if he were, Marxism, with its proclaimed laws of historical determinism, would have to be completely abandoned.

The characteristic method of the praxeological economists in developing their analysis, Lange points out, is to begin with the economics of an isolated Robinson Crusoe, an analysis which elucidates the basic laws of men in relation to things. Then, other people are brought in, and exchanges between these individuals explained as each person choosing to give up something he wants *less* in order to obtain something he wants *more*. Exchanges thus become the resultants of the subjective attitudes and preferences of the participating individuals. Lange complains that this process of beginning with man *vis-à-vis* nature is the opposite of the Marxian conception, which concentrates on "economic relations among men—relations of production and relations of distribution." He further quotes from the Marxist Rudolf Hilferding, in his charge that the Austrian School economics of Böhm-Bawerk

> takes as the starting point of its system the *individual* relation of man to things. It conceives relations from a psychological point of view, as subject to natural invariable laws; it excludes socially determined relations of production, and . . . development of the economic process according to definite laws is quite foreign to it.[23]

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[22]Lange, *Political Economy*, p. 242.

[23]For a slightly different translation of this passage, see Paul M. Sweezy, *Böhm-Bawerk's Criticism of Marx*, in Rudolf Hilferding, eds. (New York Augustus M. Kelley, 1949), p. 196.

This, to be sure, is the liquidation of the classical "political economy."

But while Lange accuses subjectivist economics of ignoring real economic relations between men, he also correctly asserts that this school of thought treats the economic categories of capitalism "as general praxeological categories, categories of rational human activity."[24] Wages, capital, profit become universal categories independent of the historical shaping of society, and therefore capitalism becomes a universal requirement of rational economic activity. Lange sees that this leads to the heart of the Mises-Lange calculation controversy on whether rational economic activity requires the private ownership of the means of production.[25] But then Lange can hardly be correct in charging that praxeological economics *ignores* concrete social and economic relations; on the contrary, his real complaint is that from these abstract, universal economic laws may be deduced the very real necessity for market capitalism in order to sustain a rational economy.

Thus, while Lange is willing to concede the universality of the economic principle and the achievement of subjectivist economics in discovering a praxeology that can be applied to political economy and to other fields, he is of course not willing to concede that economics is exclusively praxeological. The remainder of Lange's discussion is an unsatisfactory attempt to outline what Marxism or any other economic theory might add to praxeology in the formation of economics. He mentions institutional discussions of the social organization of production, of the State, labor, national income, and so on, but the unanswered question is the role of these categories in economic *theory* as compared to an accumulation of institutional data to which that theory can be applied. Lange also approvingly cites the attack on the subjectivist Austrian School by the Polish economist Stanislaw Brzozowski, who charged that the Austrians merely analyzed the relations between man and given things and comprised a theory of consumption rather than a "complete theory of society." In the first place, this contradicts Lange's previous insight that the Austrians, in contrast to Marshall and the Lausanne School, had

[24]Lange, *Political Economy*, p. 298.

[25]Ibid., p. 298*n*.

extended their subjectivist analysis from consumption to production and the productive factors; the "given things" constituted only the first step in their complete analysis. Second, why should it be a defect of praxeological economics that it does not offer a "complete theory of society"? Is physics to be condemned because it is not chemistry? Has a complete and correct theory of society been offered by any sphere of economics or social science?

Lange proceeds to unworthy and rather absurd attempts to subject the Austrian School economists to a Marxian "sociology of knowledge." The Austrian School, he asserts, is the economics of pensioners and tax officials, because it discusses only consumption and not production, and Nikolai Bukharin is cited asserting that the Austrian School, with its concentration on consumption, is the "rentier's political economy."[26] Not only does this contradict Lange's own previous concession to the Austrian integration of production and consumption, but it also leaves us with the puzzle of how to "explain" such consumption-oriented economics as that of John A. Hobson or J.M. Keynes. Are they too to be dismissed as "rentiers," even the Keynes who called for the "euthanasia" of that very class? Lange's second attempt is to "explain" the abstract and unrealistic Austrian methodology as the product of the professionalization of economics in the universities in the late nineteenth century, which thereupon developed in "isolation from the productive process."[27] But while the earlier classical economists may not have been as professionalized, they were also—apart from Ricardo—not businessmen, and thus were equally "cut off" from the productive process. Neither the university professor Adam Smith nor the civil servant Mill was any closer to the productive process than Menger or Böhm-Bawerk. Furthermore, a bit later in the book Lange turns around and salutes the professionalization of all scientific research in the past century as leading to an autonomy of science, a critical attitude toward the social system, and a science that "becomes independent of the social milieu which produces" it.[28]

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[26]Lange, *Political Economy*, pp. 300ff. Lange himself is a bit dubious on this point, since capitalism in Austria was not as highly developed as in the other Western countries where the subjectivist, praxeological economics did not take hold.

[27]Ibid., pp. 301–02.

[28]Ibid., pp. 314ff.

Lange declares that since the bourgeoisie had to know what was actually happening in the economy, they couldn't pursue completely the Austrian path of liquidating political economy. Therefore, the more "realistic" Anglo-American neoclassicists continued to study such important economic problems as money, business cycles, growth, and international trade. What Lange ignores here is that the Austrian subjectivists have studied and come to a position on all of these important questions, so that what he sees as their abstract "isolation" applies only to the fundamental laws and not to the more developed and applied branches of the theory. One need only mention the Mises-Hayek "monetary malinvestment" theory of the business cycle to see how praxeological economics has been applied to vital and realistic economic problems. The problem, however, is that Lange cannot be very happy with the policy conclusions of the Austrians in these areas: ultra-hard money, the gold standard, *laissez-faire* capitalism. Again, the problem is not so much the relevance of the method as the kind of conclusions that are obtained.

Lange's remarkable adoption of Misesian praxeology as the major base for economics, onto which Marxian and other approaches were then hastily grafted, met predictably mixed reaction in Marxian circles. Most striking was the laudatory critique of Lange by Ronald Meek, the distinguished English historian of economic thought.[29]

Professor Meek, summarizing Lange's lengthy chapter on the "Principle of Economic Rationality," notes that "significantly, the references to Marx's work become purely incidental."[30] Meek considers it "interesting and paradoxical" that praxeology, which "has now become an indispensable adjunct to Marxian economics," was the culmination of a violently anti-Marxist subjectivist trend in "bourgeois" economics.[31] The paradox might well be put the other way round: that of a leading Marxian economist adopting the economics of his own and Marxism's major opponents and then rather desperately trying to insist that there is still room for Marxian and institutional approaches in the wider rubric of political economy.

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[29]Ronald L. Meek, *Economics and Ideology and Other Essays* (London: Chapman and Hall, 1967), pp. 216ff.

[30]Ibid., p. 216.

[31]Ibid., p. 218.

To Marxian "fundamentalists," on the other hand, the Lange-Meek movement is seen for what it genuinely is: a massive "revisionist" retreat from Marxism. In his review of Meek, Ben Brewster despairingly writes:

> for if the relations of production is a general principle governing society the latter becomes merely the totality of human social interaction; there is no specificity of the economic level at all and the distinction between base and superstructure breaks down. The result is that in the last essay in the book (the title essay), Meek apparently falls for the most general principle of society and the most bourgeois ideology of them all, von Mises's "Praxeology" (the principle of all rational action) in Lange's purely ideological attempt to graft Marxist and neoclassical economics.[32]

And so, as Marxian economic thought joins the actual economies of Eastern Europe in a headlong flight from Marxism and socialist central planning to Western and capitalistic modes of thought and economic systems, Oskar Lange's original irony is truly beginning to boomerang. Perhaps the free-market, capitalist economy of a future Poland will erect a statue of Lange alongside the monument to his old antagonist?

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[32]B.B. (Ben Brewster), "Review of Ronald L. Meek, *Economics and Ideology and Other Essays*," *New Left Review* (November-December 1967): 90.

# 44

# Ludwig von Mises and Economic Calculation Under Socialism

What might be called the "orthodox," or textbook, version of the famous economic calculation debate under socialism goes somewhat as follows:

Ludwig von Mises first raised the question of socialist economic calculation in 1920 by asserting that socialism could not calculate economically because of the absence of a price system for the factors of production. Enrico Barone "then" showed (the fact that he had done so twelve years earlier is laid to accidents of timing and translation) that this was not a theoretical problem because all the equations existed for a solution. F.A. Hayek then retreated to a second line of attack by conceding the "theoretical" solution to economic calculation in a socialist state but challenging its "practical" possibility. Finally, Oskar Lange, Abba Lerner, and others "demonstrated" the practical solution by advancing the concept of "market" socialism, in which the planning board arrives at market clearing prices through trial and error. Q.E.D. and socialist planning has been salvaged, replete with Lange's ironic tribute to Mises for raising the problem for Lange and other socialists to solve. If the actual record of Communist economies is brought into the discussion at all, it is usually done as a vindication of the Lange-Lerner thesis in practice.

That there are numerous holes in this neat and triumphal saga should be immediately clear. One example is that the "market socialism" in Yugoslavia and, less so, in the other East European countries has nothing to do with the alleged Lange-Lerner "market"; for while firms in Yugoslavia engage in genuine exchanges and therefore in a

Originally appeared in *The Economics of Ludwig von Mises*, Lawrence Moss, ed. (Kansas City, Kans.: Sheed and Ward, 1976), pp. 67–77.

genuine price system, the Lange-Lerner planning boards were to be central planners who manipulated prices as a pure accounting device and in no sense allowed "markets" at all. Another example is that Barone, in the course of his alleged "theoretical" solution to the problem of socialist calculation, himself ridiculed the idea that planning by means of his equations was in any sense workable, especially when we consider the continuing economic variability of the technical coefficients involved.[1]

But a particularly important flaw in the orthodox story is, as Hayek tried to make clear during the debate, the curious disjunction between the "theoretical" and the "practical." It is not simply that Barone and his mentor Pareto scoffed at the workability of the theoretical equations under socialist planning. More important is the point that Mises and Hayek were implicitly attacking the relevance of the entire concept of Walrasian general equilibrium from which these equations flowed. For Mises and Hayek there was no disjunction between the "theoretical" and the "practical"; following the Austrian tradition, a theory that necessarily violated practical reality was an unsound theory. The fact that in a changeless world of perfect knowledge and general equilibrium a socialist planning board could "solve" equations of prices and production was for Mises a worse than useless demonstration. Clearly, as Hayek would later develop at length, if complete knowledge of economic reality is assumed to be "given" to all, including a planning board, there is no problem of calculation or, indeed, any economic problem at all, whatever the economic system. The Mises demonstration of the impossibility of economic calculation under socialism and of the superiority of private markets in the means of production applied only to the real world of uncertainty, continuing change, and scattered knowledge.

In his monumental *Human Action*, the 1949 treatise that contained his final rebuttal to his socialist critics, Mises emphasized the sterility of the mathematical approach:

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[1]See Enrico Barone, "The Ministry of Production in the Collectivist State," in *Collectivist Economic Planning*, F.A. Hayek, ed. (London: George Routledge and Sons, 1935), p. 286. See also Trygve J.B. Hoff, *Economic Calculation in the Socialist Society* (London: William Hodge, 1949), pp. 140–43.

> The mathematical economists . . . formulate equations and draw curves which are supposed to describe reality. In fact they describe only a hypothetical and unrealizable state of affairs, in no way similar to the catallactic problems in question. They substitute algebraic symbols for the determinate terms of money as used in economic calculation and believe that this procedure renders their reasoning more scientific.
>
> In the imaginary construction of the evenly rotating economy all factors of production are employed in such a way that each of them renders the most valuable service. . . . It is, of course, possible to describe this imaginary state of the allocation of resources in differential equations and to visualize it graphically in curves. But such devices do not assert anything about the market process. They merely mark out an imaginary situation in which the market process would cease to operate. . . .
>
> Both the logical and the mathematical economists assert that human action ultimately aims at the establishment of such a state of equilibrium and would reach it if all further changes in data were to cease. But the logical economist knows much more than that. He shows how the activities of enterprising men, the promoters and speculators, eager to profit from discrepancies in the price structure, tend toward eradicating such discrepancies and thereby also toward blotting out the sources of entrepreneurial profit and loss. . . . The mathematical description of various states of equilibrium is mere play. The problem is the analysis of the market process.
>
> The problems of process analysis, that is, the only economic problems that matter, defy any mathematical approach.[2]

In developing this approach, Hayek engaged in a searching critique of Schumpeter's assertion that socialism suffers from no problem of economic calculation, because, to quote Schumpeter, the "consumers, in evaluating ('demanding') consumers' goods *ipso facto* also evaluate the means of production."[3] Hayek pointed out, however, that this easy step would only follow:

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[2]Ludwig von Mises, *Human Action* (Chicago: Henry Regnery, 1966), pp. 353–56.

[3]Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper and Bros., 1942), p. 175.

> to a mind to which all these facts were simultaneously known. . . . The practical problem, however, arises precisely because these facts are never so given to a single mind . . . instead, we must show how a solution is produced by the interactions of people each of whom possesses only partial knowledge.

Hayek concluded that:

> any approach, such as that of much of mathematical economics with its simultaneous equations, which in effect starts from the assumption that people's *knowledge* corresponds with objective *facts* of the situation, systematically leaves out what is our main task to explain.[4]

Proceeding to an explicit refutation of the Lange-Lerner approach, Mises in *Human Action* scoffed at the idea that the socialist managers will be instructed to "play market as children play war, railroad, or school." Specifically, the socialists leave out the crucial function of shareholding, capital allocation, and entrepreneurship in their concentration on the purely managerial role:

> The cardinal fallacy implied in this and all kindred proposals is that they look at the economic problem from the perspective of the subaltern clerk whose intellectual horizon does not extend beyond subordinate tasks. They consider the structure of industrial production and the allocation of capital to the various branches and production aggregates as rigid, and do not take into account the necessity of altering this structure in order to adjust it to changes in conditions. What they have in mind is a world in which no further changes occur and economic history has reached its final stage. They fail to realize that the operation . . . of the managers, their buying and selling, are only a small segment of the totality of market operations. The market of the capitalist society also performs all those operations which allocate the capital goods to the various branches of industry. The entrepreneurs and capitalists establish corporations and other firms, enlarge or reduce their size, dissolve them or merge them with other enterprises; they buy and sell the shares and bonds of already existing and of new corporations; they grant, withdraw, and recover credits; in short

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[4]F.A. Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), pp. 90–91.

> they perform all those acts the totality of which is called the capital and money market. It is these financial transactions of promoters and speculators that direct production into those channels in which it satisfies the most urgent wants of the consumers in the best possible way. . . .
>
> The role that the loyal corporation manager plays in the conduct of business is . . . only a managerial function, a subsidiary assistance granted to the entrepreneurs and capitalists. . . . It can never become a substitute for the entrepreneurial function. The speculators, promoters, investors, and moneylenders, in determining the structure of the stock and commodity exchanges and of the money market, circumscribe the orbit within which definite minor tasks can be entrusted to the manager's discretion. . . .
>
> The capitalist system is not a managerial system; it is an entrepreneurial system. . . . Nobody has ever suggested that the socialist commonwealth could invite the promoters and speculators to continue their speculations and then deliver their profits to the common chest. Those suggesting a quasi-market for the socialist system have never wanted to preserve the stock and commodity exchanges, the trading in futures, and the bankers and moneylenders. . . . One cannot *play* speculation and investment. The speculators and investors expose their own wealth, their own destiny. This fact makes them responsible to the consumers. . . . If one relieves them of this responsibility, one deprives them of their very character.[5]

Mises also refuted the idea that a socialist planning board would arrive at correct pricing through trial and error, through clearing the market. While this could be done for already produced consumer goods, for which a market would presumably continue to exist, it would be precisely impossible in the realm of capital goods, where there would be no genuine market; hence, any sort of rational decisions on the kinds and amounts of the production of capital and of consumer goods could not be made. In short, the process of trial and

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[5]Mises, *Human Action*, pp. 707–09. See also Dominick T. Armentano, "Resource Allocation Problems under Socialism," in *Theory of Economic Systems*, W.P. Snavely, ed. (Columbus, Ohio: Charles E. Merrill, 1969), pp. 127–39. On the importance of the stock market in the free-market economy, see Ludwig M. Lachmann, *Capital and Its Structure* (London: London School of Economics and Political Science, 1956), pp. 67–71.

error works on the market because the emergence of profit and loss conveys vital signals to the entrepreneur, whereas such apprehensions of genuine profit and loss could not be made in the absence of a real market for the factors of production.

A common attempt to rebut Mises has been the simple empirical pointing to the existence of central planning in the Soviet Union and the other Communist states. But, in the first place, this argument is a two-edged sword, (1) because of the blatant failures of early War Communism in its abolition of the market, and (2) because the evident failures and breakdowns of central planning have led to the Communist countries in East Europe, especially in Yugoslavia, to move rapidly away from socialism toward a genuine, and not a Lange-Lerner type of pseudo, market economy. But, more importantly, Mises pointed out that the Soviet Union and the other socialist countries are not fully socialist, since they still operate within a world market environment and are at least roughly able to use world capital and commodity prices on which to base their economic calculations.[6] That Communist planners base their calculations on world market prices is now generally acknowledged and is illustrated by an amusing encounter of Professor Peter Wiles with Polish Communist planners:

> What actually happens is that "world prices," that is, *capitalist world prices*, are used in all intra-block trade. They are translated into rubles and entered in bilateral clearing accounts To the question, "What would you do if there were no capitalist world?" came only the answer "We'll cross that bridge when we come to it." In the case of electricity the bridge is already under their feet: there has been great difficulty in pricing it since there is no world market.[7]

[6]On socialist countries operating within a world market environment, see Mises, *Human Action*, pp. 698–99. On the rapid breakdown of War Communism, see Boris Brutzkus, *Economic Planning in Soviet Russia* (London: George Routledge and Sons, 1935); and Paul Craig Roberts, *Alienation and the Soviet Economy* (Albuquerque: University of New Mexico Press, 1971), pp. 20–47.

[7]P.J.D. Wiles, "Changing Economic Thought in Poland" *Oxford Economic Papers* 9 (June 1957): 202–03.

Mises's followers in the debate have continued to develop his basic critique of the impossibility of economic calculation under socialism. Thus, the attempted Lange-Lerner criterion of pricing in accordance with "marginal cost" has been attacked on what are essentially Austrian grounds, namely, that costs are not "given" and objective but are subjective estimates by various individuals of future selling prices and other economic conditions. Thus Hayek wrote that:

> excessive preoccupation with the conditions of a hypothetical state of stationary equilibrium has led modern economics . . . to attribute to the notion of costs in general a much greater precision and definiteness than can be attached to any cost phenomenon in real life. . . . As soon as we leave the realm of . . . a stationary state and consider a world where most of the existing means of production are the product of particular processes that will probably never be repeated; where, in consequence of incessant change, the value of most of the more durable instruments of production has little or no connection with the costs which have been incurred in their production but depends only on the services which they are expected to render in the future, the question of what exactly are the costs of production of a given product is a question of extreme difficulty which cannot be answered . . . without first making some assumption as regards the prices of the products in the manufacture of which the same instruments will be used. Much of what is usually termed cost of production is not really a cost element that is given independently of the price of the product but a quasi-rent, or a depreciation quota which has to be allowed on the capitalized value of expected quasi-rents, and is therefore dependent on the prices which are expected to prevail.[8]

At another place, Hayek added that Lange and others

> speak about "marginal costs" as if they were independent of the period for which the manager can plan. Clearly, actual costs depend in many instances, as much as on anything, on buying at the right time. In no sense can costs during any period be said to depend solely on prices during that period. They depend as much on whether these prices have been correctly foreseen as on the views that are held about future prices.[9]

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[8]F.A. Hayek, "The Present State of the Debate," in *Collectivist Economic Planning*, pp. 226–27.

[9]Hayek, *Individualism and Economic Order*, p. 198.

And Paul Craig Roberts, while writing generally from a different perspective, pointed out that

> under real-world conditions characterized by the passage of time, the marginal rule gives no clear guidance to those directed to organize production in accordance with it. Introducing the element of time brings in uncertainty and requires the exercise of *judgment*. Neither uncertainty nor judgment is present in the formulation of perfect competition from which Lange took his idea of the marginal rule.[10]

Moreover, the outstanding critique of the marginal cost as well as of other authoritarian rules imposed on the entrepreneur was by G.F. Thirlby, who pointed out that costs are wrapped up inextricably in subjective estimates by the individual capitalists and entrepreneurs of alternative choices that are forgone, and since these alternatives are usually never undertaken, they can never be "objectively" determined by outside observers.[11]

The subjectivist Austrian critique of the modern concept of costs and its relevance to the question of socialist calculation were neatly summed up by Professor Buchanan:

> Confusion arises . . . when the properties of equilibrium, as defined for markets, are transferred as criteria of optimization in *nonmarket* or political settings. It is here that the critical distinction between the equilibrium of the single decisionmaker and that attained through market interaction, the distinction stressed by Hayek, is absolutely essential. . . . The theory of social interaction, of the mutual adjustment among the plans of separate human beings, is different in kind from the theory of planning, the maximization of some objective function by a conceptualized omniscient being. The latter is equivalent, in all respects, to the problems faced by Crusoe or by any individual decision-maker. But this is not the theory of markets, and it is artificial and basically false thinking that makes it out to be. . . . Shadow prices are not market prices, and the opportunity costs that inform market decisions are not those that inform the choices of even the omniscient planner. These

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[10]Roberts, *Alienation and the Soviet Economy*, p. 97.

[11]G.E. Thirlby, "The Rule?' in *L.S.E. Essays on Cost*, James M. Buchanan and G.E. Thirlby, eds. (London: London School of Economics and Political Science, 1973), pp. 163–200.

appear to be identical only because of the false objectification of the magnitudes in question. . . .

Simply considered, cost is the obstacle or barrier to choice, that which must be got over before choice is made. Cost is the under-side of the coin, so to speak, cost is the displaced alternative, the rejected opportunity. Cost is that which the decision-maker sacrifices or gives up when he selects one alternative rather than another. Cost consists therefore in his own evaluation of the enjoyment or utility that he anticipates having to forgo as a result of choice itself. There are specific implications to be drawn from this choice-bound definition of opportunity cost:

1. Cost must be borne exclusively by the person who makes decisions; it is not possible for this cost to be shifted to or imposed on others.

2. Cost is subjective; it exists only in the mind of the decision-maker or chooser.

3. Cost is based on anticipations; it is necessarily a forward-looking or *ex ante* concept.

4. Cost can never be realized because of the fact that choice is made; the alternative which is rejected can never itself be enjoyed.

5. Cost cannot be measured by someone other than the chooser since there is no way that subjective mental experience can be directly observed.

In any general theory of choice cost must be reckoned in a *utility* rather than in a *commodity* dimension. From this it follows that the opportunity cost involved in choice cannot be observed and objectified and, more importantly, it cannot be measured in such a way as to allow comparisons over wholly different choice settings. The cost faced by the utility-maximizing owner of a firm, the value that he anticipates having to forego in choosing to produce an increment to current output, is not the cost faced by the utility-maximizing bureaucrat who manages a publicly owned firm, even if the physical aspects of the two firms are in all respects identical.[12]

There is one vital but neglected area where the Mises analysis of economic calculation needs to be expanded. For in a profound sense, the theory is not about socialism at all! Instead, it applies to

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[12]James M. Buchanan, "Introduction: L.S.E. Cost Theory in Retrospect," in *L.S.E. Essays on Cost*, pp. 4–5, 14–15.

any situation where one group has acquired control of the means of production over a large area—or, in a strict sense, throughout the world. On this particular aspect of socialism, it doesn't matter whether this unitary control has come about through the coercive expropriation brought about by socialism or by voluntary processes on the free market. For what the Mises theory focuses on is not simply the numerous inefficiencies of the political as compared to the profit-making market process, but the fact that a market for capital goods has disappeared. This means that, just as socialist central planning could not calculate economically, no One Big Firm could own or control the entire economy. The Mises analysis applies to any situation where a market for capital goods has disappeared in a complex industrial economy, whether because of socialism or because of a giant merger into One Big Firm or One Big Cartel.

If this extension is correct, then the Mises analysis also supplies us the answer to the age-old criticism leveled at the unhampered, unregulated free-market economy: *what if* all firms banded together into One Big Firm that would exercise a monopoly over the economy equivalent to socialism? The answer would be that such a firm could not calculate because of the absence of a market, and therefore that it would suffer grave losses and dislocations. Hence, while a socialist planning board need not worry about losses that would be made up by the taxpayer, One Big Firm would soon find itself suffering severe losses and would therefore disintegrate under this pressure. We might extend this analysis even further. For it seems to follow that, as we *approach* One Big Firm on the market, as mergers begin to eliminate capital goods markets in industry after industry, these calculation problems will begin to appear, albeit not as catastrophically as under full monopoly. In the same way the Soviet Union suffers calculation problems, albeit not so severe as would be the case were the entire world to be absorbed into the Soviet Union with the disappearance of the world market. If, then, calculation problems begin to arise as markets disappear, this places a free-market limit, not simply on One Big Firm, but even on partial monopolies that eradicate markets. Hence, the free market contains within itself a built-in mechanism limiting the relative size of firms in order to preserve markets throughout the economy. This point also serves to extend the notable analysis of Professor Coase on the market determinants of the size of the firm, or of the relative extent of corporate planning

within the firm as against the use of exchange and the price mechanism. Coase pointed out that there are diminishing benefits and increasing costs to each of these two alternatives, resulting, as he put it, in an "'optimum' amount of planning" in the free market system.[13] Our thesis adds that the costs of internal corporate planning become prohibitive as soon as markets for capital goods begin to disappear, so that the free-market optimum will always stop well short not only of One Big Firm throughout the world market but also of *any* disappearance of specific markets and hence of economic calculation in that product or resource. Coase stated that the important difference between planning under socialism and within business firms on the free market is that the former "is imposed on industry while firms arise voluntarily because they represent a more efficient method of organizing production."[14] If our view is correct, then, this optimal free-market degree of planning also contains within itself a built-in safeguard against eliminating markets, which are so vital to economic calculation.

In fact, we may turn the question around to ask the socialists: if, indeed, central planning is more efficient than, or even equally efficient to, the free-market economy, then why has central planning never come about through the creation of One Big Firm by the voluntary market process? The fact that One Big Firm has never arisen on the market and that it needs the coercive might of the state to establish such central planning under socialism demonstrates that the latter could not be the most efficient method of organizing the economy.[15]

In our expanded form, then, not only is Mises's insight into the irrationality of socialism in an industrial economy confirmed but so also is the self-subsistence and continuing optimality and rationality of the free-market economy.

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[13]Ronald H. Coase, "The Nature of the Firm," *Economica* 4 (November 1937): 384–405; reprinted in American Economic Association, *Readings in Price Theory* (Homewood, Ill.: Richard D. Irwin, 1952), p. 335*n*.

[14]Ibid.

[15]See Murray N. Rothbard, *Man, Economy, and State* (Los Angeles: Nash, 1970), vol. 2, pp. 547–50, 585.

# 45
# The End of Socialism and the Calculation Debate Revisited

At the root of the dazzling revolutionary implosion and collapse of socialism and central planning in the "socialist bloc" is what everyone concedes to be a disastrous economic failure. The peoples and the intellectuals of Eastern Europe and the Soviet Union are crying out not only for free speech, democratic assembly, and glasnost, but also for private property and free markets. And yet, if I may be pardoned a moment of nostalgia, four-and a-half-decades ago, when I entered graduate school, the economics Establishment of that era was closing the book on what had been for two decades the famed "socialist calculation debate." And they had all decided, left, right, and center, that there was not a thing economically wrong with socialism: that socialism's only problems, such as they might be, were political. Economically, socialism could work just as well as capitalism.

## Mises and the Challenge of Calculation

Before Ludwig von Mises raised the calculation problem in his celebrated article in 1920,[1] everyone, socialists and non-socialists alike, had long realized that socialism suffered from

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[1]Mises's article, published in 1920 in German, "Die Wirtschaftsrechnung im sozialistischen Gemeinwesen," was only made available in English in 1935; Mises, "Economic Calculation in the Socialist Commonwealth," in F.A. Hayek, ed., *Collectivist Economic Planning* (London: Routledge and Sons, 1935), pp. 87–130. The article was republished as a monograph by the Mises Institute with a notable postscript by Professor Joseph T. Salerno (Ludwig von Mises, *Economic Calculation in the Socialist Commonwealth* [Auburn, Ala.: Ludwig von Mises Institute, 1990]).

an *incentive problem*. If, for example, everyone under socialism were to receive an equal income, or, in another variant, everyone was supposed to produce "according to his ability" but receive "according to his needs," then, to sum it up in the famous question: Who, under socialism, will take out the garbage? That is, what will be the incentive to do the grubby jobs, and, furthermore, to do them well? Or, to put it another way, what would be the incentive to work hard and be productive *at any job*?

The traditional socialist answer held that the socialist society would transform human nature, would purge it of selfishness, and remold it to create a New Socialist Man. That new man would be devoid of any selfish, or indeed any self-determined, goals; his only wish would be to work as hard and as eagerly as possible to achieve the goals and obey the orders of the socialist State. Throughout the history of socialism, socialist *ultras*, such as the early Lenin and Bukharin under "War Communism," and later Mao Tse-tung and Che Guevara, have sought to replace material by so-called "moral" incentives. This notion was properly and wittily ridiculed by Alexander Gray as "the idea that the world may find its driving force in a Birthday Honours List (giving to the King, if necessary, 165 birthdays a year)."[2] At any rate, the socialists soon found that voluntary methods could hardly yield them the New Socialist Man. But even the most determined and bloodthirsty methods could not avail to create this robotic New Socialist Man. And it is a testament to the spirit of freedom that cannot be extinguished in the human breast that the socialists continued to fail dismally, despite decades of systemic terror.

But the uniqueness and the crucial importance of Mises's challenge to socialism is that it was totally unrelated to the well-known incentive problem. Mises in effect said: All right, suppose that the socialists have been able to create a mighty army of citizens all eager to do the bidding of their masters, the socialist planners. What exactly would those planners tell this army to do? How would they know what products to order their eager slaves to produce, at what stage of production, how much of the product at each stage, what

[2]Alexander Gray, *The Socialist Tradition* (London: Longmans, Green, 1946), p. 90.

techniques or raw materials to use in that production and how much of each, and where specifically to locate all this production? How would they know their costs, or what process of production is or is not efficient?

Mises demonstrated that, in any economy more complex than the Crusoe or primitive family level, the socialist planning board would simply not know what to do, or how to answer any of these vital questions. Developing the momentous concept of *calculation*, Mises pointed out that the planning board could not answer these questions because socialism would lack the indispensable tool that private entrepreneurs use to appraise and calculate: the existence of a market in the means of production, a market that brings about money prices based on genuine profit-seeking exchanges by private owners of these means of production. Since the very essence of socialism is collective ownership of the means of production, the planning board would not be able to plan, or to make any sort of rational economic decisions. Its decisions would necessarily be completely arbitrary and chaotic, and therefore the existence of a socialist planned economy is literally "impossible" (to use a term long ridiculed by Mises's critics).

## The Lange-Lerner "Solution"

In the course of intense discussion throughout the 1920s and 1930s, the socialist economists were honest enough to take Mises's criticism seriously, and to throw in the towel on most traditional socialist programs: in particular, the original communist vision that workers, not needing such institutions as bourgeois money fetishism, would simply produce and place their products on some vast socialist heap, with everyone simply taking from that heap "according to his needs." The socialist economists also abandoned the Marxian variant that everyone should be paid according to the labor time embodied into his product. In contrast, what came to be known as the Lange-Lerner solution (or, less commonly but more accurately, the Lange-Lerner-Taylor solution), acclaimed by virtually all economists, asserted that the socialist planning board could easily resolve the calculation problem by ordering its various managers to fix accounting prices. Then, according to the contribution of Professor Fred M. Taylor, the central planning board could find the proper prices in much the same way as the capitalist market: trial and error.

Thus, given a stock of consumer goods, if the accounting prices are set too low, there will be a shortage, and the planners will raise prices until the shortage disappears and the market is cleared. If, on the other hand, prices are set too high, there will be a surplus on the shelves, and the planners will lower the price, until the markets are cleared. The solution is simplicity itself![3]

In the course of his two-part article and subsequent book, Lange concocted what could only be called the Mythology of the Socialist Calculation Debate, a mythology which, aided and abetted by Joseph Schumpeter, was accepted by virtually all economists of whatever ideological stripe. It was this mythology which I found handed down as the Orthodox Line when I entered Columbia University's graduate school at the end of World War II—a line promulgated in lectures by no less an expert on the Soviet economy than Professor Abram Bergson, then at Columbia. In 1948, indeed, Professor Bergson was selected to hand down the Received Opinion on the subject by a committee of the American Economic Association, and Bergson interred the socialist calculation question with the Orthodox Line as its burial rite.[4]

The Lange-Bergson Orthodox Line went about as follows: Mises, in 1920, had done an inestimable service to socialism by raising the problem of economic calculation, a problem of which socialists had not generally been aware. Then Pareto and his Italian disciple Enrico Barone had shown that Mises's charge, that socialist calculation was impossible, was incorrect, since the requisite number of supply, demand, and price equations existed under socialism as under a capitalist system. At that point, F.A. Hayek and Lionel

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[3]Oskar Lange's well-known article was originally in two parts: "On the Economic Theory of Socialism," *Review of Economic Studies* 4 (October 1936): 53–71, and ibid., p. 5 (February 1937): 132–42; Fred M. Taylor's article was "The Guidance of Production in a Socialist State," *American Economic Review* 19 (March 1929); Taylor was reprinted and Lange revised and published in Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism*, B. Lippincott, ed. (Minneapolis: University of Minnesota Press, 1938).

[4]Abram Bergson, "Socialist Economics," in H.S. Ellis, ed., *A Survey of Contemporary Economics* (Philadelphia: Blakiston, 1948), pp. 412–48.

Robbins, abandoning Mises's extreme position, fell back on a second line of defense: that, while the calculation problem could be solved *theoretically*, in practice it would be too difficult. Thereby Hayek and Robbins fell back on a practical problem, or one of degree of efficiency rather than of a drastic difference in kind. But now, happily, the day has been saved for socialism, since Taylor-Lange-Lerner have shown that, by jettisoning utopian ideas of a money-less or price-less socialism, or of pricing according to a labor theory of value, the socialist Planning Board can solve these pesky equations simply by the good old capitalist method of trial and error.[5]

Bergson, attempting to be magisterial in his view of the debate, summed up Mises as contending that "without private ownership of, or (what comes to the same thing for Mises) a free market for the means of production, the rational evaluation of these goods for the purposes of calculating costs is ruled out." Bergson correctly adds that to put Mises's point

> somewhat more sharply than is customary, let us imagine a Board of Supermen, with unlimited logical faculties, with a complete scale of values for the different consumers goods', and present and future consumption, and detailed knowledge of production techniques. Even such a Board would be unable to evaluate rationally the means of production. In the absence of a free market for these goods, decisions on resource allocation in Mises's view necessarily would be on a haphazard basis.

Bergson sharply comments that this "argument is easily disposed of." Lange and Schumpeter both point out that, as Pareto and Barone had shown,

> once tastes and techniques are given, the values of the means of production can be determined unambiguously by imputation without the intervention of a market process. The Board of Supermen could decide readily how to allocate resources so as to assure the

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[5]Lange was aided in this construction by being able to use Hayek's collection of articles on the subject, which had just been published the year before his first article, as a useful foil. Hayek's volume included the seminal article by Mises, other contributions by Pierson and Halm, two articles by Hayek himself, and the alleged refutation of Mises by Barone. See Hayek, *Collectivist Economic Planning*.

> optimum welfare. It would simply have to solve the equations of Pareto and Barone.[6]

So much for Mises. As for the Hayek-Robbins problem of practicality, Bergson adds, that can be settled by the Lange-Taylor trial-and-error method; any remaining problems are only a matter of degree of efficiency, and political choices. The Mises problem has been satisfactorily solved.

## Some Fallacies of the Lange-Lerner Solution

The breathtaking naivete of the Orthodox Line should have been evident even in the 1940s. As Hayek later chided Schumpeter on the assumption of "imputation" outside the market, this formulation

> presumably means . . . that the valuation of the factors of production is implied in, or follows necessarily from, the valuation of consumers' goods. But . . . implication is a logical relationship which can be meaningfully asserted only of propositions simultaneously present to one and the same mind.[7]

Economists were convinced of the Lange solution because they had already come under the sway of the Walrasian general equilibrium model; Schumpeter, for example, was an ardent Walrasian. In this model, the economy is always in static general equilibrium, a changeless world in which all "data"—tastes or value scales, alternative technologies, and lists of resources—are known to everyone, and where costs are known and always equal to price. The Walrasian world is also one of "perfect" competition, where prices are given to all managers. Indeed, both Taylor and Lange make the point that the Socialist Planning Board will be better able to calculate than capitalist markets, since the socialist planners can ensure "perfect competition," whereas the real world of capitalism is shot through with various sorts of "monopolies"! The socialist planners can act like the

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[6]Bergson, "Socialist Economics," p. 446.

[7]F.A. Hayek, "The Use of Knowledge in Society" (1945), in Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), p. 90.

absurdly fictional Walrasian "auctioneer," bringing about equilibrium rapidly by trial and error.

Set aside the obvious absurdity of trusting a coercive governmental monopoly to act somehow as if it were in "perfect competition" with parts of itself. Another grievous flaw in the Lange model is thinking that general equilibrium, a world of certainty where there is no room for the driving force of entrepreneurship, can somehow be used to depict the real world. The actual world is one not of changeless "givens" but of incessant change and systemic uncertainty. Because of this uncertainty, the capitalist entrepreneur, who stakes assets and resources in attempting to achieve profits and avoid losses, becomes the crucial actor in the economic system, an actor who can in no way be portrayed by a world of general equilibrium. Furthermore, it is ludicrous, as Hayek pointed out, to think of general equilibrium as the only legitimate "theory," with all other areas or problems dismissed as mere matters of practicality and degree. No economic theory worth its salt can be worthwhile if it omits the role of the entrepreneur in an uncertain world. The Pareto-Barone-Lange, etc. "equations" is not simply excellent theory that faces problems in practice; for in order to be "good," a theory must be useful in explaining real life.[8]

Another grave flaw in the Lange-Taylor trial-and-error approach is that it concentrates on consumer good pricing. It is true that retailers, given the stock of a certain type of good, can clear the market by adjusting the prices of that good upward or downward. But, as Mises pointed out in his original 1920 article, consumer goods are not the real problem. Consumers, these "market socialists" are postulating, are free to express their values by using money they had earned on a range of consumers' goods. Even the labor

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[8]The silliness of hailing Barone's essay as a refutation of Mises is highlighted by the fact that Barone's article was published in 1908, twelve years before Mises's article which it is supposed to have refuted. The date was well known to, and made no impression upon, Ludwig von Mises. Moreover, Barone and Pareto themselves had only scorn for any notion that their equations could aid socialist planning. See Trygve J.B. Hoff, *Economic Calculation in the Socialist Society* (1949; Indianapolis, Ind.: Liberty Press, 1981), pp. 222–23.

market—at least in principle[9]—can be treated as a market with self-owning suppliers who are free to accept or reject bids for their labor and to move to different occupations. The real problem, as Mises has insisted from the beginning, is in all the intermediate markets for land and capital goods. Producers have to use land and capital resources to decide what the stocks of the various consumer goods should be. Here there are a huge number of markets where the State monopoly can only be both buyer and seller for each transaction, and these intra-monopoly, intra-state transactions permeate the most vital markets of an advanced economy—the complex lattice-work of the capital markets. And here is precisely where calculational chaos necessarily reigns, and there is no way for rationality to intrude on the immense number of decisions on the allocation of prices and factors of production in the structure of capital goods.

## Mises's Rebuttal: The Entrepreneur

Moreover, Mises's brilliant and devastating rebuttal to his Lange-Lerner "market socialism" critics has virtually never been considered—neither by the economics establishment nor by the post-World War II Hayekians. In both cases, the writers were eager to dispose of Mises as having safely made his pioneering contribution in 1920, but being superseded later, either by Lange-Lerner or by Hayek, as the case may be. In both cases, it was inconvenient to ponder that Mises continued to elaborate his position with a penetrating critique of his critics, or that Mises's "extreme" formulation may, after all, have been correct.[10]

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[9]Here, as in other parts of his argument—as we shall see further below—Mises is leaning over backward to concede the market socialists their best case, and is not considering whether such free consumer or labor markets are really likely in a world where the state is the only seller, as well as the only purchaser, of labor.

[10]Mises's later rebuttal is in his *Human Action* (New Haven, Conn.: Yale University Press, 1949), pp. 694–711. For the establishment, the debate was supposed to be over by 1938. For an example of a Hayekian survey of the debate that does not bother to so much as mention *Human Action*, see Karen I. Vaughn, "Introduction," in Hoff, *Economic Calculation*, pp. ix–xxxvii. Indeed, in an earlier paper, Vaughn had sneered that "Mises's so-called final refutation in *Human Action* is mostly polemic and glosses

Mises began his rebuttal in *Human Action* by discussing the "trial-and-error" method, and pointing out that this process only works in the capitalist market. There the entrepreneurs are strongly motivated to make greater profits and to avoid losses, and further, such a criterion does not apply to the capital goods or land market under socialism where all resources are controlled by one entity, the government.

Continuing his reply, Mises pressed on to a brilliant critique, not only of socialism, but of the entire Walrasian general equilibrium model. The major fallacy of the "market socialists," Mises pointed out, is that they look at the economic problem from the point of view of the manager of the individual firm, who seeks to make profits or avoid losses within a rigid framework of a given, external allocation of capital to each of the various branches of industry and indeed to the firm itself. In other words, the "market socialist" manager is akin, not to the real driving force of the capitalist market, the capitalist entrepreneur, but rather to the relatively economically insignificant manager of the corporate firm under capitalism. As Mises brilliantly puts it:

> the cardinal fallacy implied in [market socialist] proposals is that they look at the economic problem from the perspective of the subaltern clerk whose intellectual horizon does not extend beyond subordinate tasks. They consider the structure of industrial production and the allocation of capital to the various branches and production aggregates as rigid, and do not take into account the necessity of altering this structure in order to adjust it to changes in conditions. . . . They fail to realize that the operations

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over the real problems." Vaughn, "Critical Discussion of the Four Papers," in Lawrence Moss, ed. *The Economics of Ludwig von Mises* (Kansas City: Sheed and Ward, 1976), p. 107. The Hayekian doctrine will be treated further below.

For a refreshing example of an outstanding Misesian contribution to the debate that does not neglect or deprecate Human Action but rather builds upon it, see Joseph T. Salerno, "Ludwig von Mises as Social Rationalist," *Review of Austrian Economics* 4 (1990): 36–48. Also see Salerno, "Why Socialist Economy is Impossible," a Postscript to Mises, *Economic Calculation in the Socialist Commonwealth* (Auburn, Ala.: Ludwig von Mises Institute, 1990).

> of the corporate officers consist merely in the loyal execution of the tasks entrusted to them by their bosses, the shareholders. . . . The operations of the managers, their buying and selling, are only a small segment of the totality of market operations. The market of the capitalist society also performs those operations which allocate the capital goods to the various branches of industry. The entrepreneurs and capitalists establish corporations and other firms, enlarge or reduce their size, dissolve them or merge them with other enterprises; they buy and sell the shares and bonds of already existing and of new corporations; they grant, withdraw, and recover credits; in short they perform all those acts the totality of which is called the capital and money market. It is these financial transactions of promoters and speculators that direct production into those channels in which it satisfies the most urgent wants of the consumers in the best possible way.[11]

Mises goes on to remind the reader that the corporate manager performs only a "managerial function," a subsidiary service that "can never become a substitute for the entrepreneurial function." Who are the capitalist-entrepreneurs? They are "the speculators, promoters, investors and moneylenders, [who] in determining the structure of the stock and commodity exchanges and of the money market, circumscribe the orbit within which definite tasks can be entrusted to the manager's discretion." The crucial question, Mises continues, is not managerial activities, but: "In which branches should production be increased or restricted, in which branches should the objective of production be altered, what new branches should be inaugurated?" In short, the crucial decisions in the capitalist economy are the allocation of capital to firms and industries. With regard to these issues," Mises adds,

> it is vain to cite the honest corporation manager and his well-tried efficiency. Those who confuse entrepreneurship and management close their eyes to the economic problem. . . . The capitalist system is not a managerial system; it is an entrepreneurial system.

But here, Mises triumphantly concludes, no "market socialist" has ever suggested preserving or carrying over, much less understood the importance of, the specifically entrepreneurial functions of capitalism:

[11]Mises, *Human Action*, pp. 703–04.

> Nobody has ever suggested that the socialist commonwealth could invite the promoters and speculators to continue their speculations and then deliver their profits to the common chest. Those suggesting a quasi-market for the socialist system have never wanted to preserve the stock and commodity exchanges, the trading in futures, and the bankers and money-lenders as quasi-institutions.[12]

Mises has been cited as stating, in *Human Action*, that it is absurd for the socialist planning board to tell their managers to "play market," to act *as if* they are owners of their firms in trying to maximize profits and avoid losses. But it is important to stress that Mises was focusing, not so much on the individual managers of socialist "firms," but on the speculators and investors who decide the crucial allocations of capital throughout the structure of industry. It is at least conceivable that one can order a manager to play market and act as if he were enjoying the profits and suffering losses; but it is clearly ludicrous to ask investors and capital speculators to act as if their fortunes were at stake. As Mises adds:

> one cannot *play* speculation and investment. The speculators and investors expose their own wealth, their own destiny. This fact makes them responsible to the consumers, the ultimate bosses of the capitalist economy. If one relieves them of this responsibility, one deprives them of their very character.[13]

One time, during Mises's seminar at New York University, I asked him whether, considering the broad spectrum of economies from a purely free market economy to pure totalitarianism, he could single out one criterion according to which he could say that an economy was essentially "socialist" or whether it was a market economy. Somewhat to my surprise, he replied readily: "Yes, the key is whether the economy has a stock market." That is, if the economy has a full-scale market in titles to land and capital goods. In short: Is the allocation of capital basically determined by government or by private owners? At the time, I did not fully understand the vital importance of Mises's answer, which I realized recently when poring

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[12]Ibid., pp. 704–05.

[13]Ibid., p. 705.

over the great merits of the Misesian, as compared to the Hayekian, analysis of the socialist calculation problem.

For Mises, in short, the key to the capitalist market economy and its successful functioning is the entrepreneurial forecasting and decisionmaking of private owners and investors. The key is emphatically *not* the more minor decisions made by corporate managers within a framework already set by entrepreneurs and the capital markets. And it is obvious that Lange, Lerner, and the other market socialists merely envisioned the relatively lesser managerial decisions. These economists, who had never grasped the function of speculation or capital markets, therefore had no idea that they would need to be or could be replicated in a socialist system.[14] And this is not surprising, since in the Walrasian general micro-equilibrium model, there is no capital structure, there is no role for capital, and capital theory has become totally submerged into "growth theory," that is, growth of a homogeneous "level," or blob, of aggregate macro-capital. The allocation of capital is considered external and given, and receives no consideration.

## The Structure of Capital

Joseph Schumpeter and Frank H. Knight are interesting examples of two eminent economists who were personally anti-socialist but were seduced by their Walrasian devotion to general equilibrium and their lack of a genuine capital theory into strongly endorsing the orthodox view that there is no economic calculation problem under socialism. In particular, in capital theory, both Schumpeter and Knight were disciples of J.B. Clark, who denied any role at all for time in the process of production. For Schumpeter, production takes no time because production and consumption are somehow always "synchronized." Time is erased from the picture, even to assuming away the existence of any accumulated stocks of capital goods, and therefore of any age structure of such goods. Since production is magically

[14]The fact that some socialist bloc countries, such as Hungary, now permit a stock market, albeit small and truncated, and that other ex-communist countries are seriously considering introducing such capital markets, demonstrates the enormous importance of the de-socialization now under way in Eastern Europe.

synchronized, there is then no necessity for land or labor to receive advances in payment from capitalists out of accumulated savings. Schumpeter achieves this feat by sundering capital completely from its embodiment in capital goods, and limiting the concept to a money fund used to purchase such goods.[15]

Frank Knight, the doyen of the Chicago School, was also an ardent believer in the Clarkian view that time preference has no influence on interest paid by producers, and that production is synchronized so that time plays no role in the production structure. Hence, Knight believed, along with modern orthodoxy, that capital is a homogeneous, self-perpetuating blob that *has no* lattice-like, time-oriented structure. Knight's fiercely anti-Böhm-Bawerkian, anti-Austrian views on capital and interest led him to a then-famous war of journal articles over capital theory during the 1930s, a war he won by default when Austrianism disappeared because of the Keynesian Revolution.[16]

In his negative review of Mises's *Socialism*, Frank Knight, after hailing Lange's "excellent" 1936 article, brusquely dismisses the socialist calculation debate as "largely sound and fury." To Knight, it is simply "truistical" that the "technical basis of economic life" would continue as before under socialism, and that therefore "the managers of various technical units in production—farms, factories, railways, stores, etc.—would carry on in essentially the same way." Note, there is no reference whatever to the crucial capital market, or to the allocation of capital to various branches of production. If capital is an

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[15]See Murray N. Rothbard, "Breaking Out of the Walrasian Box: The Cases of Schumpeter and Hansen," *Review of Austrian Economics* 1 (1987): 98–100, 107; included in this volume as chapter 14.

[16]On Knight vs. Hayek, Machlup, and Boulding in the 1930s, see F.A. Hayek, "The Mythology of Capital," in W. Feliner and B. Haley, eds., *Readings in the Theory of Income Distribution* (Philadelphia: Blakiston, 1946), pp. 355–83. For a Knightian attack on the Austrian discounted marginal productivity theory on behalf of what is now the orthodox undiscounted (by time-preference) marginal productivity theory, see Earl Rolph, "The Discounted Marginal Productivity Doctrine," ibid., pp. 278–93. For an Austrian rebuttal, see Murray N. Rothbard, *Man, Economy, and State* (Los Angeles: Nash, 1970), vol. 1, pp. 431–33; and Walter Block, "The DMVP-MVP Controversy: A Note," *Review of Austrian Economics* 4 (1990): 199–207.

automatically renewing homogeneous blob, all one need worry about is growth in the amount of that blob. Hence, Knight concludes that "socialism is a political problem, to be discussed in terms of social and political psychology, and economic theory has relatively little to say about it."[17] Certainly, that is true of Knight's orthodox-Chicagoite brand of economic theory!

It is instructive to compare the naïvete and the brusque dismissal of the problem by Schumpeter and Knight with the penetrating Misesian critique of socialism by Professor Georg Halm:

> Because capital is no longer owned by many private persons, but by the community, which itself disposes of it directly, a rate of interest can no longer be determined. A pricing process is always possible only when demand and supply meet in a market. . . . In the socialist economy . . . there can be no demand and no supply when the capital from the outset is in the possession of its intending user, in this case the socialistic central authority.
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> Now it might perhaps be suggested that, since the rate of interest cannot be determined automatically, it should be fixed by the central authority. But this likewise would be quite impossible. It is true that the central authority would know quite well

[17]Frank H. Knight, "Review of Ludwig von Mises, *Socialism*," *Journal of Political Economy* 46 (April 1938): 267–68. In another review in the same issue of the journal, Knight claims that there would be a "capital market" under socialism, but it is clear that he is referring only to a market for loans, and not to a genuine market in equities throughout the production structure. Here again, Mises has a devastating critique of this sort of scheme in *Human Action*, pointing out that managers bidding for governmental planning board funds would not be bidding for or staking their own property, and hence they would

> not be restrained by any financial dangers they themselves run in promising too high a rate of interest for the funds borrowed. . . . All the hazards of this insecurity fall only upon society, the exclusive owner of all resources available. If the director were without hesitation to allocate the funds available to those who bid most, he would simply abdicate in favor of the least scrupulous visionaries and scoundrels.

See Knight, "Two Economists on Socialism," *Journal of Political Economy* 46 (April 1938): 248; and Mises, *Human Action*, p. 705.

> how many capital goods of a given kind it possessed or could procure . . . ; it would know the capacity of the existing plant in the various branches of production; but it would not know how scarce capital was. For the scarcity of means of production must always be related to the demand for them, whose fluctuations give rise to variations in the value of the good in question. . . .
>
> If it should be objected that a price for consumption-goods would be established, and that in consequence the intensity of the demand and so the value of the means of production would be determinate, this would be a further serious mistake. . . . The demand for means of production, labor and capital goods, is only indirect.

Halm goes on to add that if there were only one single factor of production in making consumers' goods, the socialist "market" might be able to determine its proper price. But this can not be true in the real world where *several* factors of production take part in the production of goods in various markets.

Halm then adds that the central authority, contrary to his above concession, would not *even* be able to find out how much capital it is employing. For capital goods are heterogeneous, and therefore how "can the total plant of one factory be compared with that of another? How can a comparison be made between the values of even only two capital-goods?" In short, while under capitalism such comparisons can be made by means of money prices set on the market for every good, in the socialist economy the absence of genuine money prices arising out of a market precludes any such value comparisons. Hence, there is also no way for a socialist system to rationally estimate the costs (which are dependent on prices in factor markets) of any process of production.[18]

## Mises's Rebuttal: Valuation and Monetary Appraisement

In his original 1920 article, Mises emphasized that "as soon as one gives up the conception of a freely established monetary price for

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[18]Georg Halm, "Further Considerations on the Possibility of Adequate Calculation in a Socialist Community," in Hayek, ed., *Collectivist Economic Planning*, pp. 162–65. Also see ibid., pp. 13–20.

goods of a higher order, rational production becomes completely impossible." Mises then states, prophetically:

> One may anticipate the nature of the future socialist society. There will be hundreds and thousands of factories in operation. Very few of these will be producing wares ready for use; in the majority of cases what will be manufactured will be unfinished goods and production goods. All these concerns will be interrelated. Every good will go through a whole series of stages before it is ready for use. In the ceaseless toil and moil of this process, however, the administration will be without any means of testing their bearings. It will never be able to determine whether a given good has not been kept for a superfluous length of time in the necessary processes of production, or whether work and material have not been wasted in its completion. How will it be able to decide whether this or that method of production is the more profitable? At best it will only be able to compare the quality and quantity of the consumable end-product produced, but will in the rarest cases be in a position to compare the expenses entailed in production.

Mises points out that while the government may be able to know what ends it is trying to achieve, and what goods are most urgently needed, it will have no way of knowing the other crucial element required for rational economic calculation: valuation of the various means of production, which the capitalist market can achieve by the determination of money prices for all products and their factors.[19]

Mises concludes that, in the socialist economy "in place of the economy of the 'anarchic' method of production, recourse will be had to the senseless output of an absurd apparatus. The wheels will turn, but will run to no effect."[20]

Moreover, in his later rebuttal to the champions of the Pareto-Barone equations, Mises points out that the crucial problem is not simply that the economy is not and can never be in the general equilibrium state described by these differential equations. In addition to

[19]Mises, "Economic Calculation in the Socialist Commonwealth," pp. 106–08.

[20]Ibid., p. 106. This conclusion of 1920 is strikingly close to the quip common in the Poland of 1989, as reported by Professor Krzyztof Ostazewaki of the University of Louisville: that the socialist planned economy is "a value-shredding machine run by an imbecile."

other grave problems with the equilibrium model (e.g., that the socialist planners do not now know their value scales in future equilibrium; that money and monetary exchange cannot fit into the model; that units of productive factors are neither perfectly divisible nor infinitesimal—and that marginal utilities of different people cannot be equated—on the market or anywhere else), the equations "do not provide any information about the human actions by means of which the hypothetical state of equilibrium" has been or can be reached. In short, the equations offer no information whatever on how to get from the existing disequilibrium state to the general equilibrium goal.

In particular, Mises points out, "even if, for the sake of argument, we assume that a miraculous inspiration has 'enabled' the director without economic calculation to solve all problems concerning the most advantageous arrangement of all production activities and that the price image of the final goal he must aim at is present to his mind," there remain crucial problems on the path from here to there. For the socialist planner does not start from scratch and then build a capital goods structure most perfectly designed to meet his goals. He necessarily starts with a capital goods structure produced at many stages of the past and determined by past consumer values and past technological methods of production. There are different degrees of such past determinants built into the existing capital structure, and anyone starting today must use these resources as best he can to meet present and expected future goals. For these heterogeneous choices, no mathematical equations can be of the slightest use.[21]

Finally, the unique root of Mises's position, and one that distinguishes him and his "socialist impossibility" thesis from Hayek and the Hayekians, has been neglected until the present day. And this neglect has persisted despite Mises's own explicit avowal in his memoirs of

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[21]Mises, *Human Action*, pp. 706–09. As Mises puts it:

> socialists of all shades of opinion, repeat again and again that what makes the achievement of their ambitious plans realizable is the enormous wealth hitherto accumulated. But in the same breath they disregard the fact that this wealth consists to a great extent in capital goods produced in the past and more or less antiquated from the point of view of our present valuations and technological knowledge. (Ibid., p. 710)

the root and groundwork of his calculation thesis.[22] For Mises was *not*, like Hayek and his followers, concentrating on the flaws in the general equilibrium model when he arrived at his position; nor was he led to his discussion solely by the triumph of the socialist revolution in the Soviet Union. For Mises records that his position on socialist calculation emerged out of his first great work, *The Theory of Money and Credit* (1912). In the course of that notable integration of monetary theory and "micro" marginal utility theory, Mises was one of the very first to realize that subjective valuations of the consumers (and of laborers) on the market are purely ordinal, and are in no way measurable. But market prices are cardinal and measurable in terms of money, and market money prices bring goods into cardinal comparability and calculation (e.g., a $10 hat is "worth" five times as much as a $2 loaf of bread).[23] But Mises realized that this insight meant it was absurd to say (as Schumpeter would) that the market "imputes" the values of consumer goods back to the factors of production. Values are not directly "imputed"; the imputation process works only indirectly, by means of money prices on the market. Therefore socialism, necessarily devoid of a market in land and capital goods, must lack the ability to calculate and compare goods and services, and therefore any rational allocation of productive resources under socialism is indeed *impossible*.[24]

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[22]In Mises's *Notes and Recollections* (Spring Mills, Penn.: Libertarian Press, 1978), p. 112. Also see the discussion in Murray N. Rothbard, *Ludwig von Mises: Scholar, Creator, Hero* (Auburn, Ala.: Ludwig von Mises Institute, 1988), pp. 35–38.

[23]On the market, then, consumers evaluate goods and services ordinally, whereas entrepreneurs appraise (estimate and forecast future prices) cardinally. On valuation and appraisement, see Mises, *Human Action*, pp. 327–330; Salerno, "Mises as Social Rationalist," pp. 39–49; and Salerno, "Socialist Economy is Impossible."

[24]Mises says in his memoirs:

> They [the socialists] failed to see the very first challenge: How can economic action that always consists of preferring and setting aside, that is, of making unequal valuations, be transformed into equal valuations, by the use of equations? Thus the advocates of socialism came up with the absurd recommendation of substituting equations of mathematical catallactics, depicting an

For Mises, then, his work on socialist calculation was part and parcel of his expanded integration of direct and monetary exchange, of "micro" and "macro," that he had begun but not yet completed in *The Theory of Money and Credit*.[25]

## Fallacies of Hayek and Kirzner

The orthodox line of the 1930s and 40s was wrong in claiming that Hayek and his followers (such as Lionel Robbins) abandoned Mises's "theoretical" approach by bowing down to the Pareto-Barone equations, falling back on "practical" objections to socialist planning.[26] As we have already seen, Hayek scarcely ceded to mathematical equations of general equilibrium the monopoly of correct economic theory. But it is also true that Hayek and his followers fatally and radically changed the entire focus of their "Austrian" position, either by misconstruing Mises's argument or by consciously though silently shifting the crucial terms of the debate.

It is no accident, in short, that Hayek and the Hayekians dropped Mises's term "impossible" as embarrassingly extreme and imprecise. For Hayek, the major problem for the socialist planning board is its lack of *knowledge*. Without a market, the socialist planning board has no means of knowing the value-scales of the consumers, or the supply of resources or available technologies. The capitalist economy is, for Hayek, a valuable means of disseminating knowledge from one individual to another through the pricing "signals" of the free market. A static, general equilibrium economy would be able to overcome the Hayekian problem of dispersed knowledge, since eventually all data would come to be known by all, but the everchanging, uncertain data of the real world prevents the socialist planning board from acquiring such knowledge. Hence, as is usual for Hayek, the argument for the free economy and against statism rests on an argument from ignorance.

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image from which human action is eliminated, for the monetary calculation in the market economy. (Mises, *Notes and Recollections*, p. 112)

[25]This integration was later completed by his business-cycle theory in the 1920s, and then in his monumental treatise *Human Action*.

[26]Except for the unfortunate emphasis of Hayek and Robbins on the alleged socialist difficulty of computing or "counting" the equations. See below.

But to Mises the central problem is not "knowledge." He explicitly points out that *even if* the socialist planners knew perfectly, and eagerly wished to satisfy, the value priorities of the consumers, and even if the planners enjoyed a perfect knowledge of all resources and all technologies, they *still* would not be able to calculate, for lack of a price system of the means of production. The problem is not knowledge, then, but calculability. As Professor Salerno points out, the *knowledge* conveyed by present—or immediate "past"—prices is consumer valuations, technologies, supplies, etc. of the immediate or recent past. But what acting man is interested in, in committing resources into, production and sale, is future prices, and the present committing of resources is accomplished by the entrepreneur, whose function is to *appraise*—to anticipate—future prices, and to allocate resources accordingly. It is precisely this central and vital role of the *appraising entrepreneur*, driven by the quest for profits and the avoidance of losses, that cannot be fulfilled by the socialist planning board, for lack of a market in the means of production. Without such a market, there are no genuine money prices and therefore no means for the entrepreneur to calculate and appraise in cardinal monetary terms.

More philosophically, the entire Hayekian emphasis on "knowledge" is misplaced and misconceived. The purpose of human action is not to "know" but to employ means to satisfy goals. As Salerno perceptively summarizes Mises's position:

> The price system is not—and praxeologically cannot be—a mechanism for economizing and communicating the knowledge relevant to production plans [the Hayekian position]. The realized prices of history are an accessory of appraisement, the mental operation in which the faculty of understanding is used to assess the quantitative structure of price relationships which corresponds to an anticipated constellation of economic data. Nor are anticipated future prices tools of knowledge; they are instruments of economic calculation. And economic calculation itself is not the means of acquiring knowledge, but the very prerequisite of rational action within the setting of the social division of labor. It provides individuals, whatever their endowment of knowledge, the indispensable tool for attaining a mental grasp and comparison of the means and ends of social action.[27]

[27]Salerno, "Mises as Social Rationalist," p. 44.

In a recent article, Professor Israel Kirzner argues for the Hayekian position. For Hayek and for Kirzner, the market is a "discovery procedure," that is, an unfolding of knowledge. There is, in this view of the market and of the world, no genuine recognition of the entrepreneur, not as a "discoverer," but as a dynamic risk taker, risking losses if his appraisal and forecast go awry. Kirzner's commitment to the "discovery process" fits all too well with his own original concept of the entrepreneurial function as being that of "alertness," and of different entrepreneurs as being variously alert to the opportunities that they see and discover. But this outlook totally misconceives the role of the entrepreneur. The entrepreneur is not simply "alert"; he forecasts; he appraises; he meets and bears risk and uncertainty by questing for profits and risking losses. As Salerno points out, for all their talk of dynamism and uncertainty, the Hayek-Kirzner "entrepreneur" is curiously bloodless and passive, receiving and passively imbibing knowledge imparted to him by the market. The Hayek-Kirzner entrepreneur is far closer than they like to think to the Walrasian automaton, to the fictional "auctioneer" who avoids all real trades in the marketplace.[28]

Unfortunately, while lucidly expounding the Hayekian position, Kirzner obfuscates the history of the debate by claiming that the later Mises, along with Hayek, changed his position (or, at the least, "elaborated" it) from his original, "static" view of 1920. But on the contrary, as Salerno points out, the "later" Mises explicitly spurned uncertainty of the future as the key to the calculation problem. The key to the calculation question, stated Mises in *Human Action*, is *not* that "all human action points to the future and the future is always uncertain." No, socialism has

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[28]Israel M. Kirzner, "The Economic Calculation Debate: Lessons for Austrians," *Review of Austrian Economics* 2 (1988): 1–18. Hayek coined the term "discovery procedure" in F.A. Hayek, "Competition as a Discovery Procedure," in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1978), pp. 179–90. For a critique of Kirzner's concept of entrepreneurship, see Murray N. Rothbard, "Professor Hébert on Entrepreneurship," *Journal of Libertarian Studies* 7 (Fall, 1985): 281–85. For Hayek's own contributions to the socialist calculation debate after Lange-Lerner, see F.A. Hayek, "Socialist Calculation III: The Competitive 'Solution'" (1940), and "The Use of Knowledge in Society," (1945), in I*ndividualism and Economic Order*, pp. 181–208, 77–91.

quite a different problem. Today we calculate from the point of view of our present knowledge and. of our present anticipation of future conditions. We do not deal with the problem of whether or not the [socialist] director will be able to anticipate future conditions. What we have in mind is that the director cannot calculate from the point of view of his own present value judgments and his own present anticipation of future conditions, whatever they may be. If he invests today in the canning industry, it may happen that a change in consumers' tastes or in the hygienic opinions concerning the wholesomeness of canned food will one day turn his investment into a malinvestment. But how can he find out today how to build and equip a cannery most economically?

Some railroad lines constructed at the turn of the century would not have been built if the people had at that time anticipated the impending advance of motoring and aviation. But those who at the time built railroads knew which of the various possible alternatives for the realization of their plans they had to choose from the point of view of their appraisements and anticipations and of the market prices of their day in which the valuations of the consumers were reflected. It is precisely this insight that the director will lack. He will be like a sailor on the high seas unfamiliar with the methods of navigation.[29,30]

## Solving Equations and Lange's Last Word

One of the unfortunate formulations of Hayek and the Hayekians in the 1930s, giving rise to the general misunderstanding that the only problems of socialist planning are "practical" not "theoretical," was their stress on the alleged difficulty of specialist planners in computing or solving all the demand and supply functions, all the "simultaneous differential equations" needed to plan prices and the allocation of resources. If socialistic planning is to rely on the

[29]Mises, *Human Action*, p. 696. Also see Salerno, "Mises as Social Rationalist," pp. 46–47ff.

[30]Kirzner apparently believes that Mises's concentration on entrepreneurship in his *Human Action* discussion of socialism demonstrates that Mises had gone over to the Hayek position. Kirzner seems to overlook the vast difference between Mises's forecasting and appraisement view of entrepreneurship and his own "alertness" doctrine, which totally leaves out the possibility of entrepreneurial loss.

Pareto-Barone equations, then how will all of them be known, especially in a world of necessarily changing data of values, resources, and technology?

Lionel Robbins began this equation-difficulty approach in his study of the 1929 depression, *The Great Depression*. Conceding, with Mises, that the planners could determine consumer preferences by allowing a market in consumer goods, Robbins correctly added that the socialist planners would also have to "know the relative efficiencies of the factors of production in producing all the possible alternatives." Robbins then unfortunately added:

> On paper we can conceive this problem to be solved by a series of mathematical calculations. We can imagine tables to be drawn up expressing the consumers' demands. . . . And we can conceive technical information giving us the productivity . . . which could be produced by each of the various possible combinations of the factors of production. On such a basis a system of simultaneous equations could be constructed whose solution would show the equilibrium distribution of factors and the equilibrium production of commodities.
>
> But in practice this solution is quite unworkable. It would necessitate the drawing up of millions of equations on the basis of millions of statistical tables based on many more millions of individual computations. By the time the equations were solved, the information on which they were based would have become obsolete and they would need to be calculated anew.[31]

While Robbins's strictures about changes in data were and still are true enough, they helped divert the emphasis from Mises's even-if-static and full-knowledge calculation approach, to Hayek's emphasis on uncertainty and change. More important, they gave rise to the general myth that Robbins's strictures against socialism, unlike Mises's, were only "practical" in the sense of not being able to calculate all these simultaneous equations. Furthermore, in the concluding essay in his *Collectivist Economic Planning*, Hayek set forth all the reasons why the planners could not know essential data, one of which is that they would have to solve "hundreds of thousands" of unknowns. But

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[31]Lionel Robbins, *The Great Depression* (New York: Macmillan, 1934), p. 151.

> this means that, at each successive moment, every one of the decisions would have to be based on the solution of an equal number of simultaneous differential equations, a task which, with any of the means known at present, could not be carried out in a lifetime. And yet these decisions would . . . have to be made continuously.[32]

It is fascinating to note the twists and turns in Oskar Lange's reaction to the equation-solving argument. In his 1936 article, which was long considered the last word on the subject, Lange ridiculed the very terms of the problem. Adopting his "quasi-market" socialist approach, and ignoring the crucial Misesian problem of the necessary absence of any market in land or capital, Lange simply stated that there is no need for planners to worry about these equations, since they would be "solved" by the socialist market:

> Neither would the Central Planning Board have to solve hundreds of thousands . . . or millions . . . of equations. The only "equations" which would have to be "solved" would be those of the consumers and the managers of production plants. These are exactly the same "equations" which are solved in the present economic system and the persons who do the "solving" are the same also. Consumers . . . and managers . . . "solve" them by a method of trial and error. . . . And only few of them have been graduated in higher mathematics. Professor Hayek and Professor Robbins themselves "solve" at least hundreds of equations daily, for instance, in buying a newspaper or in deciding to take a meal in a restaurant, and presumably they do not use determinants or Jacobians for that purpose.[33]

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[32]F.A. Hayek, "The Present State of the Debate," in Hayek, *Collectivist Economic Planning*, p. 212.

[33]Oskar Lange, "On the Economic Theory of Socialism, Part One," p. 67. The Norwegian economist and defender of Mises's position, Trygve Hoff, commented that "Quite apart from the fact that the equations the central authority would have to solve are of quite a different nature to those of the private individual, the latter tend to solve themselves automatically, which Dr. Lange must admit the former do not." Hoff, *Economic Calculation in the Socialist Society*, pp. 221–22. This excellent book on the socialist calculation controversy was originally published in Norwegian in 1938. In contrast to Bergson's almost contemporaneous survey article, Hoff's English-language translation, published in 1949 in Britain but not in the United States, sank without a trace.

Thus, the orthodox neoclassical economic establishment had settled the calculation dispute with Lange-Lerner the acclaimed winner. Accordingly, when the end of World War II brought communism/socialism to his native Poland, Professor Oskar Lange left the plush confines of the University of Chicago to play a major role in bringing his theories to bear on the brave new world of socialist Poland. Lange became Polish ambassador to the United States, then Polish delegate to the United Nations Security Council, and finally chairman of the Polish Economic Council. And yet not once in this entire period or later, did Poland—or any other communist government, for that matter—attempt to put into practice anything remotely like Lange's fictive accounting-type, play-at-market socialism. Instead, they all put into effect the good old Stalinist command-economy model.

It did not take long for Oskar Lange to adjust to the persistence of the Stalinist Model. Indeed, it turns out that Lange, in post-war Poland, argued strongly for the historical necessity of the persistence of the Stalinist model as opposed to his own market socialism. Arguing against his own quasi-decentralized solution, Lange, in 1958, revealed that "in Poland, we had some discussions whether such a period of highly centralized planning and management was historical necessity or a great political mistake. Personally, I hold the view that it was a historical necessity."

Why? Lange now claimed:

(a) that the "very process of the social revolution which liquidates one social system and establishes another requires centralized disposal of resources by the new revolutionary state, and consequently centralized management and planning."

(b) second, in underdeveloped countries—and which socialist country was not underdeveloped?—"Socialist industrialization, and particularly very rapid industrialization which was necessary in the first socialist countries, particularly in the Soviet Union . . . requires centralized disposal of resources." Soon, however, Lange promised, the dialectic of history will require the socialist government to organize quasi-market, decentralized decision-making within the overall plan.[34]

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[34]Oskar Lange, "The Role of Planning in Socialist Economy," in *The Political Economy of Socialism* (1958) in M. Bornstein, ed., *Comparative Economic Systems*, rev. ed. (Homewood, Ill.: Richard D. Irwin, 1969), pp. 170–71.

Shortly before his death in 1965, however, Oskar Lange, in his neglected last word on the socialist calculation debate, implicitly revealed that his socialist-market "solution" had been little more than a hoax, to be jettisoned quickly when he indeed saw a way for the Planning Board to solve all those hundreds of thousands or millions of simultaneous equations! Strangely gone was his gibe that everyone "solves equations" every day without having to do so formally. Instead, technology had now supposedly come to the rescue of the Planning Board! As Lange put it:

> Were I to rewrite my essay ["On the Economic Theory of Socialism"] today my task would be much simpler. My answer to Hayek and Robbins would be: so what's the trouble? Let us put the simultaneous equations on an electronic computer and we shall obtain the solution in less than a second. The market process with its cumbersome *tatonnements* appears old-fashioned. Indeed, it may be considered as a computing device of the pre-electronic age.[35]

Indeed, Lange claims that the computer is superior to the market, because the computer can perform long-range planning far better, since it somehow already knows "future shadow prices" which markets cannot seem to obtain.

Lange's naive enthusiasm for the magical planning qualities of the computer in its early days can only be considered a grisly joke to the economists and the people in the socialist countries who have seen their economies go inexorably from bad to far worse despite the use of computers. Lange apparently never became familiar with the computer adage, GIGO ("garbage in, garbage out"). Nor could be have become familiar with the recent estimate of a top Soviet economist that, even assuming that the planning board and its computers could learn the correct data, it would take even the current generation of computers 30,000 years to process the information and allocate the resources.[36]

But there is a more important flaw in Lange's last article than his naivete about the magical powers of the then-new technology of the

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[35]Oskar Lange, "The Computer and the Market," in A. Nove and D. Nuti, eds., *Socialist Economics* (London: Penguin Books, 1972), pp. 401–02.

[36]Yuri M. Maltsev, "Soviet Economic Reform: An Inside Perspective," *The Freeman* (March 1990).

computer. His eagerness to embrace a way of solving those equations he earlier had claimed didn't *need* conscious solving, demonstrates that he had been disingenuous in claiming that his pseudo-market trial-and-error method would provide a facile way for the socialist society to solve the calculation problem.

## Socialist Impossibility and the Argument from Existence

Ever since 1917, or at least since Stalin's great leap forward into socialism in the early 1930s, the defenders of the possibility of socialism against Mises's strictures had one final, clinching, fallback argument. When all the arguments over general equilibrium or equations or entrepreneurship or Walrasian *tatonnements* or the command economy or pseudo-markets had been hashed over, the defenders of socialism could simply fall back on one point: Well, socialism exists, doesn't it? When all is said and done, it exists, and therefore it must be, for one reason or another, possible. Mises must clearly be wrong, even if the "practical" arguments of Hayek or Robbins, arguments of mere degrees of efficiency, need to be soberly considered. At the end of his celebrated survey essay on socialist economics Professor Abram Bergson put the point starkly:

> there can hardly be any room for debate: of course, socialism can work. On this, Lange certainly is convincing. If this is the sole issue, however, one wonders whether at this stage such an elaborate theoretic demonstration is in order. After all, the Soviet planned economy has been operating for thirty years. Whatever else may be said of it, it has not broken down.[37]

In the first place, this triumphal conclusion now rings hollow, since the economies of the Soviet Union and the other socialist bloc countries have now manifestly broken down. And now it also turns out that the Soviet GNP and production figures that Bergson, the CIA, and other Sovietologists have been taking at face value for decades have been nothing but a pack of lies, designed to deceive not the United States, but the Soviet managers' own ruling elite. Even now, Western Sovietologists are reluctant to believe the Soviet economists who are finally trying to tell them the truth about these alleged and much revered data.

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[37]Bergson, "Socialist Economics," p. 447.

But apart from all that, this sort of seemingly decisive empiricist counter to the Misesian critique reveals the perils of using allegedly simple and brute "facts" to rebut theory in the sciences of human action. For why must we assume that the Soviet Union and the Eastern European countries ever really enjoyed full and complete socialism? There are many reasons to believe that, try as they might, the communist rulers were never able to impose total socialism and central planning. For one thing, it is now known that the entire Soviet economy and society has been shot through with a vast network of black markets and evasions of controls, fueled by a pervasive system of bribery known as *blat* to allow escape from those controls. Managers who could not meet their annual production quotas were approached by illegal entrepreneurs and labor teams to help them meet the quotas and get paid off the books. And black markets in foreign exchange have long been familiar to every tourist. Long before the Eastern European collapse of communism, these countries stopped trying to stamp out their black markets in hard currency, even though they were blatantly visible in the streets of Warsaw, Budapest, and Prague. Without uncontrolled black markets fueled by bribery, the communist economies may well have collapsed long ago.[38] This historical point has also been bolstered by Michael Polanyi's "span of control" theory, which denies the possibility of effective central planning from a rather different viewpoint than Mises's.[39]

But the decisive rebuttal has, once again, been levelled by Mises in *Human Action*: the Soviet Union and Eastern European economies were not fully socialist because they were, after all, islands in a world capitalist market. The communist planners were therefore able, albeit clumsily and imperfectly, to use prices set by world markets as indispensable guidelines for the pricing and allocation of capital resources. As Mises pointed out:

> People did not realize that these were not isolated social systems. They were operating in an environment in which the price system

[38]One source on this pervasive system in the Soviet Union is Konstantin M. Simis, *USSR: The Corrupt Society* (New York: Simon and Schuster, 1982).

[39]Michael Polanyi, *The Logic of Liberty* (Chicago: University of Chicago Press, 1951), pp. 111–37 and passim.

> still worked. They could resort to economic calculation on the ground of the prices established abroad. Without the aid of these prices their actions would have been aimless and planless. Only because they were able to refer to these foreign prices were they able to calculate, to keep books, and to prepare their much talked about plans.[40]

Mises's insight was confirmed as early as the mid-1950s, when the British economist Peter Wiles visited Poland, where Oskar Lange was helping to plan Polish socialism. Wiles asked the Polish economists how they planned the economic system. As Wiles reported:

> What actually happens is that "world prices," i.e., *capitalist world prices*, are used in all intra-[Soviet] bloc trade. They are translated into rubles . . . entered into bilateral clearing accounts.

Wiles then asked the Polish communist planners the crucial question. Since the Poles were, as good Marxist-Leninists, presumably committed to the triumph, as soon as possible, of world-wide socialism, Wiles asked: "What would you do if there were no capitalist world" from which you could obtain all those crucial prices? The Polish planners' rather cynical answer: "We'll cross that bridge when we come to it." Wiles added that "In the case of electricity the bridge is already under their feet: there has been great difficulty in pricing it since there is no world market."[41] But fortunately for the world and for the Polish planners themselves, they were never truly forced to cross that bridge.

## Epilogue: The End of Socialism and Mises's Statue

In his supposedly definitive article of 1936 vindicating economic calculation under socialism, Oskar Lange delivered a once-famous gibe at Ludwig von Mises. Lange began his essay by ironically hailing Mises's services to socialism:

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[40]Mises, *Human Action*, pp. 698–99.

[41]Peter J.D. Wiles, "Changing Economic Thought in Poland," *Oxford Economic Papers* 9 (June 1957): 202–03. Also see Murray N. Rothbard, "Ludwig von Mises and Economic Calculation Under Socialism," in Lawrence Moss, *The Economics of Ludwig von Mises*, pp. 67–77; included in this volume as chapter 44.

> Socialists have certainly good reason to be grateful to Professor Mises, the great *advocatus diaboli* of their cause. For it was his powerful challenge that forced the socialists to recognize the importance of an adequate system of economic accounting . . . the merit of having caused the socialists to approach this problem systematically belongs entirely to Professor Mises.

Lange then went on to taunt Mises:

> Both as an expression of recognition for the great service rendered by him and as a memento of the prime importance of sound economic accounting, a statue of Professor Mises ought to occupy an honorable place in the great hall of the Ministry of Socialization or of the Central Planning Board of the socialist state.

Lange went on to say that "I am afraid that Professor Mises would scarcely enjoy what seemed the only adequate way to repay the debt of recognition incurred by the socialists." For one thing, Lange concluded, to complete Mises's discomfiture

> a socialist teacher might invite his students in a class on dialectical materialism to go and look at the statue, in order to exemplify the Hegelian *List der Vernuft* [cunning of Reason] which made even the staunchest of *bourgeois* economists unwittingly serve the proletarian cause.[42]

Curiously enough, Lange, during his years as socialist planner in Poland, never got around to erecting the statue to Mises at the Ministry of Socialization in Warsaw. Perhaps socialist planning was not successful enough to accord Mises that honor—or perhaps there were not enough resources to build the statue. In any case, the opportunity has been lost. The countries of Eastern Europe now stand in the rubble wrought by what used to be called in the 1930s "the great socialist experiment." Emerging gloriously out of the rubble of the collapse of socialism are a myriad of Misesian economists, to whom socialism is little more than a grisly joke. Even as early as the 1960s it was a common quip among economists that, at international economic conferences, "the Western economists talk about the glories of planning while the Eastern economists talk about the virtues of the free market." Now Misesian economists are springing

[42]Lange, "The Economic Theory of Socialism," p. 53.

out of the ruins of socialism in Poland, Lithuania, Czechoslovakia, Hungary, Yugoslavia (especially Croatia and Slovenia) and the Soviet Union. Neither socialist planning nor Marxism-Leninism hold any charms for the economists of the once-socialist nations.

In all of these countries, the giant statues of Lenin are being unceremoniously toppled from the public squares. Whether or not the coming free societies of Eastern Europe choose to replace them with statues of Ludwig von Mises, as the prophet of their liberation, one thing seems certain: there will be no statues erected to Oskar Lange in Cracow or Warsaw. It is hard to see how even the cunning of Reason and the Hegelian dialectic can make Lange out to be a prophet or an important contributor to the *laissez-faire* Polish economy of the future. Perhaps the closet approach was a bitter quip pervading Eastern Europe during the revolutionary year of 1989: "Communism can be defined as the longest route from capitalism to capitalism."

# 46

# The Myth of Free Banking in Scotland

## "Free Banking" in Scotland

Professor White's *Free Banking in Britain* has already had a substantial impact on the economics profession. The main influence has been exerted by one of the book's major themes: the "wonderful" results of the system of free banking in Scotland, a system that allegedly prevailed from 1716 (or 1727) until suppressed by the Peel Act in 1845.[1] White's Scottish free-banking thesis consists of two crucial propositions. The first is that Scottish banking, in contrast to English, was free during this era; that while the English banking system was dominated by the Bank of England, pyramiding their notes and deposits on top of the liabilities of that central bank, the Scottish system, in stark contrast, was free of the Bank of England. In White's words, Scotland "rather maintained a system of 'each tub on its own bottom.' Each bank held onto its own specie reserves."[2]

The second part of the syllogism is that this free system in some way worked much better than the English. Hence, the triumphant conclusion: that free banking in Scotland was far superior to centrally controlled banking in England. White claims that the salutary effects of free banking in Scotland have been long forgotten, and he raises the hope that current public policy will heed this lesson.

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Originally appeared in *The Review of Austrian Economics* 2, no. 1 (1988): 229–45. This is a review of Lawrence H. White, *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845* (Cambridge: Cambridge University Press, 1984).

[1]On "wonderful" results, see White, *Free Banking*, p. xiii.

[2]Ibid., p. 43.

The influence of White's thesis is remarkable considering the paucity of his research and the thinness of his discussion. In a brief book of less than two hundred pages, only 26 are devoted to the Scottish question, and White admits that he relies for facts of Scottish banking almost solely on a few secondary sources.[3] And yet, White's thesis on Scottish banking has been hastily and uncritically accepted by many diverse scholars, including the present writer.[4] This has been particularly unfortunate because, as I shall demonstrate, both parts of Professor 'White's syllogism are wrong. That is, the Scottish banks were (1) not free—indeed, they too pyramided upon the Bank of England—and (2) not surprisingly, they worked no better than the English banks.

Let me take the second part of Professor White's syllogism first. What is his basis for the conclusion that the Scottish banks worked significantly better than the English banks? Remarkably, there is not a word that they were significantly less inflationary; indeed, there is no attempt to present any data on the money supply, the extent of bank credit, or prices in England and Scotland during this period. White does say that the Scottish banks were marked by greater "cyclical stability," but it turns out that he does not mean that they generated less inflation in booms or less contraction during recessions. By cyclical stability, 'White means solely that the extent of Scottish bank failures was less than in England. Indeed, this is Professor White's *sole* evidence that Scottish banking worked better than English.

But why should lack of bank failure be a sign of superiority? On the contrary, a dearth of bank failure should rather be treated with suspicion, as witness the drop of bank failures in the United States

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[3]Most of the White book, indeed, is devoted to another question entirely—a discussion and analysis of free-banking theorists in Britain during the first half of the nineteenth century. I shall deal with that part of his book subsequently.

[4]Murray N. Rothbard, *The Mystery of Banking* (New York: Richardson and Snyder, 1983), pp. 185–87. Also see the report on a forthcoming *Journal of Monetary Economics* article by Milton Friedman and Anna Jacobson Schwartz in *Fortune* (March 31, 1986): 163. I did have grave preliminary doubts about his Scottish thesis in an unpublished comment on Professor White's paper in 1981, but unfortunately, these doubts did not make their way into the *Mystery of Banking*.

since the advent of the FDIC. It might indeed mean that the banks are doing better, but at the expense of society and the economy faring worse. Bank failures are a healthy weapon by which the market keeps bank credit inflation in check; an absence of failure might well mean that that check is doing poorly and that inflation of money and credit is all the more rampant. In any case, a lower rate of bank failure can scarcely be accepted as any sort of evidence for the superiority of a banking system.

In fact, in a book that Professor White acknowledges to be the definitive history of Scottish banking, Professor Sydney Checkland points out that Scottish banks expanded and contracted credit in a lengthy series of boom-bust cycles, in particular in the years surrounding the crises of the 1760s, 1772, 1778, 1793, 1797, 1802–03, 1809–10, 1810–11, 1818–19, 1825–26, 1836–37, 1839, and 1845–47.[5] Apparently, the Scottish banks escaped none of the destabilizing, cycle-generating behavior of their English cousins.

Even if free, then, the Scottish banking system worked no better than central-bank-dominated English banking. But I turn now to Professor White's central thesis on Scottish banking: that it, in contrast to English banking, was free and independent, with each bank resting on its own specie bottom. For Scottish banking to be "free," its banks would have to be independent of central banking, with each redeeming its notes and deposits on demand in its own reserves of gold.

From the beginning, there is one embarrassing and evident fact that Professor White has to cope with: that "free" Scottish banks suspended specie payment when England did, in 1797, and, like England, maintained that suspension until 1821. Free banks are not supposed to be able to, or want to, suspend specie payment, thereby violating the property rights of their depositors and noteholders, while they themselves are permitted to continue in business and force payment upon *their* debtors.

White professes to be puzzled at this strange action of the Scottish banks. Why, he asks, did they not "remain tied to specie and let their currency float against the Bank of England note?" His puzzlement would vanish if he acknowledged an evident answer: that Scottish

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[5]Sydney G. Checkland, *Scottish Banking: A History, 1695–1973* (Glasgow: Collins, 1975).

banks were *not* free, that they were in no position to pay in specie, and that they pyramided credit on top of the Bank of England.[6] Indeed, the Scottish banks' eagerness for suspension of their contractual obligations to pay in specie might be related to the fact, acknowledged by White, that specie reserves held by the Scottish banks had averaged from 10 to 20 percent in the second half of the eighteenth century, but then had dropped sharply to a range of less than 1 to 3 percent in the first half of the nineteenth. Instead of attributing this scandalous drop to "lower costs of obtaining specie on short notice" or "lower risk of substantial specie outflows," White might realize that suspension meant that the banks would not have to worry very much about specie at all.[7]

Professor Checkland, indeed, presents a far more complete and very different account of the suspension crisis. It began, not in 1797, but four years earlier, in the banking panic that struck on the advent of the war with France. Representatives of two leading Scottish banks immediately went to London, pleading for government intervention to bail them out. The British government promptly complied, issuing Treasury bills to "basically sound" banks, of which £400,000 went to Scotland. This bailout, added to the knowledge that the government stood ready to do more, allayed the banking panic.

When the Scottish banks followed the Bank of England in suspending specie payments in 1797, White correctly notes that the suspension was illegal under Scottish law, adding that it was "curious" that their actions were not challenged in court. Not so curious, if we realize that the suspension obviously had the British government's tacit consent. Emboldened by the suspension, and by the legality of bank issue of notes under £1 after 1800, a swarm of new banks entered the field in Scotland, and Checkland informs us that the circulation of bank paper in Scotland doubled from 1793 to 1803.

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[6]In a footnote, Professor White grudgingly hints at this point, while not seeming to realize the grave implications of the facts for his own starry-eyed view of Scottish banking. Note, then, the unacknowledged implications of his hint that London was "Britain's financial centre," that the Scottish banks depended on funds from their correspondent banks and from sales of securities in London, and that Britain was an "optimal currency area." White, *Free Banking*, p. 46 and 12*n*.

[7]White, *Free Banking*, pp. 43–44, 9*n*.

Before the Scottish banks suspended payment, all Scottish bank offices were crowded with depositors demanding gold and small-note holders demanding silver in payment. They were treated with contempt and loathing by the bankers, who denounced them as the "lowest and most ignorant classes" of society, presumably for the high crime of wanting their money out of the shaky and inherently bankrupt banking system. Not only the bankers, but even elite merchants from Edinburgh and throughout Scotland complained, in 1764, of "obscure people" demanding cash from the banks, which they then had the effrontery to send to London and profit from the rate of exchange.[8] Particularly interesting, for more than just the twenty-four years of the British suspension, was the reason the Scottish banks gave for turning to suspension of specie payments. As Checkland summed up, the Scottish banks were "most gravely threatened, for the inhibitions against demanding gold, so carefully nurtured in the customers of Scottish banks, was rapidly breaking down."[9]

Now I come to the nub: that, as a general rule, and not just during the official suspension period, the Scottish banks redeemed in specie in name only; that, in substance, depositors and note holders generally could not redeem the banks' liabilities in specie. The reason that the Scottish banks could afford to be outrageously inflationary, i.e., keep their specie reserves at a minimum, is that, in practice, they did not really have to pay.

Thus, Professor Checkland notes that, long before the official suspension, "requests for specie [from the Scottish banks] met with disapproval and almost with charges of disloyalty." And again:

> The Scottish system was one of continuous partial suspension of specie payments. No one really expected to be able to enter a Scots bank . . . with a large holding of notes and receive the equivalent immediately in gold or silver. They expected, rather, an argument, or even a rebuff. At best they would get a little specie and perhaps bills on London. If they made serious trouble, the matter would be noted and they would find the obtaining of credit more difficult in future.[10]

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[8]See Charles A. Malcolm, *The Bank of Scotland, 1695–1945* (Edinburgh: R. & R. Clark, n.d.).

[9]Checkland, *Scottish Banking*, p. 221.

[10]Ibid., pp. 184–85.

At one point, during the 1750s, a bank war was waged between a cartel of Glasgow banks, which habitually redeemed in London bills rather than specie, and the banks in Edinburgh. The Edinburgh banks set up a private Glasgow banker, Archibald Trotter, with a supply of notes on Glasgow banks, and Trotter demanded that the banks of his city redeem them, as promised, in specie. The Glasgow banks delayed and dragged their feet, until Trotter was forced to file a law suit for damages for "vexatious delay" in honoring his claims. Finally, after four years in court, Trotter won a nominal victory, but could not get the law to force the Glasgow banks to pay up. *A fortiori*, of course, the banks were not shut down or their assets liquidated to pay their wilfully unpaid debts.

As we have seen, the Scottish law of 1765, providing for summary execution of unredeemed bank notes, remained largely a dead letter. Professor Checkland concludes that "this legally impermissible limitation of convertibility, though never mentioned to public inquiries, contributed greatly to Scottish banking success."[11] No doubt. Of one thing we can be certain: this condition definitely contributed to the paucity of bank failures in Scotland.

The less-than-noble tradition of nonredeemability in Scottish banks continued, unsurprisingly, after Britain resumed specie payments in 1821. As the distinguished economic historian Frank W. Fetter put it, writing about Scotland:

> Even after the resumption of payments in 1821 little coin had circulated; and to a large degree there was a tradition, almost with the force of law, that banks should not be required to redeem their notes in coin. Redemption in London drafts was the usual form of paying noteholders. There was a core of truth in the remark of an anonymous pamphleteer [writing in 1826] "Any southern fool [from south of the Scottish-English border] who had the temerity to ask for a hundred sovereigns, might, if his nerves supported him through the cross examination at the bank counter, think himself in luck to be hunted only to the border."[12]

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[11]Ibid., p. 186.

[12]Frank W. Fetter, *Development of British Monetary Orthodoxy, 1797–1875* (Cambridge, Mass.: Harvard University Press, 1965), p. 122. The anonymous pamphlet was *A Letter to the Right Hon. George Canning* (London, 1826), p. 45. Also see Charles W. Munn, *The Scottish Provincial*

If gold and silver were scarcely important sources of reserves or of grounding for Scottish bank liabilities, what was? Each bank in Scotland stood not on its own bottom, but on the very source of aid and comfort dear to its English cousins—the Bank of England. As Checkland declares: "the principal and ultimate source of liquidity [of the Scottish banks] lay in London, and, in particular, in the Bank of England."[13]

I conclude that the Scottish banks, in the eighteenth and first half of the nineteenth centuries, were neither free nor superior, and that the thesis to the contrary, recently revived by Professor White, is but a snare and a delusion.

## The Free-Banking Theorists Reconsidered

The bulk of *Free Banking in Britain* is taken up, not with a description or analysis of Scottish banking, but with analyzing the

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*Banking Companies, 1747–1864* (Edinburgh: John Donald Pubs., 1981), pp. 140ff.

A similar practice was also prevalent at times in the "free-banking" system in the United States. After the "resumption" of 1817, obstacles and intimidation were often the fate of those who tried to ask for specie for their notes. In 1821, the Philadelphia merchant, economist and state Senator Condy Raguet perceptively wrote to David Ricardo:

> You state in your letter that you find it difficult to comprehend why persons who had a right to demand coin from the Banks in payment of their notes, so long forebore to exercise it. This no doubt appears paradoxical to one who resides in a country where an act of parliament was necessary to protect a bank, but the difficulty is easily solved. The whole of our population are either stockholders of banks or in debt to them. It is not in the interest of the first to press the banks and the rest are afraid. This is the whole secret. An independent man, who was neither a stockholder or debtor, who would have ventured to compel the banks to do justice, would have been persecuted as an enemy of society. (Quoted in Murray N. Rothbard, *The Panic of 1819: Reactions and Policies* [New York: Columbia University Press, 1962], pp. 10–11)

There is unfortunately no record of Ricardo's side of the correspondence.

[13]Checkland, *Scottish Banking*, p. 432. Also see S.G. Checkland, "Adam Smith and the Bankers," in A. Skinner and T. Wilson, eds., *Essays on Adam Smith* (Oxford, England: Clarendon Press, 1975), pp. 504–23.

free-banking controversies in the famous monetary debates of the two decades leading up to Peel's Act of 1844. The *locus classicus* of discussion of free versus central banking in Europe is the excellent work by Vera C. Smith, *The Rationale of Central Banking*.[14] While Professor White makes a contribution by dealing in somewhat more depth with the British controversialists of the era, he unfortunately takes a giant step backward from Miss Smith in his basic interpretation of the debate. Miss Smith realized that the Currency School theorists were hard-money men who saw the evils of bank credit inflation and who tried to eliminate them so that the money supply would as far as possible be equivalent to the commodity standard, gold or silver. On the other hand, she saw that the Banking School theorists were inflationists who favored bank credit expansion in accordance with the "needs of trade." More importantly, Miss Smith saw that for both schools of thought, free banking and central banking were contrasting means to arrive at their different goals. As a result, she analyzes her monetary writers according to an illuminating 2 x 2 grid, with "Currency School" and "Banking School" on one side and "free banking" and "central banking" on the other.

In *Free Banking in Britain*, on the other hand, Professor White retreats from this important insight, misconceiving and distorting the entire analysis by separating the theorists and writers into three distinct camps, the Currency School, Banking School, and Free-Banking School. By doing so, he lumps together analysis and policy conclusions, and he conflates two very distinct schools of free bankers: (1) those who wanted free banking in order to promote monetary inflation and cheap credit and (2) those who, on the contrary, wanted free banking in order to arrive at hard, near-100 percent specie money. The Currency School and Banking School are basically lumped by White into one group: the pro-central-banking faction. Of the two, White is particularly critical of the Currency

[14]Vera C. Smith, *The Rationale of Central Banking* (London: P.S. King and Sons, 1936). This book was a doctoral dissertation under F.A. Hayek at the London School of Economics, for which Miss Smith made use of Hayek's notes on the subject. See Pedro Schwartz, "Central Bank Monopoly in the History of Economic Thought: A Century of Myopia in England," in Pascal Salin, ed., *Currency Competition and Monetary Union* (The Hague: Martinus Nijhoff, 1984), pp. 124–25.

School, which supposedly all wanted central banks to levy "arbitrary" restrictions on commercial banks. While White disagrees with the pro-central-banking aspects of the Banking School, he is clearly sympathetic with their desire to inflate bank credit to supply the "needs of trade." In that way, White ignores the substantial minority of Currency School theorists who preferred free banking to central bank control as a way of achieving 100 percent specie money. In addition, he misunderstands the nature of the inner struggles to find a correct monetary position by *laissez-faire* advocates, and he ignores the vital differences between the two wings of free bankers.

On the Currency School, it is true that most currency men believed in 100 percent reserves issued either by a central bank monopoly of note issue or by an outright state bank monopoly. But, as Smith pointed out, the aim of the currency men was to arrive at a money supply equivalent to the genuine free market money of a pure specie commodity (gold or silver). And furthermore, since currency men tended to be *laissez-faire* advocates distrustful of state action, a substantial minority advocated free banking as a better political alternative for reaching the desired 100 percent gold money than trusting in the benevolence of the state. As Smith notes, Ludwig von Mises was one of those believing that free banking in practice would approximate a 100 percent gold or silver money. Free banking and 100 percent metallic money advocates in the nineteenth century included Henri Cernuschi and Victor Modeste in France, and Otto Hübner in Germany.[15] Mises's approach was very similar to that of Otto Hübner, a leader of the German Free Trade Party. In his multivolume work, *Die Banken* (1854), Hübner states that his ideal preference would have

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[15]After quoting favorably Thomas Tooke's famous dictum that "free trade in banking is free trade in swindling," Mises adds:

> However, freedom in the issuance of banknotes would have narrowed down the use of banknotes considerably if it had not entirely suppressed it. It was this idea which Cernuschi advanced in the hearings of the French Banking Inquiry on October 24, 1865: "I believe that what is called freedom of banking would result in a total suppression of banknotes in France. I want to give everybody the right to issue banknotes so that nobody should take banknotes any longer." (Ludwig von Mises, *Human Action: A Treatise on Economics*, 3rd rev. ed. [Chicago: Henry Regnery, 1966], p. 446)

been a state-run monopoly 100 percent specie reserve bank, along the lines of the old Banks of Amsterdam and Hamburg. But the state cannot be trusted. To quote Vera Smith's paraphrase of Hübner's position:

> If it were true that the State could be trusted always only to issue notes to the amount of its specie holdings, a State-controlled note issue would be the best system, but as things were, a far nearer approach to the ideal system was to be expected from free banks, who for reasons of self-interest would aim at the fulfilment of their obligations.[16]

Henri Cernuschi desired 100 percent specie money. He declared that the important question was not monopoly note issue versus free banking, but whether or not bank notes should be issued at all. His answer was no, since "they had the effect of despoiling the holders of metallic money by depreciating its value." All bank notes, all fiduciary media, should be eliminated. An important follower of Cernuschi's in France was Victor Modeste, whom Vera Smith erroneously dismisses as having "the same attitude" as Cernuschi's. Actually, Modeste did not adopt the free-banking policy conclusion of his mentor. In the first place, Modeste was a dedicated libertarian who frankly declared that the state is "the master . . . the obstacle, the enemy" and whose announced goal was to replace all government by "self-government." Like Cernuschi and Mises, Modeste agreed that freely competitive banking was far better than administrative state control or regulation of banks. And like Mises a half-century later (and like most American currency men at the time), Modeste realized that demand deposits, like bank notes beyond 100

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[16]Smith, *Rationale*, p. 101. Mises, after endorsing the idea of 100 percent reserves to gold of banknotes and demand deposits (the latter unfortunately overlooked by the Currency School in Britain), decided against it because of the "drawbacks inherent in every kind of government interference with banking." And again:

> Government interference with the present state of banking affairs could be justified if its aim were to liquidate the unsatisfactory conditions by preventing or at least seriously restricting any further credit expansion. In fact the chief objective of present-day government interference is to intensify further credit expansion. (Mises, *Human Action*, pp. 443, 448)

percent reserves, are illicit, fraudulent, and inflationary as well as being generators of the business cycle. Demand deposits, like bank notes, constitute "false money." But Modeste's policy conclusion was different. His answer was to point out that "false" demand liabilities that pretend to be but cannot be converted into gold are in reality tantamount to fraud and embezzlement. Modeste concludes that false titles and values, such as false claims to gold under fractional-reserve banking, are at all times

> equivalent to theft; that theft in all its forms everywhere deserves its penalties . . . that every bank administrator . . . must be warned that to pass as value where there is no value . . . to subscribe to an engagement that cannot be accomplished . . . are criminal acts which should be relieved under the criminal law.[17]

The answer to fraud, then, is not administrative regulation, but prohibition of tort and fraud under general law.[18]

For Great Britain, an important case of currency men not discussed by Smith are the famous *laissez-faire* advocates of the Manchester School. Hobbled by his artificial categories, Professor White can only react to them in total confusion. Thus, John Benjamin Smith, the powerful president of the Manchester Chamber of Commerce, reported to the chamber in 1840 that the economic and financial crisis of 1839 had been caused by the Bank of England's contraction, following inexorably upon its own earlier "undue expansion of the currency." Simply because Smith condemned Bank of England policy, White chides Marion Daugherty for putting J.B. Smith into the ranks of the Currency School rather than the free bankers. But then, only four pages later, White laments the parliamentary

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[17]Victor Modeste, "Le Billet des banques d'emission est-il fausse monnaie?" [Are bank notes false money?] *Journal des economistes* 4 (October 1866): 77–78 (translation mine). Also see Henri Cernuschi, *Contre le billet de banque* (1866).

[18]This policy conclusion is completely consistent with Mises's objective: "What is needed to prevent any further credit expansion is to place the banking business under the general rules of commercial and civil laws compelling every individual and firm to fulfill all obligations in full compliance with the terms of the contract." Mises, *Human Action*, p. 443.

For more on fractional-reserve banking as embezzlement, see Rothbard, *Mystery of Banking*, pp. 91–95.

testimony during the same year of Smith and Richard Cobden as revealing "the developing tendency for adherents of *laissez-faire*, who wished to free the currency from discretionary management, to look not to free banking but to restricting the right of issue to a rigidly rule-bound state bank as the solution." So what were Smith, Cobden, and the Manchesterites? Were they free bankers (p. 71) or—in the same year—currency men (p. 75), or what? But how could they have been currency men, since White has defined the latter as people who want total power to accrue to the Bank of England? White avoids this question by simply not listing Smith or Cobden in his table of Currency-banking–Free-Banking School adherents (p. 135).[19]

White might have avoided confusion if he had not, as in the case of Scottish banking, apparently failed to consult Frank W. Fetter's *Development of British Monetary Orthodoxy*, although the book is indeed listed in his bibliography. Fetter notes that Smith, in his parliamentary testimony, clearly enunciates the currency principle. Smith, he points out, was concerned about the fluctuations of the commercial banks as well as of the Bank of England and flatly declared his own Currency School objective: "it is desirable in any change in our existing system to approximate as nearly as possible to the operation of a metallic currency; it is desirable also to divest the plan of all mystery, and to make it so plain and simple that it may be easily understood by all."[20] Smith's proposed solution was the scheme derived from Ricardo, of creating a national bank for purposes of issuing 100 percent reserve bank notes.

The same course was taken, in his testimony, by Richard Cobden, the great leader of the Manchester *laissez-faire* movement. Attacking the Bank of England and any idea of discretionary control over the currency, whether by the Bank or by private commercial banks, Cobden declared:

> I hold all idea of regulating the currency to be an absurdity; the very terms of regulating the currency and managing the currency I

[19]White, *Free Banking*, pp. 71, 75, 135. Also see Marion R. Daugherty, "The Currency-Banking controversy, Part I," *Southern Economic Journal* 9 (October 1942): 147.

[20]Quoted in Fetter, *Development*, p. 176.

> look upon to be an absurdity; the currency should regulate itself; it must be regulated by the trade and commerce of the world; I would neither allow the Bank of England nor any private banks to have what is called the management of the currency. . . . I would never contemplate any remedial measure, which left it to the discretion of individuals to regulate the amount of currency by any principle or standard whatever.[21]

In short, the fervent desire of Richard Cobden, along with other Manchesterians and most other Currency School writers, was to remove government or bank manipulation of money altogether and to leave its workings solely to the free-market forces of gold or silver. Whether or not Cobden's proposed solution of a state-run bank was the proper one, no one can deny the fervor of his *laissez-faire* views or his desire to apply them to the difficult and complex case of money and banking.

Let me now return to Professor White's cherished free-banking writers and to his unfortunate conflation of the very different hard-money and soft-money camps. The Currency School and the free bankers were both launched upon the advent of the severe financial crisis of 1825, which, as usual, was preceded by a boom fueled by bank credit. The crisis brought the widespread realization that the simple return to the gold standard, as effected in 1821, was not enough and that something more had to be done to eliminate the instability of the banking system.[22]

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[21]Ibid.

[22]One measure of partial reform accomplished by the British government was the outlawing, in 1826, of small-denomination (under £5) bank notes (an edict obeyed by the Bank of England for over a century), which at least insured that the average person would be making most transactions in gold or silver coin. Even Adam Smith, the leading apologist for Scottish "free" banking, had advocated such a measure. But it is instructive to note, in view of Professor White's admiration for Scottish banking, that political pressure by the Scottish Tories gained the Scottish banks an exemption from this measure. The Tory campaign was led by the eminent novelist, Sir Walter Scott. Hailing the campaign, the spokesman for Scottish High Toryism, *Blackwood's Edinburgh Magazine*, published two articles on "The Country Banks and the Bank of England" in 1827–28, in which it wove together two major strains of archinflationism: going off the gold standard and praising the country banks. *Blackwood*'s also attacked the Bank of England as overly

Among four leading free-banking advocates of the 1820s and early 1830s—Robert Mushet, Sir John Sinclair, Sir Henry Brooke Parnell, and George Poulett Scrope—Professor White sees little difference. And yet they were split into two very different camps. The earlier writers, Mushet and Parnell, were hard money men. Mushet, a long-time pro–gold-standard "bullionist" and clerk at the Royal Mint, set forth a currency-principle–type of business cycle theory in 1826, pointing out that the Bank of England had generated an inflationary boom, which later had to be reversed into a contractionary depression. Mushet's aim was to arrive at the equivalent of a purely metallic currency, but he believed that free rather than central banking was a better way to achieve it. Once again, White's treatment muddies the waters. While admitting that Mushet took a Currency School approach toward purely metallic money, White still chooses to criticize Daugherty for classifying Mushet with the Currency School, since he opted for a free- rather than a central-banking method to achieve currency goals (p. 62*n*). The more prominent Parnell was also a veteran bullionist writer and Member of Parliament, who took a position very similar to Mushet's.[23]

Sir John Sinclair and George Poulett Scrope, however, were horses of a very different color. White admits that Sinclair was not a pure free-banking man, but he characteristically underplays Sinclair's

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restrictionist (!), thus helping to inaugurate the legend that the trouble with the bank was that it was too restrictive instead of being itself the major engine of monetary inflation. In contrast, the *Westminster Review*, the spokesman for James Mill's philosophic radicals, scoffed at the Scots for threatening "a civil war in defense of the privilege of being plundered" by the banking system. See Fetter, *Development*, pp. 123–24.

[23]Professor White has performed a valuable service in rescuing Parnell's work from obscurity. Parnell's tract of 1827 was attacked from a more consistent hard-money position by the fiery populist radical, William Cobbett. Cobbett averred that "ever since that hellish compound paper-money was understood by me, I have wished for the destruction of the accursed thing: I have applauded every measure that tended to produce its destruction, and censured every measure having a tendency to preserve it." He attacked Parnell's pamphlet for defending the actions of the country banks and for praising the Scottish system. In reply, Cobbett denounced the "Scottish monopolists" and proclaimed that "these ravenous Rooks of Scotland . . . have been a pestilence to England for more than two hundred years."

fervent lifelong views as being concerned with "preventing deflation" and calls Sinclair a "tireless promoter of agricultural interests" (p. 60 and note). In truth, Sinclair, a Scottish nobleman and agriculturist, was, all his life, a determined and fanatical zealot on behalf of monetary inflation and government spending. As soon as the pro-gold-standard, anti-fiat paper Bullion Committee Report was issued in 1810, Sir John wrote to Prime Minister Spencer Perceval urging the government to reprint his own three-volume proinflationist work, *History of the Public Revenues of the British* (1785–90), as part of the vital task of rebutting the Bullion Committee. "You know my sentiments regarding the importance of paper circulation," Sinclair wrote the Prime Minister, "which is in fact the basis of our prosperity." In fact, Sinclair's *Observations on the Report of the Bullion Committee*, published in September 1810, was the very first of many pamphlet attacks on the Bullion Report, most of them orchestrated by the British government.

When Britain went back to the gold standard in 1819–21, Sinclair, joining with the proinflationist and pro-fiat money Birmingham School, was one of the most energetic and bitter critics of resumption of specie payments. It is no wonder that Frank Fetter should depict Sinclair's lifelong enthusiasm: "that more money was the answer to all economic problems."[24] It is also no wonder that Sinclair should have admired the Scottish "free" banking system and opposed the currency principle. But one would have thought that Professor White would feel uncomfortable with Sinclair as his ally.

Another of Professor White's dubious heroes is George Poulett Scrope. While Scrope is also characterized as not a pure or mainstream free-banking man, his analysis is taken very seriously by White and is discussed numerous times. And he is mentioned prominently in White's table as a leading free banker. Scrope's inveterate inflationary bent is handled most gently by White: "Like Sinclair, he [Scrope] placed higher priority on combating deflation" (p. 82*n*). In fact, Scrope not only battled against the return to the gold standard

[24]Fetter, *Development*, p. 22. Among his other sins, Sinclair, an indefatigable collector of statistics, in the 1790s published the twenty-one volume *A Statistical Account of Scotland* and actually introduced the words statistics and statistical into the English language.

in 1819–21, he was also the leading theorist of the fortunately small band of writers in Britain who were ardent underconsumptionists and proto-Keynesians. In his *Principles of Political Economy* (written in 1833, the same year as his major pro-free-banking tract), Scrope declared that any decline in consumption in favor of a "general increase in the propensity to save" would necessarily and "proportionately diminish the demand as compared with the supply, and occasion a general glut."

Let us now turn to the final stage of the Currency School—Banking School—free-banking controversy. The financial crisis of 1838–39 touched off an intensified desire to reform the banking system, and the controversy culminated with the Peel Acts of 1844 and 1845.

Take, for example, one of Professor White's major heroes, James William Gilbart. Every historian except White has included Gilbart among the members of the Banking School. Why does not Professor White? Despite White's assurance, for example, that the Free-Banking School was even more fervent than the Currency School in attributing the cause of the business cycle to monetary inflation, Gilbart held, typically of the Banking School, that bank notes simply expand and contract according to the "wants of trade" and that, therefore, issue of such notes, being matched by the production of goods, could not raise prices. Furthermore, the active causal flow goes from "trade" to prices to the "requirement" for more bank notes to flow into circulation.

Thus said Gilbart: "if there is an increase of trade without an increase of prices, I consider that more notes will be required to circulate that increased quantity of commodities; if there is an increase of commodities and an increase of prices also, of course, you would require a still greater amount of notes."[25] In short, whether prices rise or not, the supply of money must always increase! Putting aside the question of who the "you" is supposed to be in this quote, this is simply rank inflationism of the Banking School variety. In fact, of course no increase of money is "required" in either case. The genuine causal chain is the other way round, from increased bank notes to increased prices, and also to increased money value of the goods being produced.

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[25]Quoted in White, *Free Banking*, p. 124.

Professor White may not be alive to this distinction because he, too, is a follower of the "needs of trade" (or "wants of trade") rationale for bank credit inflation. White's favorable discussion of the needs-of-trade doctrine (pp. 122–26) makes clear that he himself is indeed a variant of Banking-School inflationist. Unfortunately, White seems to think all this to be consonant with the "Humean-Ricardian" devotion to a purely metallic currency (p. 124). For one thing, White does not seem to realize that David Hume, in contrast to his Banking-School friend Adam Smith, believed in 100 percent specie reserve banking.

While Professor White, in the previous quote from Gilbart, cites his Parliamentary testimony in 1841, he *omits* the crucial interchange between Gilbart and Sir Robert Peel. In his testimony, Gilbart declared not only that country bank notes Increase solely in response to the wants of trade and, therefore, that they could never be overissued. He *also* claimed—in keeping with the tenets of the Banking School—that even the Bank of England could never overissue notes so long as it only discounted commercial loans! So much for Professor White's claims of Gilbart's alleged devotion to free banking! There followed some fascinating and revealing colloquies between Peel and the alleged free banker (i.e., pro-free-banking pro-gold-standard) James Gilbart. Peel sharply continued his questioning: "Do you think, then, that the legitimate demands of commerce may always be trusted to, as a safe test of the amount of circulation under all circumstances?" To which Gilbart admitted: "I think they may." (Note: nothing was said about exempting the Bank of England from such trust.)

Peel then asked the critical question. The Banking School (followed by Professor White) claimed to be devoted to the gold standard, so that the "needs of trade" justification for bank credit would not apply to inconvertible fiat currency. But Peel, suspicious of the Banking School's devotion to gold, then asked: In the bank restriction [fiat money] days, "do you think that the legitimate demands of commerce constituted a test that might be safely relied upon?" Gilbart evasively replied: "That is a period of which I have no personal knowledge"—a particularly disingenuous reply from a man who had written *The History and Principles of Banking* (1834). Indeed, Gilbart proceeded to throw in the towel on the gold standard: "I think the legitimate demands of commerce, even then, would be a

sufficient guide to go by." When Peel pressed Gilbart further on that point, the latter began to back and fill, changing and rechanging his views, finally once more falling back on his lack of personal experience during the period.[26]

Peel was certainly right in being suspicious of the Banking School's devotion to the gold standard—whether or not Professor White was later to reclassify them as free bankers. In addition to Gilbart's revelations, Gilbart's fellow official at the London & Westminster Bank, J.W. Bosanquet, kept urging bank suspensions of specie payment whenever times became difficult. And in his popular tract of 1844, *On the Regulation of Currencies*, John Fullarton—a banker in India by then retired in England and a key leader of the Banking School—gave the game away. Wrote Fullarton:

> And, much as I fear I am disgracing myself by the avowal, I have no hesitation in professing my own adhesion to the decried doctrine of the old Bank Directors of 1810, "that so long as a bank issues its notes only on the discount of good bills, at not more than sixty days' date, it cannot go wrong in issuing as many as the public will receive from it.[27]

Fullarton was referring, of course, to the old antibullionist position that so long as any bank, even under an inconvertible currency,

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[26]The interchange between Peel and Gilbart may be found in the important article by Boyd Hilton, "Peel: A Reappraisal," *Historical Journal* 22 (September 1979): 593–94. Hilton shows that Peel (far from being the unprincipled opportunist he had usually been portrayed as by historians) was a man of increasingly fixed classical liberal principles, devoted to minimal budgets, free trade, and hard money. Not understanding economics, however, Hilton characteristically brands Peel's questioning of Gilbart as "inept" and sneers at Peel for scoffing at Gilbart's patent dodge of lacking "personal knowledge."

Moreover, not being a classical liberal, Hilton ridicules Sir Robert Peel's alleged inflexible dogmatism on behalf of *laissez-faire*. It is most unfortunate that White, in his eagerness to censure Peel's attack on inflationary bank credit, praises Hilton's "insightful account of Peel's little-recognized dogmatism on matter of monetary policy" (p. 77*n*). Does White also agree with Hilton's denunciation of Peel's "dogmatism" on free trade?

[27]Quoted in Fetter, *Development*, p. 193.

sticks to short-term real bills, it cannot cause an inflation or a business-cycle boom. It is no wonder that Peel suspected all opponents of the currency principle to be crypto-Birmingham men.[28]

The only distinguished economist to take up the free-banking cause is another one of Professor White's favorites: Samuel Bailey, who had indeed demolished Ricardian value theory in behalf of subjective utility during the 1820s. Now, in the late 1830s and early 1840s, Bailey entered the lists in behalf of free banking. Unfortunately, Bailey was one of the worst offenders in insisting on the absolute passivity of the British country and joint-stock banks as well as in attacking the very idea that there might be something worrisome about changes in the supply of money. By assuring his readers that competitive banking would always provide a "nice adjustment of the currency to the wants of the people," Bailey overlooked the fundamental Ricardian truth that there is never any social value in increasing the supply of money, as well as the insight that bank credit entails a fraudulent issue of warehouse receipts to nonexistent goods.

Finally, Professor White ruefully admits that when it came to the crunch—the Peel Acts of 1844 and 1845 establishing a Bank of England monopoly of note issue and eliminating the "free" banking system of Scotland—his free-banking heroes were nowhere to be found in opposition. White concedes that their support of Peel's acts was purchased by the grant of cartelization. In short, in exchange for Bank of England monopoly on note issue, the existing English and

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[28]Neither is the example of James Wilson reassuring. Wilson, founding editor of the new journal, *The Economist*, was dedicated to *laissez-faire* and to the gold standard. He entered the monetary debate quite late, in spring 1845, becoming one of the major leaders of the Banking School. Though of all the Banking School, Wilson was one of the friendliest to free banking and to the Scottish system, he also claimed that the Bank of England could never overissue notes in a convertible monetary system. And though personally devoted to the gold standard, Wilson even made the same damaging concession as Gilbart, though far more clearly and candidly. For, of all the major Banking School leaders, Wilson was the only one who stated flatly and clearly that no banks could ever overissue notes if they were backed by short-term, self-liquidating real bills, even under an inconvertible fiat standard. See Lloyd Mints, *A History of Banking Theory in Great Britain and the United States* (Chicago: University of Chicago Press, 1945), p. 90.

Scottish banks were "grandfathered" into place; they could keep their existing circulation of notes, while no new competitors were allowed to enter into the lucrative note-issuing business. Thus, White concedes:

> He [Gilbart] was relieved that the [Peel] act did not extinguish the joint-stock banks' right of issue and was frankly pleased with its cartelizing provisions: "Our rights are acknowledged—our privileges are extended—our circulation guaranteed—and we are saved from conflicts with reckless competitors." (p. 79)

Very well. But White avoids asking himself the difficult questions. For example: what kind of a dedicated "free-banking" movement is it that can be so easily bought off by cartel privileges from the state? The answer, which White sidesteps by avoiding the question is precisely the kind of a movement that serves simply as a cloak for the interests of the commercial bankers.

For, with the exception of the older, hard-money free-banking men—such as Mushet (long dead by 1844) and Parnell (who died in the middle of the controversy in 1842)—virtually all of White's free bankers were themselves officials of private commercial banks. Gilbart had been a bank official all his life and had long been manager of the London & Westminster Bank. Bailey was chairman of the Sheffield Banking Company. Consider, for example, the newly founded *Bankers' Magazine*, which White lauds as a crucial organ of free-banking opinion. White laments that a writer in the June 1844 issue of *Bankers' Magazine*, while critical of the currency principle and monopoly issues for the Bank of England, yet approved the Peel Act as a whole for aiding the profits of existing banks by prohibiting all new banks of issue.

And yet, Professor White resists the realization that his entire cherished free-banking movement—at least in its later inflationist "need of trade" manifestation—was simply a special pleading on behalf of the inflationary activities of the commercial banks. Strip away White's conflation of the earlier hard-money free-banking theorists with the later inflationists, and his treasured free-banking movement turns out to be merely special pleaders for bank chicanery and bank credit inflation.

# 47

# Aurophobia: Or, Free Banking on What Standard?

In recent years, disillusionment with the record of central banking has led a number of economists to return to the nineteenth-century concept of "free banking": that is, free and unregulated banking without a central bank. Unfortunately, this return has not been toward the Currency Principle/Mises tradition of free banking within a firm matrix of demand liabilities (notes or deposits) grounded in 100 percent reserves in specie (gold or silver). Instead, this new movement has harked back to the contrasting inflationary credit generated by what used to be known as "wildcat banking." In lauding free banking as akin to a free market in any other good or service, these new free bankers have overlooked two vital defects. First, that a genuine free market must be based on an absence of fraud or theft, whereas issuing demand liabilities in excess of assets is equivalent to a warehouse issuing fraudulent receipts to nonexisting assets, and is therefore a species of fraud or embezzlement. And second, the free bankers neglect the insight of Currency Principle men from Ricardo down, that all quantities of money are optimal, and that therefore in stark contrast to all other goods, increased supplies of money can only be redistributive and can confer no social benefit.[1]

On the first point, we contend that bank notes or deposits are bailments and not debt, and that therefore an issue of fractional

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Originally appeared in *The Review of Austrian Economics* 6, no. 1 (1992): 97–108. Review of *Gold, Greenbacks, and the Constitution*, by Richard H. Timberlake (Berryville, Va.: George Edward Durrell Foundation, 1991).

[1]With the exception, of course, of increased nonmonetary benefit from an increase in gold or silver, a gain that cannot accrue from an increase in fiat paper or in fractional-reserve bank credit.

reserve liabilities can only be a violation of the bailment contract. In addition to the pressure of bankers on the law, one of the reasons why the critical court decisions in the nineteenth century ruled the other way is that bailment law was then in an undeveloped state. In the late nineteenth century, and even in the 1930s in the United States, grain warehouses, which, as in the case of banks, issue warehouse receipts to fungible goods, were able to issue, unchecked and unpunished, fraudulent receipts to nonexistent wheat, which they loaned out to speculators in the Chicago wheat market. Interestingly enough, this fractional-reserve process generated a local boom-bust cycle in Chicago wheat.[2] In a genuinely free market, absent force or fraud, bank loans or investments would reflect only their own equity or their genuine debt (e.g., bonds or certificates of deposit), which would constitute genuine credit transactions—exchange of a present good (e.g., money) for a future good (e.g., money at a future date). Free marketeers are sometimes in danger of forgetting that fraud or robbery can be committed by private organizations as well as by government. As Mises favorably quoted Thomas Tooke, "free trade in banking is free trade in swindling."[3]

On the second, more narrowly economic point, from Ricardo to Mises and his followers it has been demonstrated that an increase in the money supply can only dilute the effectiveness of each existing money unit, and therefore must be "inflationary" in the sense of raising prices beyond what they would have been otherwise. In addition, we know from Mises's theory of the business cycle that such inflationary bank credit can only lead to a destructive boom-bust business cycle. And it is not true, on Misesian theory, that central banking is necessary in order to generate this cyclical process. Any bank credit

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[2]Ours is the view of the losing counsel in the 1816 English case of *Devaynes v. Noble*, who argued that "a banker is rather a bailee of his customer's funds than his debtor . . . because the money in . . . [his] hands is rather a deposit than a debt, and may therefore be instantly demanded and taken up." See J. Milnes Holden, *The Law and Practice of Banking*, vol. 1: *Banker and Customer* (London: Pitman, 1970), p. 31; Murray N. Rothbard, *The Mystery of Banking* (New York: Richardson and Snyder, 1983), pp. 87–95.

[3]Ludwig von Mises, *Human Action*, 3rd rev. ed. (Chicago: Henry Regnery, 1963), p. 446.

expansion in commercial loans is sufficient to generate the business cycle, whether a central bank exists or not. In the Misesian view, however, there will tend to be far more room for bank credit expansion whenever a central bank, with its privileging by government and its role as a lender of last resort, is active in the economy.

The recent free bankers have consisted of a coalition of ex-Misesians (White, Selgin, Glasner), English subjectivists (Dowd), and neo-monetarists or neo-Friedmanites (Yeager, Timberlake). Friedman himself, while not totally committed to free banking, has been indicating his disillusion with the Fed's failure to follow his famed Money Rule (in addition to the increasing monetarist difficulty in figuring out which of the various Ms should be subject to that Rule). Hayek may be added to that list, except that he was never a Misesian on this question, at least since the 1930s.

I do not propose here to rehash the substantial controversy between the modern free bankers and the modern Misesians (Rothbard, Salerno, Hoppe, Skousen, North), much less discuss the older 100 percent tradition (most eighteenth-century British economists, including Hume, except Adam Smith; the Currency School; the Jeffersonians and Jacksonians), or the 100 percent fiat paper reserve tradition of the Chicago School (Fisher, Knight, Simons, Hart, and the early Friedman). What I want to do here is to focus on another vitally important, but neglected, area of the free-banking controversy. Assuming for the sake of argument that banks will be free without restrictions to issue demand liabilities to standard money, what, in the view of the free bankers, is that standard money supposed to be? In a sense, this problem is more important and fundamental than the question of the reserve ratio: What is money, and what is going to be the "standard" money, in which these liabilities are supposed to be redeemable on demand?[4]

Oddly enough, the answer to this vital question by the free bankers have been vague, murky, and inconsistent answers that reveal deep and unexamined flaws in the free-banking camp. The

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[4]In 1975, at least, Hans F. Sennholz, a former Mises student, had no doubt on the proper answer to this question, as note the title of the book he then edited, *Gold Is Money* (Westport, Conn.: Greenwood Press, 1975). Since then, however, Sennholz has apparently become an ex-Misesian and joined the free-banking camp.

recent booklet by Professor Timberlake in the same vague and murky tradition provides us with an opportunity to examine the views of modern free bankers on the monetary standard, and on what exactly would constitute the "cash" upon which the banks would be allowed to pyramid as many demand liabilities as they could get away with.[5]

Professor Timberlake's work is a curious performance. Ostensibly, it is a brief history of the greenbacks and of the judicial controversy over the constitutionality of the greenbacks and of their legal tender powers. Much of Timberlake's discussion of the Legal Tender Cases is indeed illuminating, since Timberlake is squarely opposed to the constitutionality of fiat money. And yet there are curious distortions and overtones, which build to a climax in the concluding chapters when Timberlake reveals his own positive monetary proposals. For one thing, his attack on greenbacks would seem to imply a pro-gold standard position, and yet throughout his analysis there is a subtle but continuing disparagement of gold which becomes evident when he unrolls his own inflationist, fiat money program. Thus, Timberlake states that the gold standard only existed for four decades in the nineteenth century, omitting the crucial point that from time immemorial only two standard moneys existed, gold and silver, with confusion only emerging from the co-existence either of parallel standards, in which gold or silver were free to fluctuate, or bimetallic standards, in which governments attempted to fix the gold/silver

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[5]Hayek's proposal, which can only be considered grotesque, can be dismissed quickly. For Hayek would solve this problem by having each bank create its own fiat paper currency. In short, a Rothbard Bank could issue notes or deposits in 50, 100, and 1,000 Rothbards, which would be redeemable in the same amount of paper Rothbard tickets! Such a bank could of course never fail, but it is doubtful if anyone save close friends and relatives could ever be induced to use and hold these notes and deposits, regardless of what grandiose promises about "price stability" Rothbard might wave in front of potential customers. In addition, Hayek's proposal is absurdly "constructivist" on his own methodological terms. It is doubtful that anyone not a Nobel Laureate making such a proposal would be taken seriously. Thus, see F.A. Hayek, *Denationalisation of Money* (2nd ed., 1976; London: Institute of Economic Affairs, 1978). For a critique, see Murray N. Rothbard, "The Case for a Genuine Gold Dollar," in Llewellyn H. Rockwell, Jr., ed., *The Gold Standard: An Austrian Perspective* (Lexington, Mass.: D.C. Heath Lexington Books, 1985), pp. 2–6; included in this volume as chapter 41.

at a ratio varying from the market. The fact that gold monometallism existed for only a few decades is beside the point, which is the well-deserved monetary longevity of both gold and silver.

Furthermore, while critically analyzing the judicial defenders of greenbacks, Timberlake manages to focus the issue almost exclusively on the illegitimacy of government power to make greenbacks, or fiat paper, legal tender for private contracts. But the power to make paper legal tender for payments to government is left unscathed by Timberlake, which as we shall see seems to fit into his ultimate monetary agenda. This omission contrasts starkly with the magnificently hard-money Jacksonians, who endeavored to end the federal government's power to receive paper or deposits in taxes or fees. The Jacksonians tried, and partially succeeded, in limiting the government to accepting only specie in payments.[6]

Once curious aspect of Timberlake's anti-gold stance is to embrace Milton Friedman's new-found attachment to bimetallism. Timberlake actually refers to Gresham's Law as demonstrating the gently stabilizing effects of bimetallism (pp. 8–9). And yet one of the more valuable insights of monetarism was to demonstrate that fixing of exchange rates inevitably causes distortions by creating shortages of the undervalued, and surpluses of the overvalued, money. From the fourteenth-century French scholastic Nicole Oresme to Ludwig von Mises, Gresham's Law has been seen as the inevitable and unfortunate consequence of maximum price control for the undervalued money and of minimum price control for the overvalued. And yet in pursuit of his lifelong hatred of gold, Milton Friedman seems willing to embrace virtually any alternative, including bimetallism, and Timberlake is willing to follow suit.

Part of Timberlake's problem here is thinness of scholarship. Thus, he discusses the central role of Civil War Secretary of Treasury (and later Chief Justice) Salmon P. Chase, without bothering to mention the national banking system, or Chase's intimate corruptionist

[6]The Jacksonian Democrats, under Van Buren and Polk, were able to impose the Independent Treasury system, in which the federal government kept its money only in its own Treasury vaults, and not in any bank. They did not succeed, however, in requiring the government to accept taxes and fees only in specie. See Major L. Wilson, *The Presidency of Martin Van Buren* (Lawrence: University Press of Kansas, 1984), pp. 61–121.

connection with the investment banker Jay Cooke. He mentions Chase's ambition, and notes with surprise that Chase wanted to run on the Democratic ticket in 1868, without realizing that Chase was an old Jacksonian Democrat, and with slavery defeated there was every reason for him to return to the Democracy. More important, Jay Cooke was an old friend and literal patron of Chase, and Cooke and his influential Ohio journalist brother Henry lobbied the Lincoln Administration heavily and effectively to make their client Chase Secretary of the Treasury. As soon as Chase gained the post, Cooke easily persuaded Chase to grant him the unprecedented power of monopoly underwriter of all government bonds—a monopoly Cooke was able to retain, almost unbroken, until he went bankrupt in the Panic of 1873. Then, Chase went along with Cooke's plan to destroy the decentralized pre-Civil War banking system and to replace it with a quasi-monopoly National Banking System, a system in which the federally chartered national banks had a monopoly privilege to issue notes, and their note issue was based pro rata on how many government bonds they might purchase. The bonds, of course, had to be purchased from Jay Cooke, who also managed to have himself granted several national bank charters. And so, when Timberlake refers crossly to Chase's "patent . . . anti-bank prejudice" (p. 211), he neither seems to understand that that "prejudice" stemmed from Jacksonian hard-money principle, nor that Chase stood ready to violate that principle in behalf of his corruptionist patron Cooke and so created the national banking system.

And while Timberlake correctly notes that the Republicans in this era were inflationist while the Democrats favored gold and hard money, he fails to link up these positions with economic interests. One of the major forces in favor of greenback inflation was the iron and steel industry, centered in Pennsylvania. Under the leadership of the Pennsylvania economist and ironmaster Henry C. Carey, the Radical Republicans and iron and steel interests were instructed that falling dollar rates caused by greenback inflation acted as a temporary but welcome extra tariff, discouraging iron and steel imports and encouraging their export. The other major inflationist interest was the big railroads, the major big businesses and incorporated enterprises in the country. Heavily indebted to their bondholders, the railroads saw that inflation would lower the real value of their outstanding debts. Thus, Timberlake correctly notes the significance of

the action of the Grant administration in appointing two Supreme Court Justices to fill vacancies. The Administration was sure these judges would quickly reverse the Legal Tender Cases and declare greenbacks and fiat money constitutional. Timberlake notes that these two swing justices were William Strong and Joseph P. Bradley, but fails to make the important point that Strong had been a top attorney for the Philadelphia and Reading Railroad, and a director of the Lebanon Valley Railroad; and as for Bradley, his connections with the railroad interests were almost as great, having been a director of the Camden and Amboy Railroad and of the Morris and Essex Railroad, both in New Jersey.[7]

One pervading problem is that Timberlake's scholarship is spotty. Thus, on the post-Civil War monetary situation, there is reference to Irwin Unger's *The Greenback Era*, but no mention whatever of the equally important Robert P. Sharkey, *Money, Class and Party: An Economic Study of Civil War and Reconstruction* (Baltimore: Johns Hopkins University Press, 1959). Timberlake mentions Bray Hammond's classic *Banks and Politics in America*, but overlooks Hammond's important *Sovereignty and an Empty Purse: Banks and Politics in the Civil War* (Princeton, N.J.: Princeton University Press, 1970). He uses the splendidly hard-money Don C. Barrett's article in the *Quarterly Journal of Economics* (May 1902), but omits Barrett's fully developed book, *Greenbacks and the Resumption of Specie Payments, 1862–1879* (Cambridge: Harvard University Press, 1931). And how can anyone, as Timberlake does, deal with silver and bimetallism without so much as mentioning the famed revisionist article by Paul M. O'Leary, "The Scene of the Crime of 1873 Revisited: A Note," (*Journal of Political Economy* 68 [1960]: 388–92), or the splendid work by Allen Weinstein, *Prelude to Populism: Origins of the Silver Issue 1867–1878* (New Haven, Conn.: Yale University Press, 1970)?

Perhaps the problem is that Professor Timberlake, or his Durrell Foundation editor, John W. Robbins, was anxious to rush past the history to get to the policy conclusions, the monetary agenda which is only loosely based on the preceding historical discussion. In his

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[7]Ron Paul, *The Ron Paul Money Book* (Clute, Texas: Plantation Publishing, 1991), pp. 115–16. On the railroad ties of Strong and Bradley, see Philip H. Burch, Jr., *Elites in American History*, vol. 2: *The Civil War to the New Deal* (New York: Holmes & Meier, 1981), pp. 44–45.

conclusion, Timberlake brusquely dismisses the gold standard. Gold, he says, has been subject to government manipulation by central banks. Very true, but how about the gold standard that also abolished the central bank? This Misesian solution is not mentioned, nor indeed is the extensive Jacksonian literature to the same effect. Timberlake states as if a new point that under the gold standard government need not have minted gold coins, a theme that has long been part of the Misesian literature. He need scarcely rely for reference on a forthcoming article by J. Huston McCulloch. Timberlake only bothers making two other negative references to justify his dismissal of gold. One, that gold might "shut out technically more efficient systems" (p. 52), whatever they might be, but without pointing out that efficient clearing systems can be and have been based on standard metallic money. His other point is the disingenuous one that even Ludwig von Mises, a champion of gold, admits that gold "introduces an incalculable factor into economic activity" (p. 47). But Timberlake fails to note Mises's very next point: that this incalculable factor, stemming from variations in the supply of gold, has been minuscule compared to the volatility introduced by government and by bank manipulations of the supply of money.[8]

What then is Professor Timberlake's proffered alternative, one which he avows would "more effectively constrain the state" than the gold standard (p. 52)? What, in Timberlake's words, "is a market-directed monetary system completely free from any possible government intervention" (p. 62)? Or to return to our earlier question, in Timberlake's proposed world, in what thing would banks liabilities be redeemable? The one cogent note in Hayek's bizarre "denationalized currency" scheme is the pungent clarity of his answer: banks that issue Hayeks, Rothbards, and ducats would redeem these paper tickets or open book liabilities in Hayeks, Rothbards, and ducats. Timberlake, unfortunately, is not nearly so clear. He does seem to realize that Americans are stuck with "dollars" as their currency unit and standard, just as Englishmen are stuck with pounds and Germans marks. He does not, however, explain why these countries are necessarily stuck with currency names. Instead, he becomes even murkier by adopting the curious and grotesquely "constructivist" plan of

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[8]Ludwig von Mises, *The Theory of Money and Credit* (1934; Indianapolis, Ind.: LibertyClassics, 1980), p. 27.

Greenfield and Yeager: that the monetary unit of account be totally and ineluctably sundered from the medium of exchange. The monetary unit would still be the dollar, but how then is the "dollar" to be defined? Originally, the dollar, along with every national currency, was simply defined as a definite unit of weight of gold or silver. Before 1933, for example, the "dollar," the monetary standard in the United States, was defined as 1/20 of an ounce of gold. Nowadays, of course, the "dollar" is fiat; it is simply a paper ticket issued by the Federal Reserve System that says, on its face, "one dollar" or "ten dollars."

What would Timberlake do about this; or, following Greenfield and Yeager, how would he proceed to "the practical purpose of getting the government [in the guise of the Federal Reserve System] out of any policy-making role" (p. 60)? By severing the dollar from the medium of exchange. The government would define the "dollar" as equal "to a market price index made up of a limited array of staple, conventional, basic commodities—items that would ideally mirror an all-markets average of prices." But if the government defines the dollar as an overall price index, wouldn't this definition be subjected to political pressure for continually redefining the index; and wouldn't the government almost automatically strive to stabilize the price level as gauged by its precious index? No, because incredibly, according to Timberlake, Greenfield and Yeager, the government would be sternly advised not to stabilize its own index. But does anyone in his right mind, anyone at all familiar with our political system, think for one moment that the government would thus keep its hands off its own index?[9]

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[9]Professor Timberlake would have done well to heed Mises's insights about index numbers in the passage just before the sentence he yanked out of context:

> If it should be thought that index numbers offer us an instrument for providing currency policy with a solid foundation and making it independent of the changing economic programs of governments and political parties, perhaps I may be permitted to refer to what I have said . . . on the impossibility of singling out any particular method of calculating index numbers as the sole scientifically correct one. . . . There are many ways of calculating purchasing power by means of index numbers, and every single one of them is right, from certain tenable points of view; but

And what, too, would be the medium of exchange in Timberlake's system, and would that medium be redeemable in the dollar-index? None of that is clear. If it is redeemable, then presumably people would not be walking around with index market-baskets; if instead, it is to be redeemable in the "purchasing power" of the index, then we are back to stabilizing the price level, and also in what would the medium be redeemed, and would that index then become the medium? If not, and if there is to be no redemption whatever, then who is to supply the medium of exchange, and what is to keep the "free" money suppliers from issuing money *ad infinitum*? (In the gold standard, of course, what keeps the banks at least partially in check is the necessity to redeem in gold.) Timberlake is of little help in supplying this crucial answer.[10] At one point he refers to the "medium of exchange [as] the Federal Reserve note" (p. 60)! That's getting the government and the Fed "out of any policymaking role?" At another point, he inconsistently "would leave this function [supply the quantity of money] to dealers and arbitrageurs in financial and commodity markets" (p. 60). What is all this supposed to mean? At another point, the confusion is even worse compounded by Timberlake's calling for "privatizing" the government's gold stockpile "and the twelve Federal Reserve Banks" (p. 62). Privatizing the Federal Reserve? What can this mean? In a profound sense, the Federal

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> every single one of them is also wrong. . . . Since each method of calculation will yield results that are different from those interests and injure others, it is obvious that each group of persons will declare for those methods that will best serve its own interests. (Mises, *Theory of Money and Credit*, pp. 26–27)

Also see Mises's scintillating critique of index numbers in ibid., pp. 215–23.

[10]Greenfield and Yeager are not much more helpful either. In contrast to Timberlake's hint about "privatized" Federal Reserve notes still constituting the medium of exchange, Greenfield and Yeager avow the absence of "any dominant" medium of exchange, which seems close to calling for no general medium of exchange at all, and hence a return to some form of barter. Greenfield and Yeager also propose a convenient new criterion for the advance of science: that the burden of proof to clarify and persuade others of a totally new proposal, such as theirs, should rest on the readers bound in their old frameworks rather than on the authors themselves. R. Greenfield and L. Yeager, "Competitive Payment Systems: Comment," *American Economic Review* 76 (September 1986): 848–49.

Reserve, as well as all previous central banks, are already "private"—a government-established and enforced cartel of the private banking system. Are we then to be stuck forever with Federal Reserve notes as "dollars," whether or not they are officially defined as such? Privatizing the Fed is about as cogent, and about as genuinely free-market-oriented, as the idea of "privatizing" the Internal Revenue Service. No, it is important to realize that those government operations which supply or monopolize genuine goods and services should be privatized—e.g., carrying the mail, supplying streets and roads, putting out fires. But other government activities, which are counterproductive and destructive to the market—e.g., the IRS, government regulatory commissions, concentration camps for dissenters—should not be privatized but abolished. Surely, that massive monopolistic and inflationary engine of legalized and legitimated counterfeiting called the Federal Reserve System should be abolished rather than privatized.

In supporting the idea of sundering the unit of account from the medium of exchange, Timberlake fallaciously refers to the researches into medieval money of the great economic historian Luigi Einaudi.[11] But he fails to realize that in his historical cases, Einaudi was not writing about an abstract unit of account of "imaginary money" that came from the sky or from professors and was never used as a medium of exchange. On the contrary, in all cases, Einaudi was referring to the bimetallic or parallel metallic situation in which units of weight of gold (or silver) was the medium of exchange in a certain country, whereas units of weight of the other precious metal, silver (or gold) functioned as the unit of account. In this situation, both gold and silver originally emerged, on the market, as media of exchange and hence units of account. Not only do Einaudi's cases

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[11]In addition to citing Einaudi's article in the Gayer Festschrift for Irving Fisher, Timberlake might have momentarily strengthened his case by referring to the impressive article by Luigi Einaudi, "The Theory of Imaginary Money from Charlemagne to the French Revolution," in F.C. Lane and J.C. Riemersma, eds., *Enterprise and Secular Change* (Homewood, Ill.: Richard D. Irwin, 1953), pp. 229–61. The Einaudi article was originally written in *Rivista de storia economica*, 1936, and its English translation by Giorgio Tagliacozzo was approved and added to by Einaudi.

not constitute historical support for the Timberlake-Greenfield-Yeager scheme; they are precisely the reverse.[12]

The problem with all these plans, from Greenfield and Yeager to Timberlake to Hayek, is that they ignore one of Ludwig von Mises's most original and profound contributions to monetary theory: the "regression theorem," which demonstrates that no money can originate in any society except as a medium of exchange, and as a medium that arose on the free market as a useful nonmonetary commodity, e.g., gold or silver.[13] Hence, the regression theorem explains the fallacy and the dismal prospects for all such constructivist schemes as the magic index or the Hayekian ducat. The reason why we must start with the dollar as the money for Americans, the franc as the money for the French, etc., is that the people of these countries are used to those units of account, and since those units grew originally out of a unit of weight of gold or silver, they were useful nonmonetary commodities on the market before they became employed as moneys.[14]

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[12]On the theory of parallel standards, see Mises, *The Theory of Money and Credit*, pp. 205–13. For historical examples of parallel standards, see also W. Stanley Jevons, *Money and the Mechanism of Exchange* (London: Kegan Paul, 1905), pp. 88–96. Robert S. Lopez points out that whereas gold coinage was introduced into modem Europe almost simultaneously in the mid-thirteenth century by Florence and Genoa, Florence instituted bimetallism, whereas "Genoa, on the contrary, in conformity to the principle of restricting state intervention as much as possible, did not try to enforce a fixed relation between coins of different metals." Robert S. Lopez, "Back to Gold, 1252," *Economic History Review* (December 1956): 224.

[13]On the regression theorem, see Mises, *The Theory of Money and Credit*, pp. 129–59; *Human Action*, pp. 408–16.

[14]Greenfield and Yeager, dismissing the relevance of the point that their monetary scheme could never emerge from the market, argue that "dismantling government domination of the existing system will require deliberate policy actions, and the positive actions taken will unavoidably condition the successor system." Greenfield and Yeager, "Competitive Payments Systems," p. 849. But it is precisely because economic history is path-dependent that we don't want to foist upon the future a system that will not work, and that will not work largely because such indices and media cannot emerge "organically" from individual actions on the market. Surely, the idea in dismantling the government and returning (or advancing) to a free market is to be as

If we really wish, then, to separate government from monetary policy or from monetary functions, we must totally divest government of those roles. We must therefore start with reality—the dollar defined as a government paper ticket or Federal Reserve note—and proceed to privatize the dollar precisely by ending its relationship to the note, and by redefining it as a unit of weight of gold. How is this to be done? By abolishing the Federal Reserve System. Abolishing that "corporation" means, as in the death of any corporation, liquidating its liabilities, and parcelling out the assets of the liquidated organization to its creditors. Since Federal Reserve notes are legally liabilities of the Fed, and since its assets are the Fed's accumulated gold stock kept in Fort Knox and other Treasury repositories, the gold should be parcelled out pro rata to the Fed's creditors (holders of Federal Reserve notes and banks that keep demand deposits at the Fed). The dollar would be redefined in units of weight of gold to permit 100 percent liquidation as well as the exchange of gold assets for all liquidated notes and liabilities. As its last monetary function, the Treasury could mint the gold coins out of the deposited bullion to exchange for these notes and deposits. The money supply would then consist solely of gold coins, which could be deposited for warehouse receipts in commercial banks. Federal Reserve notes and deposits would then have disappeared.[15]

One of the few places where I agree with Professor Timberlake's prescription is to "privatize the government's stockpile of gold." But of course legally the gold is owned not by the government *per se* but by the Federal Reserve; and therefore the only way to privatize the

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consonant with the market as possible, and to eliminate government intervention with the greatest possible dispatch. Foisting upon the public a bizarre scheme at variance with the nature and functions of money and of the market, is precisely the kind of technocratic social engineering from which the world has suffered far too much in the twentieth century.

[15]What of the government securities that now constitute the bulk of the assets of the Federal Reserve System? An urge for genuine privatization and a decent respect for the taxpayer would require the immediate writing off of these bonds; why should the taxpayer be forced to pay interest and principal when one agency of the federal government owns the bonds of another? With the exception, of course, of increased nonmonetary benefit from an increase in gold or silver, a gain that cannot accrue from an increase in fiat paper or in fractional-reserve bank credit.

gold stock, and at one and the same time to abolish the Federal Reserve and to return from a fiat to a gold standard, would be the plan I have described above: redefinition of the dollar as a unit of weight of gold, and abolition of the Fed and the disgorging of its gold stock, to be exchanged, one for one, for its liquidated liabilities, the Fed's notes and deposits.

I submit that we would then have a gold standard without a central bank, without fiat money, without Federal Reserve notes, and with none of the actualities or even possibilities of government intervention that Professor Timberlake professes to abhor. But for Timberlake, or for Greenfield or Yeager, to adopt such a plan, would require them to abandon once and for all, their flight from gold, that veritable phobia about gold, or "aurophobia," that has marked all respectable schools of economic thought, whether Keynesian or monetarist, for most of the inflationist twentieth century.

# Section Seven

# Criticism

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# Milton Friedman Unraveled

Mention "free-market economics" to a member of the lay public and chances are that if he has heard the term at all, he identifies it completely with the name Milton Friedman. For several years, Professor Friedman has won continuing honors from the press and the profession alike, and a school of Friedmanites and "monetarists" has arisen in seeming challenge to the Keynesian orthodoxy.

However, instead of the common response of reverence and awe for "one of our own who has made it," libertarians should greet the whole affair with deep suspicion: "If he's so devoted a libertarian, how come he's a favorite of the Establishment?" An advisor of Richard Nixon and a friend and associate of most administration economists, Friedman has, in fact, made his mark in current policy, and indeed reciprocates as a sort of leading unofficial apologist for Nixonite policy.

In fact, in this as in other such cases, suspicion is precisely the right response for the libertarian, for Professor Friedman's particular brand of "free-market economics" is hardly calculated to ruffle the feathers of the powers-that-be. Milton Friedman is the Establishment's Court Libertarian, and it is high time that libertarians awaken to this fact of life.

## The Chicago School

Friedmanism can be fully understood only in the context of its historical roots, and these roots are the so-called "Chicago School"

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Originally published in *The Individualist* in 1971.

of economics of the 1920s and 1930s. Friedman, a professor at the University of Chicago, is now the undisputed head of the modern, or second-generation, Chicago School, which has adherents throughout the profession, with major centers at Chicago, UCLA, and the University of Virginia.

The members of the original, or first-generation, Chicago School were considered "leftish" in their day, as indeed they were by any sort of genuine free-market criterion. And while Friedman has modified some of their approaches, he remains a Chicago man of the thirties.

The political program of the original Chicagoans is best revealed in the egregious work of a founder and major political mentor: Henry C. Simons's *A Positive Program for Laissez Faire*.[1] Simons's political program was laissez faireist only in an unconsciously satiric sense. It consisted of three key ideas:

(1) a drastic policy of trust-busting of all business firms and unions down to small blacksmith-shop size, in order to arrive at "perfect" competition and what Simons conceived to be the "free market";

(2) a vast scheme of compulsory egalitarianism, equalizing incomes through the income-tax structure; and

(3) a proto-Keynesian policy of stabilizing the price-level through expansionary fiscal and monetary programs during a recession.

Extreme trust-busting, egalitarianism, and Keynesianism: the Chicago School contained within itself much of the New Deal program, and, hence, its status within the economics profession of the early 1930s as a leftish fringe. And while Friedman has modified and softened Simons's hard-nosed stance, he is still, in essence, Simons redivivus; he only appears to be a free-marketeer because the remainder of the profession has shifted radically leftward and stateward in the meanwhile. And, in some ways, Friedman has added unfortunate statist elements that were not even present in the older Chicago School.[2]

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[1]Henry C. Simons, *A Positive Program for Laissez Faire: Some Proposals for a Liberal Economic* Policy (Chicago: University of Chicago Press, 1934).

[2]In this article, I am confining discussion to the politico-economic, and omitting the technical problems of economic theory and methodology. It is

### *The Chicago School on Monopoly and Competition*

Let us take the leading elements of Simonsian collectivist laissez faire in their turn. On monopoly and competition, Friedman and his colleagues have happily come a long way toward rationality from the old ultra-trust-busting of Simons. Friedman now concedes that the major source of monopoly in the economy is the activity of government, and focuses on repeal of these monopolizing measures.

The Chicagoans have gotten progressively more friendly to large business operating on the free market, and such Friedmanites as Lester Telser have even emerged with excellent arguments on behalf of advertising, previously anathema to all "perfect competitionists." But while in practice Friedman has become more libertarian on the monopoly question, he still retains the old Chicagoite theory: that in some way, the absurd, unreal, and unfortunate world of "perfect competition" (a world in which every firm is so minute that nothing it does can affect its demand and the price of its products) is better than the real, existing world of competition, which is dubbed "imperfect."

An infinitely superior view of competition is found in the totally neglected school of "Austrian economics" which scorns the "perfect competition" model and prefers the real world of free-market competition.[3] So while Friedman's practical view of competition and monopoly is not too bad, the weakness of his underlying theory could permit at any time a return to the frenetic trust-busting of the Chicagoans of the 1930s. It was not very long ago, for example, that Friedman's most distinguished associate, Professor George J. Stigler, advocated before Congress the trust-busting break-up of U.S. Steel into many constituent parts.

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in the latter where Friedman has been at his worst, for Friedman has managed to change the older Chicagoan methodology, in its essence Aristotelian and rationalist, to an egregious and extreme variant of positivism.

[3]For an excellent introduction to the Austrian view, see of F.A. Hayek, *Individualism and the Economic Order* (Chicago: University of Chicago Press, 1948), chap. 5.

### *Friedman's Chicagoite Egalitarianism*

While Friedman has abandoned Simons's call for extreme egalitarianism through the income tax structure, the basic lineaments of statist egalitarianism still remain. It remains in the Chicagoite desire to lay the tax structure's greatest stress on the income tax, undoubtedly the most totalitarian of all taxes. Chicagoites prefer the income tax because, in their economic theory, they follow the disastrous tradition of orthodox Anglo-American economics in sharply separating the "microeconomic" from the "macroeconomic" spheres.

The idea is that there are two sharply separated and independent worlds of economics. On the one hand, there is the "micro" sphere, the world of individual prices determined by the forces of supply and demand. Here, the Chicagoans concede, the economy is best left to the unhampered play of the free market. But, they assert, there is also a separate and distinct sphere of "macro" economics, of economic aggregates of government budget and monetary policy, where there is no possibility or even desirability of a free market.

In common with their Keynesian colleagues, the Friedmanites wish to give to the central government absolute control over these macro areas, in order to manipulate the economy for social ends, while maintaining that the micro world can still remain free. In short, Friedmanites as well as Keynesians concede the vital macro sphere to statism as the supposedly necessary framework for the micro-freedom of the free market.

In reality, the macro and micro spheres are integrated and intertwined, as the Austrians have shown. It is impossible to concede the macro sphere to the State while attempting to retain freedom on the micro level. Any sort of tax, and the income tax not least of all, injects systematic robbery and confiscation into the micro sphere of the individual, and has unfortunate and distortive effects on the entire economic system. It is deplorable that the Friedmanites, along with the rest of Anglo-American economics, have never paid attention to the achievement of Ludwig von Mises, founder of the modern Austrian School, in integrating the micro and macro spheres in economic theory as far back as 1912 in his classic *The Theory of Money and Credit*.[4]

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[4]Ludwig von Mises, *The Theory of Money and Credit*, trans. H.E. Batson (Indianapolis, Ind.: LibertyClassics, 1980).

Milton Friedman has revealed his quintessential pro-income tax and egalitarian position in numerous ways. As in many other spheres, he has functioned not as an opponent of statism and advocate of the free market, but as a technician advising the State on how to be more efficient in going about its evil work. (From the viewpoint of a genuine libertarian, the more inefficient the State's operations, the better![5]) He has opposed tax exemptions and "loopholes" and worked to make the income tax more uniform.

One of Friedman's most disastrous deeds was the important role he proudly played, during World War II in the Treasury Department, in foisting upon the suffering American public the system of the withholding tax. Before World War II, when income tax rates were far lower than now, there was no withholding system; everyone paid his annual bill in one lump sum, on March 15. It is obvious that under this system, the Internal Revenue Service could never hope to extract the entire annual sum, at current confiscatory rates, from the mass of the working population. The whole ghastly system would have happily broken down long before this. Only the Friedmanite withholding tax has permitted the government to use every employer as an unpaid tax collector, extracting the tax quietly and silently from each paycheck. In many ways, we have Milton Friedman to thank for the present monster Leviathan State in America.

In addition to the income tax itself, Friedman's egalitarianism is revealed in the Friedman-Stigler pamphlet attacking rent controls. "For those, like us, who would like even more equality than there is at present . . . it is surely better to attack directly the existing inequalities in income and wealth at their source" than to restrict the purchases of particular commodities, like housing.[6]

The single most disastrous influence of Milton Friedman has been a legacy from his old Chicagoite egalitarianism: the proposal for a guaranteed annual income to everyone through the income tax system—an idea picked up and intensified by such leftists as Robert

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[5]There is a charming anecdote about the distinguished industrialist Charles F. Kettering. Visiting the hospital bed of a friend who was complaining about the growth of government, Kettering told him "Cheer up Jim. Thank God we don't get as much government as we pay for!"

[6]Milton Friedman and George J. Stigler, *Roofs or Ceilings?* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1946), p. 10.

Theobald, and one which President Nixon will undoubtedly be able to ram through the new Congress.[7]

In this catastrophic scheme, Milton Friedman has once again been guided by his overwhelming desire not to remove the State from our lives, but to make the State more efficient. He looks around at the patchwork mess of local and state welfare systems, and concludes that all would be more efficient if the whole plan were placed under the federal income tax rubric and everyone were guaranteed a certain income floor. More efficient, perhaps, but also far more disastrous, for the only thing that makes our present welfare system even tolerable is precisely its inefficiency, precisely the fact that in order to get on the dole one has to push one's way through an unpleasant and chaotic tangle of welfare bureaucracy. The Friedman scheme would make the dole automatic, and thereby give everyone an automatic claim upon production.

### *Welfare's "Supply Function"*

We have to realize that being on welfare is not, as most people believe, a simple and absolute act of God or nature, a stark given like a volcanic eruption. Being-on-welfare, like all other human economic acts, has a "supply function": in other words, if you make welfare pay enough, you can produce as many welfare clients as you wish to have. Pay them little enough and you can reduce the number of clients at will. In short, if the government should announce that anyone who signs up at a "welfare" desk gets an automatic annual check of $40,000 for as long as he wishes, we will find soon enough that almost everyone has become a welfare recipient—and what is more, will join a "welfare rights" organization to lobby for $60,000 to offset the rise in the cost of living.

More specifically, the supply function of welfare clients is inversely proportional to the difference between the prevailing wage rate in the area and the level of welfare payments. This difference is the "opportunity cost" of going on welfare—the amount that one loses by loafing instead of working. If, for example, the prevailing

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[7]For a further critique of the Friedman-Nixon guaranteed income doctrine, see Murray N. Rothbard, "The Guaranteed Annual Income," *The Rational Individualist* (September 1969); and Henry Hazlitt, *Man vs. The Welfare State* (New Rochelle, N.Y.: Arlington House, 1969), pp. 62–100.

wage rises in an area and the welfare payments remain the same, the differential and the "opportunity cost" of loafing rise, and people tend to leave the welfare dole and go to work. If the opposite happens, more people will go on the dole. If being on welfare were an absolute fact of nature, then there would be no relation between this differential and the number on welfare.[8]

Second, the supply of welfare clients is inversely proportional to another vitally important factor: the cultural or value disincentive of going on welfare. If this disincentive is strong, if, for example, an individual or group strongly believes that it is evil to go on welfare, they will not do it, period. If, on the other hand, they do not care about the stigma of welfare, or, worse yet, they regard welfare payments as their right—a right to exert a compulsory, looting claim upon production—then the number of people on welfare will increase astronomically, as has happened in recent years.

There are several recent examples of the "stigma effect." It has been shown that, given the same level of income, more people tend to go on welfare in urban than in rural areas, presumably as a function of the greater visibility of welfare clients and hence the greater stigma in the more sparsely populated region. More important, there is the glowing fact that certain religious groups, even when significantly poorer than the rest of the population, simply do not go on welfare because of their deeply held ethical beliefs. Thus, the Chinese-Americans, while largely poor, are almost never to be found on welfare. A recent article on Albanian-Americans in New York City highlights that same point. These Albanians are invariable poor slum dwellers, and yet there is no Albanian-American on welfare. Why? Because, said one of their leaders, "Albanians do not beg, and to Albanians, taking welfare is like begging in the street."[9]

Another example is the Mormon Church, very few of whose members are on public welfare. For the Mormons not only inculcate in their members the virtues of thrift, self-help, and independence, they also take care of their own needy through church charity programs which

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[8]For an empirical demonstration of this relationship, see C.T. Brehm and T.R. Saving, "The Demand for General Assistance Payments," *American Economic Review* 54, no. 6 (December 1964): 1002–18.

[9]*New York Times* (April 13, 1970).

are grounded on the principle of helping people to help themselves, and thereby getting them off charity as quickly as possible.[10] Thus, the Mormon Church counsels its members that "to seek and accept direct public relief all too often invites the curse of idleness and fosters the other evils of dole. It destroys one's independence, industry, thrift, and self-respect."[11] Hence, the Church's highly successful private welfare program is based on the principles that

> the Church has encouraged its members to establish and maintain their economic independence: it has encouraged thrift and foster the establishment of employment-creating industries; it has stood ready at all times to help needy faithful members.

And:

> Our primary purpose was to set up, in so far as it might be possible, a system under which the curse of idleness would be done away with, the evils of a dole abolished, and independence, industry, thrift, and self-respect be once more established among our people. The aim of the Church is to help the people help themselves. Work is to be re-enthroned as the ruling principles of the lives of our Church membership. . . . Faithful to this principle, welfare workers will earnestly teach and urge Church members to be self-sustaining to the full extent of their powers. No true latter-day Saint will, while physically able, voluntarily shift from himself the burden of his own support.[12]

The Libertarian approach to the welfare problem, then, is to abolish all coercive, public welfare, and to substitute for it private charity based on the principle of encouraging self-help, bolstered also

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[10]This was the same principle as the one guiding the Charity Organization Society in nineteenth-century England. That classical-liberal organization "believed that the most serious aspect of poverty was the degradation of the character of the poor man or woman. Indiscriminate charity only made things worse; it demoralized. True charity demanded friendship, thought, the sort of help that would restore a man's self-respect and his ability to support himself and his family." Charles Loch Mowat, *The Charity Organization Society* (London: Methuen, 1961), p. 2.

[11]*Welfare Plan of the Church of Jesus Christ of Latter-Day Saints* (The General Church Welfare Committee, 1960), p. 48.

[12]Ibid., pp. 1–2.

by inculcating the virtues of self-reliance and independence throughout society.

#### *Incentives under the Friedman Plan*

But the Friedman plan, on the contrary, moves in precisely the opposite direction, for it establishes welfare payments as an automatic right, an automatic, coercive claim upon the producers. It thereby removes the stigma effect altogether, disastrously discourages productive work by steep taxation, and by establishing a guaranteed income for not working, which encourages loafing. In addition, by establishing an income floor as a coercive "right," it encourages welfare clients to lobby for ever-higher floors, thus continually aggravating the entire problem. But Friedman, caught in the Anglo-American separation of "micro"and "macro," gives very little attention to these cataclysmic effects on incentives.

Even the handicapped are hampered by the Friedmanite plan, for an automatic dole removes the marginal incentive for the handicapped worker to invest in his own vocational rehabilitation, since the net monetary return from such investment is now greatly lowered. Hence, the guaranteed income tends to perpetuate these handicaps. Finally, the Friedmanite dole would pay a higher income per person to welfare families, thereby subsidizing a continuing increase in the child population among the poor—precisely those who can least afford such a population growth. Without joining in the current hysteria about the "population explosion," it is certainly absurd to deliberately subsidize the breeding of more pauper-children, which is what the Friedman plan would do as an automatic right.

### Money and the Business Cycle

The third major feature of the New Deal program was proto-Keynesian: the planning of the "macro" sphere by the government in order to iron out the business cycle. In his approach to the entire area of money and the business cycle—an area on which unfortunately Friedman has concentrated most of his efforts—Friedman harks back not only to the Chicagoans, but, like them, to Yale economist Irving Fisher, who was the Establishment economist from the 1900s through the 1920s. Friedman, indeed, has openly hailed Fisher as the "greatest economist of the twentieth century," and when one reads Friedman's writings, one often gets the impression of reading

Fisher all over again, dressed up, of course, in a good deal more mathematical and statistical mumbo-jumbo. Economists and the press, for example, have been hailing Friedman's recent "discovery" that interest rates tend to rise as prices rise, adding an inflation premium to keep the "real" rate of interest the same; this ignores the fact that Fisher had pointed this out at the turn of the twentieth century.

But the key problem with Friedman's Fisherine approach is the same orthodox separation of the micro and macro spheres that played havoc with his views on taxation. For Fisher believed, again, that on the one hand there is a world of individual prices determined by supply and demand, but on the other hand there is an aggregate "price level" determined by the supply of money and its velocity of turnover, and never the twain do meet. The aggregate, macro, sphere is supposed to be the fit subject of government planning and manipulation, again supposedly without affecting or interfering with the micro area of individual prices.

### *Fisher on Money*

In keeping with this outlook, Irving Fisher wrote a famous article in 1923, "The Business Cycle Largely a 'Dance of the Dollar'"—recently cited favorably by Friedman—which set the model for the Chicagoite "purely monetary" theory of the business cycle. In this simplistic view, the business cycle is supposed to be merely a "dance," in other words, an essentially random and causally unconnected series of ups and downs in the "price level." The business cycle, in short, is random and needless variations in the aggregate level of prices. Therefore, since the free market gives rise to this random "dance," the cure for the business cycle is for the government to take measures to stabilize the price level, to keep that level constant. This became the aim of the Chicago School of the 1930s, and remains Milton Friedman's goal as well.

Why is a stable price level supposed to be an ethical idea, to be attained even by the use of governmental coercion? The Friedmanites simply take the goal as self-evident and scarcely in need of reasoned argument. But Fisher's original groundwork was a total misunderstanding of the nature of money, and of the names of various currency units. In reality, as most nineteenth century economists knew full well, these names (dollar, pound, franc, etc.) were not

somehow realities in themselves, but were simply names for units of weight of gold or silver. It was these commodities, arising in the free market, that were the genuine moneys; the names, and the paper money and bank money, were simply claims for payment in gold or silver. But Irving Fisher refused to recognize the true nature of money, or the proper function of the gold standard, or the name of a currency as a unit of weight in gold. Instead, he held these names of paper money substitutes issued by the various governments to be absolute, to be money. The function of this "money" was to "measure" values. Therefore, Fisher deemed it necessary to keep the purchasing power of currency, or the price level, constant.

This quixotic goal of a stable price level contrasts with the nineteenth-century economic view—and with the subsequent Austrian School. They hailed the results of the unhampered market, of laissez faire capitalism, in invariably bringing about a steadily falling price level. For without the intervention of government, productivity and the supply of goods tends always to increase, causing a decline in prices. Thus, in the first half of the nineteenth century—the "Industrial Revolution"—prices tended to fall steadily, thus raising the real wage rates even without an increase of wages in money terms. We can see this steady price decline bringing the benefits of higher living standards to all consumers, in such examples as TV sets falling from $2000 when first put on the market to about $100 for a far better set. And this in a period of galloping inflation.

It was Irving Fisher, his doctrines, and his influence, which was in large part responsible for the disastrous inflationary policies of the Federal Reserve System during the 1920s, and therefore for the subsequent holocaust of 1929. One of the major aims of Benjamin Strong, head of the Federal Reserve Bank (Fed) of New York and virtual dictator of the Fed during the 1920s, was, under the influence of the Fisher doctrine, to keep the price level constant. And since wholesale prices were either constant or actually falling during the 1920s, Fisher, Strong, and the rest of the economic Establishment refused to recognize that an inflationary problem even existed. So, as a result, Strong, Fisher, and the Fed refused to heed the warnings of such heterodox economists as Ludwig von Mises and H. Parker Willis during the 1920s that the unsound bank credit inflation was leading to an inevitable economic collapse. So pig-headed were these worthies that, as late as 1930, Fisher, in his swansong as economic

prophet, wrote that there was no depression, and that the stock market collapse was only temporary.[13]

### *Friedman on Money*

And now, in his highly touted *Monetary History of the United States*, Friedman has demonstrated his Fisherine bias in interpreting American economic history.[14] Benjamin Strong, undoubtedly the single most disastrous influence upon the economy of the 1920s, is lionized by Friedman for his inflation and price-level stabilization during that decade.[15] In fact, Friedman attributes the 1929 depression not to the preceding inflation boom but to the failure of the post-Strong Federal Reserve to inflate the money supply enough before and during the depression.

In short, while Milton Friedman has performed a service in bringing back to the notice of the economics profession the overriding influence of money and the money supply on business cycles, we must recognize that this "purely monetarist" approach is almost the exact reverse of the sound—as well as truly free-market—Austrian view. For while the Austrians hold that Strong's monetary expansion made a later 1929 crash inevitable, Fisher-Friedman believe that all the Fed needed to do was to pump more money in to offset any recession. Believing that there is no causal influence running from boom to bust, believing in the simplistic "Dance of the Dollar" theory, the Chicagoites simply want government to manipulate that dance, specifically to increase the money supply to offset recession.

During the 1930s, therefore, the Fisher-Chicago position was that, in order to cure the depression, the price level needed to be

[13]Irving Fisher, *The Stock Market Crash—And After* (New York: Macmillan, 1930).

[14]Milton Friedman and Anna Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton, N.J.: Princeton University Press, 1963).

[15]See Murray N. Rothbard, America's *Great Depression* (Princeton, N.J.: D. Van Nostrand, 1963), for a contrasting view of the 1920s. More on the Friedmanite vs. Austrian view of the business cycle can be found in Murray N. Rothbard, "The Great Inflationary Recession Issue: 'Nixonomics' Explained," *The Individualist* (June 1970): 1–5.

"reflated" back to the levels of the 1920s, and that reflation should be accomplished by:

(1) the Fed expanding the money supply, and

(2) the Federal government engaging in deficit spending and large-scale public works programs.

In short, during the 1930s, Fisher and the Chicago School were "pre-Keynes Keynesians," and were, for that reason, considered quite radical and socialistic—and with good reason. Like the later Keynesians, the Chicagoans favored a "compensatory" monetary and fiscal policy, though always with greater stress on the monetary arm.

Some might object that Milton Friedman does not believe so much in a manipulative monetary and fiscal policy as in an "automatic" increase by the Federal Reserve at a rate of 3–4 percent per year. But this modification of the older Chicagoans is purely a technical one, stemming from Friedman's realization that day-to-day, short-term manipulations by the Fed will suffer from inevitable time lags, and are therefore bound to aggravate rather than ameliorate the cycle. But we must realize that Friedman's automatic inflationist policy is simply another variant in his pursuit of the same old Fisherine-Chicagoite aim: stabilization of the price level—in this case, stabilization over the long run.

Thus, Milton Friedman is, purely and simply, a statist-inflationist, albeit a more moderate inflationist than most of the Keynesians. But that is small consolation indeed, and hardly qualifies Friedman as a free-market economist in this vital area.

### *Fisher, Friedman, and the End of the Gold Standard*

From his earliest days, Irving Fisher was—properly—considered to be a monetary radical and a statist for his desire to scrap the gold standard. Fisher realized that the gold standard—under which the basic money is a commodity mined on the free market rather than created by government—was incompatible with his overpowering desire to stabilize the price level. Hence, Fisher was one of the first modern economists to call for the abolition of the gold standard and its replacement by fiat money.

Under a fiat system, the currency name—dollar, frank, mark, etc.—becomes the ultimate monetary standard, and absolute control over the supply and use of these units is necessarily vested in the

central government. In short, fiat currency is inherently the money of absolute statism. Money is the central commodity, the nerve center, as it were, of the modern market economy, and any system that vests the absolute control of that commodity in the hands of the State is hopelessly incompatible with a free-market economy or, ultimately, with individual liberty itself.

Yet, Milton Friedman is a radical advocate of cutting all current ties, however weak, with gold, and going onto a total and absolute fiat dollar standard, with all control vested in the Federal Reserve System.[16] Of course, Friedman would then advise the Fed to use that absolute power wisely, but no libertarian worth the name can have anything but contempt for the very idea of vesting coercive power in any group and then hoping that such group will not use its power to the utmost. The reasons that Friedman is totally blind to the tyrannical and despotic implications of his fiat money scheme is, once again, the arbitrary Chicagoite separation between the micro and the macro, the vain, chimerical hope that we can have totalitarian control of the macro sphere while the "free market" is preserved in the micro. It should be clear by now that this kind of a truncated, Chicagoite micro-"free market" is "free" only in the most mocking and ironic sense: it is far more the Orwellian "freedom" of "Freedom is Slavery."

### *A Return to the Gold Standard*

There is no question about the fact that the present international monetary system is an irrational and abortive monstrosity, and needs drastic reform. But Friedman's proposed reform, of cutting all ties with gold, would make matters far worse, for it would leave everyone at the complete mercy of his own fiat-issuing state. We need to move precisely in the opposite direction: to an international gold standard that would restore commodity money everywhere and get all the money-manipulating states off the backs of the peoples of the world.

Furthermore, gold, or some other commodity, is vital for providing an international money—a basic money in which all nations can

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[16]See Murray N. Rothbard, *What Has Government Done To Our Money?* (Auburn, Ala.: Ludwig von Mises Institute, 1990).

trade and settle their accounts. The philosophical absurdity of the Friedmanite plan of each government providing its own fiat money, cut loose from all others, can be seen clearly if we consider what would happen if every region, every province, every state, nay every borough, county, town, village, block, house, or individual would issue its own money, and we then had, as Friedman envisions, freely fluctuating exchange rates between all these millions of currencies. The ensuing chaos would stem from the destruction of the very concept of money—the entity that serves as a general medium for all exchanges on the market. Philosophically, Friedmanism would destroy money itself, and reduce us to the chaos and primitivism of the barter system.

One of Friedman's crucial errors in his plan of turning all monetary power over to the State is that he fails to understand that this scheme would be inherently inflationary. For the State would then have in its complete power the issuance of as great a supply of money as it desired. Friedman's advice to restrict this power to an expansion of 3–4 percent per year ignores the crucial fact that any group, coming into the possession of the absolute power to "print money," will tend to . . . print it! Suppose that John Jones is granted by the government the absolute power, the compulsory monopoly, over the printing press, and allowed to issue as much money as he sees fit, and to use it in any way that he sees fit. Isn't it crystal clear that Jones will use this power of legalized counterfeiting to a fare-thee-well, and therefore that his rule over money will tend to be inflationary? In the same way, the State has long arrogated to itself the compulsory monopoly of legalized counterfeiting, and so it has tended to use it: hence, the State is inherently inflationary, as would be any group with the sole power to create money. Friedman's scheme would only intensify that power and that inflation.

The only libertarian solution, in contrast, is to make the State disgorge its hoards of commodity money. Franklin Roosevelt, under cover of a "depression emergency," confiscated all of the gold held by the American people in 1933, and nothing has been said for nearly four decades about giving our gold back. In contrast to Friedman, the genuine libertarian must call upon the government to give the people back their stolen gold, which the government had seized from us in return for its paper dollars.

## Neighborhood Effects

Thus, in the two vital macro fields of taxation and money, Milton Friedman's influence has been enormous—far greater than in any other area—and almost uniformly disastrous from the point of view of a genuinely free market. But even on the micro level, where his influence has been smaller and usually more beneficial, Friedman has provided to interventionists a theoretical loophole as wide as a barn door. For Friedman maintains that it is legitimate for the government to interfere with the free market whenever anyone's actions have "neighborhood effect." Thus, if A does something which will benefit B, and B does not have to pay for it, Chicagoites consider this a "defect" in the free market, and it then becomes the task of government to "correct" that defect by taxing B to pay A for this "benefit."

It is for this reason that Friedman endorses government supplying funds for mass education, for example; since the education of kids is supposed to benefit other people, then the government is allegedly justified in taxing these people to pay for these "benefits." (Once again, in this area, Friedman's pernicious influence has been in trying to make an inefficient State operation far more efficient; here he suggests replacing unworkable public schools by public voucher payments to parents—thus leaving intact the whole concept of tax-funds for mass education.)

Apart from the vitally important realm of education, Friedman would, in practice, limit the neighborhood effects argument to such measures as urban parks. Here, Friedman is worried that if the parks were private, someone might enjoy looking at one from afar and not be forced to pay for this psychic benefit. Hence, he advocates public urban parks only. Rural parks, he feels, can be private for they can be secluded enough to force all users to pay for services rendered.

It is small comfort that Friedman himself would confine this neighborhood-effects argument to a few instances, such as education and urban parks. In reality, this argument could be used to justify almost any intervention, and subsidy and tax scheme. I, for example, read Mises's *Human Action*; I therefore imbibe more wisdom and become a better person; by becoming a better person, I benefit my fellow man; yet, hang it, they are not being forced to pay for those

benefits! Shouldn't the government tax these people and subsidize me for being so worthy as to read *Human Action*?

Or, to take another example, whether Women's Libbers like it or not, many men obtain a great deal of enjoyment from watching girls in mini-skirts; yet, these men are not paying for this enjoyment. Here is another neighborhood effect remaining uncorrected! Shouldn't the men of this country be taxed in order to subsidize girls to wear mini-skirts?

There is no point in multiplying examples; they proliferate almost endlessly, and expose the total absurdity and the pervasiveness of Chicagoite neighborhood-effect concessions to statism. The only reply that Chicagoites have been able to make to this *reductio ad absurdum* is that they wouldn't carry government intervention that far, though they concede the logic. But why not? By what standard, by what criterion, do they stop at parks and schools? The point is that there is no such criterion, and this only points up the intellectual bankruptcy, the lack of logical rigor, at the core of most current-day economics and social science—Friedmanism included.

## The Impact of Friedman

And so, as we examine Milton Friedman's credentials to be the leader of free-market economics, we arrive at the chilling conclusion that it is difficult to consider him a free-market economist at all. Even in the micro sphere, Friedman's theoretical concessions to the egregious ideal of "perfect competition" would permit a great deal of governmental trust-busting, and his neighborhood-effect concession to a government intervention could permit a virtual totalitarian state, even though Friedman illogically confines its application to a few areas. But even here, Friedman uses this argument to justify the State's provision of mass education to everyone.

But it is in the macro sphere, unwisely hived off from the micro by economists who remain after sixty years ignorant of Ludwig von Mises's achievement in integrating them, it is here that Friedman's influence has been at its most baleful. For we find Friedman bearing heavy responsibility both for the withholding tax system and for the disastrous guaranteed annual income looming on the horizon. At the same time, we find Friedman calling for absolute control by the State over the supply of money—a crucial part of the market economy.

Whenever the government has, fitfully and almost by accident, stopped increasing the money supply (as Nixon did for several months in the latter half of 1969), Milton Friedman has been there to raise the banner of inflation once again. And wherever we turn, we find Milton Friedman, proposing not measures on behalf of liberty, not programs to whittle away the Leviathan State, but measures to make the power of that State more efficient, and hence, at bottom, more terrible.

The libertarian movement has coasted far too long on the intellectually lazy path of failing to make distinctions, or failing to discriminate, of failing to make a rigorous search to distinguish truth from error in the views of those who claim to be its members or allies. It is almost as if any passing joker who mumbles a few words about "freedom" is automatically clasped to our bosom as a member of the one, big, libertarian family. As our movement grows in influence, we can no longer afford the luxury of this intellectual sloth. It is high time to identify Milton Friedman for what he really is. It is high time to call a spade a spade, and a statist a statist.

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# Paul Samuelson's *Economics*, Ninth Edition

Reviewing another edition of Paul Samuelson's *Economics* is a task as impossible as reviewing in brief the present state of American economics itself. This spectacular best seller in the history of economic textbooks has inspired a flotilla of imitators. A new edition appears every triennium, replete with multi-colors, charts, diagrams, and the latest techniques in professional layout, and surrounded by satellite ships: instructors' manual, student workbook, readings, transparencies, test banks, you name it.

It is no accident that, in every succeeding edition, the colors get gaudier and, more important, the size gets bigger (868 pages in the eighth edition, 917 in the new ninth). For what the hapless undergraduate discovers in Samuelson and his flock of imitators is a vast potpourri (or kitchen midden, depending on one's point of view) of bits and smidgens of technique and of data, none of them integrated into any sort of digestible or comprehensible whole. Samuelson concludes the preface to his new edition by asserting, in his typically breezy style: "My envy goes out to the reader, setting out to explore the exciting world of economics for the first time . . . may I only say, bon appetit!" (p. xii). In contrast, my heart goes out to the poor bewildered undergraduate, confronted with this gigantic stew, ranging from opinionated wisecracks to the Giffen Paradox to marginal productivity analysis to Harrod-Domar-Modigliani growth models to notes on economists past and present to the latest ultrasophistication in reswitching analysis. What in the world can he make of all this? It is no wonder that economics is almost universally the most disliked

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subject in the college curriculum. The undergraduate is presented with no clear and coherent picture, no cogent guidelines on what economics is all about. Instead, beginning by knowing next to nothing about the field, he can only hold on, memorize like mad, and pray for the course to be over and his six credits achieved. Not that the other major texts are much better; Samuelson's *Economics* differs from its rivals largely in being bigger, more indigestible, and filled with the flip and unsupported wisecracks with which Samuelson is wont to dismiss deviant economic views.

Samuelson and most other texts get larger each edition because they are written as compendia of received economic opinion at the time of publication. And so very little gets dropped; as new economic problems are faced in the society, more chapters—more problem areas—get added to the book, whether the new fashion be underdevelopment or unemployment or inflation or the New Left or ecology. Hence, by their very nature, it is almost impossible for these textbooks to lead the profession, or to lead the concerns of society, or, therefore, to prepare the student for the new problems he is bound to face in the world he will enter. Instead, these textbooks are always and necessarily bringing up the rear, adding yet another section or chapter on a "relevant" fashion at the time of revision, only to find the subject old hat shortly after publication. Yet, several more indigestible bits and pieces are added permanently to the stew. How much better it would be to stop trying to touch on every conceivable economic topic and to take the basic essentials of economic theory and develop them carefully and thoroughly (as, for example, Alchian and Allen do in their brilliant *University Economics*, although this too is far above the true level of the basic introductory course).[1]

Before turning to the specifics of the ninth edition, let it be said that, as in the case of the preceding eight, the text suffers from the standard major ills of contemporary American economics: notably the sterile emphasis on the conditions of a static equilibrium which never can (and never should) exist, and the repeated sonorities of the Keynesian model presented without so much as indicating its major flaws and fallacies. Finally, like its predecessors, Samuelson's

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[1]Armen A. Alchian and William R. Allen, *University Economics*, 3rd ed. (Belmont, Calif.: Wadsworth Publishing, 1972).

ninth scarcely equips the reader for facing the real world of ever-accelerating inflation or of the recurring reality of inflationary recession. No cogent explanation of these burgeoning and unwelcome phenomena is offered.

The central feature of Samuelson's new ninth edition, as contrasted to the eighth, is his sincere attempt to dilute the aggressive and monolithic middle-of-the-roadism that marked his previous editions. Here he attempts to introduce his students to other, contrasting approaches to economics: from the Marxists and New Leftists on his left to Milton Friedman and the Chicago school on his right. Letting the nation's undergraduates know of other serious forms of economics than his own centrism is, of course, all to the good, and will hopefully instruct the student that there is more to economics than one man's (or even the majority's) crotchets.

Much needs to be done, for we still learn of critical points of view not as integral to the body of economics, but as just a few more indigestible pieces to add to our ever more impossible stew. Take the way in which Samuelson handles the numerous and cogent critiques of the validity of the GNP as any sort of welfare criterion. GNP and its allied concepts have been central to Samuelson's brand of Keynesian economics since the inception of his text in 1948. After nearly four decades of deadly criticism from both Right and Left, Samuelson is compelled to do something to acknowledge and even incorporate these criticisms. Instead of gaining some much-needed humility, and acknowledging the GNP and allied concepts are flawed to the very core (as he would do, for example, if he took to heart the lessons of Alex Rubner and Oskar Morgenstern), Samuelson simply and aggressively keeps GNP and tacks on one more flawed and unmeasurable concept, "net economic welfare," taken from Nordhaus and Tobin. Instead of discarding or at least downgrading GNP, Samuelson thus simply adds an NFW which tries vainly, for example, to measure such unmeasurable concepts as leisure and the "disamenities" of life (pp. 195–97).[2]

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[2]The Nordhaus-Tobin discussion is in William Nordhaus and James Tobin, "Is Growth Obsolete?" *Fifteenth Anniversary Colloquium V* (New York: National Bureau of Economic Research, Columbia University Press, 1972). Rubner's critique of GNP is in Alex Rubner, *Three Sacred Cows of*

In his new discussion of "sex discrimination" in the labor market, Samuelson does even more poorly, for he naïvely and uncritically accepts the simplistic charges of the women's lib movement that the lower earnings of women merely reflect discrimination and "exploitation" by employers. At some points, Samuelson's rhetoric is scarcely less hysterical than that of the embattled feminists: "Who is exploited? Women, of course. Who is the exploiter? In a sense, men, who are climbing, so to speak, on the shoulders of the downtrodden women" (p. 798). There is no consideration by Samuelson of the alternative possibility that female marginal productivity is lower than that of men. If that were not the case, then employers could reap extra profits by hiring only women at the lower wage rates. Why do they not do so? Nor does Samuelson mention the important empirical findings of Victor Fuchs that the earnings of women in self-employed occupations are relatively far lower, compared to men, than in employee occupations, which cuts directly against the idea of employer discrimination against females.[3]

In his attempt to give more weight to the views of the free-market economists to his right, Samuelson falls into the egregious error of including Friedrich A. Hayek among "Chicago School libertarians" and then compounds and reverses the error by including Frank Knight in the "Austrian School" (a term he leaves unexplained). Clearly, if Samuelson had granted to the libertarians a fraction of the care he has given to distinguishing between various brands and offshoots of Marxism, he would have taken the time to distinguish between these two very different variants of free-market economics.

In other areas, Samuelson's ninth edition merely repeats the errors and fallacies of the eighth. Thus, on his final page, he tries to refute Hayek's brilliant and complex analysis and warning in *The Road to Serfdom* by simplifying it beyond recognition and then dismissing it in a

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*Economics* (New York: Barnes and Noble, 1970), pt. 1. Also see Oskar Morgenstern, *On the Accuracy of Economic Observations*, 2nd rev. ed. (Princeton, N.J.: Princeton University Press, 1963).

[3]Victor R. Fuchs, "Difference in Hourly Earnings Between Men and Women," *Monthly Labor Review* (May 1971): 9–15. For an introductory textbook which does incorporate these finds, see Roger Leroy Miller, *Economics* (San Francisco: Canfield Press, 1973).

totally spurious "regression" diagram between "economic freedom" and "political freedom." Apart from the absurdity of this sort of regression, and the impossibility of "measuring" such freedoms, what can one think of a regression diagram that grants Hitler's Third Reich virtually the same degree of economic freedom as the United States in 1973? Does Samuelson know that the Third Reich was a collectivized and planned economy? One wonders, too, why the Communist countries rate no inclusion in this diagram at all. Perhaps a glimmering of doubt has invaded the small world in which Samuelson can call for ever bigger government in the economic sphere while expecting to retain full civil liberties. For he has omitted from the current edition (p. 885) the eighth edition's note to the freedom-regression diagram (p. 834): "Since the 1953 witchhunting days of Senator Joseph McCarthy, political freedoms of American citizens have improved despite increased economic role of government." Perhaps Professor Samuelson had a prophetic inkling of the soon-to-be-revealed horrors of the Watergate!

Another unfortunate repetition of error is Samuelson's failure to devote more attention to the business cycle and theories explaining this phenomenon. Now that the business cycle has been shown to be still with us, we can no longer settle for the glib Keynesian assurance that the cycle is a thing of the past, abolished by fiscal policy, even if we add on Friedmanian monetarism as an extra tool in the planners' arsenal. Hence the inadequacy of the brief and misleading footnote taken from previous editions which sums up the various cycle theories. The Austrian theory is almost scandalously treated as follows (in its entirety): "the over-investment theory . . . claims too much rather than too little investment causes recessions (Hayek, Mises, et al.)" (p. 256*n*). Here it is at least Samuelson's responsibility to explain the theory at some length, and to point out (a) that the "over-investment" is caused by continuous monetary inflation by the banks, and (b) that the result of the bank credit expansion is overinvestment in the "higher orders" of capital goods, matched by underinvestment in the consumer-goods industries.[4]

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[4]We might mention here the *bizarrerie* of Samuelson's including in his ninth edition a discussion of the highly advanced and sophisticated "reswitching" theory of capital in an elementary textbook (pp. 615–16).

Moreover, and still without presenting any evidence, Samuelson repeats the myth of ever-widening income differentials between the advanced and the underdeveloped countries. There is no hint of recognition by Samuelson of the subtle and sophisticated work that Peter T. Bauer has done over many years in demonstrating the mythology of this much-repeated assertion.[5]

Finally, Samuelson's eagerness to include every new development in the profession or in the economy has unaccountably overlooked what is perhaps the most important development in the economics profession in the past decade: the Coase-Demsetz analysis of the importance of property rights and of transaction costs and their use of property-rights concepts to analyze all the various problems of external economies and costs. The fact that there is not a single mention of transaction costs or of property-rights analysis in Samuelson demonstrates that perhaps our chef of the economic mulligan stew has a blind eye to developments that occur among his free-market colleagues.

Samuelson's ninth, in short, is a considerable improvement over previous editions. There is at least an attempt, however feeble, to pay attention to different points of views in economics. But Samuelson has a long way to go, and not only in including important theoretic concepts and new empirical research. In what future edition will he rethink the central idea of the swollen and elephantine grab-bag textbook, ever adding bits and pieces of data and technique, and never discarding or concentrating on the fundamentals of economic analysis? And in what future edition will he seriously call into question, not such fashionable "relevant" worries as the "quality of life" or ecology or alienation-and-the-early Marx, but the very heart of contemporary economics: static equilibrium and the Keynesian model? When indeed?

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Apparently, the inclusion of an alleged refutation of orthodox Austrian capital theory was too much of a temptation as a stick with which to beat free-market economics for Samuelson to resist.

[5]Thus, see Peter T. Bauer, *Dissent on Development: Studies and Debates in Development Economics* (Cambridge, Mass.: Harvard University Press, 1972), pp. 49–68.

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# Heilbroner's *Economic Means and Social Ends*

All symposia necessarily suffer from dispersion and lack of focus, but often they are redeemed by being permeated by an overarching and significant central theme. This symposium suffers even more than others on two vital counts: its vagueness and absence of clear focus, and the banality and lack of importance of its central theme.

For these are papers presented in two two-day symposia held in the spring of 1968 at the New School for Social Research, all dealing with the allegedly new science of "Political Economics" developed by Adolph Lowe, a professor emeritus at the New School. The entire work is suffused by a reverential "old boy" atmosphere that turns the papers into a celebratory exercise for the existence and the output of Professor Lowe; as a result, even the papers which could have been more searching and critical take on a muted and suffused tone, as if not to spoil the atmosphere of laudation. The disunity of the work is intensified by the fact that half the contributors are philosophers and the other half economists; the philosophers display minimal knowledge of economics and most of the economists ignore the philosophical problems involved. Professor Lowe begins the work by summarizing his position and then concludes with a reply to his commentators.

The abiding curiosity of the book is what Professor Lowe has accomplished to merit this extensive treatment. For his "new science

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of political economics" is little more than a cloudy and abstruse call for an instrumental form of socialism, and there is nothing here that has not been presented far more clearly and trenchantly by Marx, Veblen, and countless writers in the socialist literature.

To Professor Lowe, the great flaw of the free-market economy is that it is "disorderly" and unpredictable, presumably because every individual is free to pursue his own goals in his own way. It is the necessary task of government, then, guided, to be sure, by Lowe's "political economists," to coerce the citizenry into acting in a "predictable" fashion, and to impose "order" upon the economy in the service of what Lowe concedes are the purely arbitrary goals of the political economists. In short, the goals and ends decided upon by the economists-rulers, no matter how arbitrary they may be, are to be imposed upon the rest of society by dictatorial fiat and by the coercive arm of the State. In common with most would-be dictators throughout history, of course, Professor Lowe would like as many people as possible to adopt his goals themselves in a voluntary or at least quasi-voluntary manner. Hence his eagerness for massive propaganda efforts by the government and its political economists to "educate" the citizenry to support the goals of their rulers. But should such "manipulation"—a term conceded by Professor Lowe—fail, as in many cases it must, then the government must move on to frankly coercive measures. As Professor Lowe puts it, "So long as they have not conquered public opinion, such goals can be accomplished only if the sponsoring minority [his "political economists"] succeeds in imposing its will on an antagonistic majority." Of course, this elitist coercion is purely for the "good" of the coerced: "an enlightened minority perceives as a long-term necessity what to a majority, blinded by short-term concerns, appears as a is violation of its interests" (pp. 191–92).

Ever since the days of the classical economists, the advocates of dictatorial statism have run up against the rock of economic law. This is not simply because the bulk of economists have been committed to economic freedom and the decentralized decision-making of the market, but because economists have shown that government interventionism and full-scale socialist planning simply do not work, that is, do not achieve the stated goals of the rulers themselves. Hence the necessity for statists to deny the existence of economic law. Professor Lowe continues in this tradition. Hence his need to

create a methodology of economics which rejects the two major methodologies of modern economics: the "praxeology" of the Austrian school, and the positivism of the currently dominant Anglo-American orthodoxy, both of which arrive in variant ways at a structure of economic law. Lowe's "instrumental" methodology simply denies economics and relies solely on (a) arbitrary goals imposed by the political economists and other rulers; and (b) on "technology," which offers a purely technological guide to the achievement of these goals. Hence we are back in a form of Veblenian "technocracy," with economics discarded altogether. And yet, pure technology can offer no guide to the opportunity costs that must be weighed in any sort of rational allocation of economic resources; for this, a relatively free price system must be allowed to function along with its corollary of private ownership and freedom of exchange of ownership titles to resources. There is no hint of recognition by Professor Lowe that the socialist countries of Eastern Europe, led by Yugoslavia, have found it necessary to abandon socialist central planning and to move rapidly in the direction of a free-market economy, with its price system, decentralized decision-making and planning, and profit-and-loss tests for the allocation of resources.

Professor Lowe's political economics is of a piece with an unfortunate penchant of intellectuals since the days of Plato: to impose their own arbitrary and static "order" upon the rest of society, to freeze and annul change by their coercive fiat and to exert power over the rest of mankind. As a corollary, the structure of reality as embodied in economic law must be ignored and denied in order to make the vain attempt to enforce the whims and wishes of the intellectual upon the rest of mankind. The structure of reality must be ignored in order to try to impose the whims of the intellectual upon the world. In this attempt, the intellectual and the political ruler are closely allied. As the economist Ludwig von Mises has stated:

> It is impossible to understand the history of economic thought if one does not pay attention to the fact that economics as such is a challenge to the conceit of those in power. . . . The laws of the universe about which physics, biology, and praxeology [economics] provide knowledge are independent of the human will, they are primary ontological facts rigidly restricting man's power to act. . . . Only the insane venture to disregard physical and biological laws. But it is quite common to disdain economic laws. Rulers do not

> like to admit that their power is restricted by any laws other than those of physics and biology. They never ascribe their failures and frustrations to the violation of economic law.[1]

Apart from the central issue of Adolph Lowe's economics, there are important tangential questions which the book raises, though usually inadvertently. There is, for example, Professor Lowe's passion for "predictability," a passion which leads him to advocate governmental coercion to *make* people act in predictable ways. Much of this stems from a grave misunderstanding that economists and other social scientists have fallen on the notion that "science means prediction." For the "prediction" that the physical scientist makes in enunciating his physical laws is totally different from the "prediction" that economists have been indulging in. The scientist's predictions are of the form "If A, then B"; if copper and sulfur are mixed in certain proportions, they will yield copper sulfate. But the scientist is not a soothsayer engaged in "predicting" or foretelling the future: he never presumes to predict *how many* of his fellows, for example, will be making copper sulfate in their laboratories over the next year. And yet this is precisely the totally unscientific trap that economists have fallen into; instead of confining themselves to the scientific "prediction," "if A, then B," they are presuming to forecast the future. It is no wonder that, as Victor Zarnowitz and others have shown, the record of econometric forecasting, despite the use of the most sophisticated models and computers, has been so dismal—indeed, has been worse than simple extrapolation of trend, of even such a relatively simple forecast as predicting GNP for the next quarter. So long as men have free will and change their values and choices, and so long as knowledge changes and accumulates, scientific forecasting of the future will be impossible. Professor Lowe, entranced by the erroneous view of predictability, rightly sees that econometric forecasting has been a failure; but instead of concluding from this that economic science should be recast into a qualitative and "praxeological" mold, he presumes to abandon economics altogether and to turn to the secular arm to *force* people to act in predictable ways.

John Jewkes has aptly written that "the economist's claim to predictive authority must be false in that it leads to a palpable absurdity. If the economic future can, indeed, be described, why not also the

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[1]Ludwig von Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1949), pp. 67, 755–56.

scientific future, the political future, the social future, the future in each and every sense? Why should we not be able to plumb the mysteries of future time?"[2] And Professor Peter T. Bauer has written wittily and trenchantly comparing the contemporary mania for forecasting with the upsurge in credulity and belief in oracles and soothsayers during the years of decline of the Roman Empire.[3]

There is one group of people in society who are skilled in forecasting aspects of the future, and they do it far better than economists or politicians. These are the entrepreneurs and speculators: the entrepreneur who estimates his future costs and revenues; the speculator who tries to estimate the future course of stock or commodity prices. For forecasting is not and cannot be a science; at best it is an art, and the best such "artists" are those who have a "feel" for the conditions of their particular markets. There is a process of natural selection on the market which brings the better forecasters to the fore and discourages the poorer ones: the making of profits and capital gains and the suffering of losses. The poor forecaster on the commodity or stock markets will not last long in his chosen occupation. Yet it is precisely these superior forecasters on the market whom Professor Lowe finds to be harbingers of "disorder."

There is another fundamental flaw in Lowe's turning to government to insure predictability. What makes him believe that the actions of *government* are more predictable than the actions of individuals on the market! The latter are at least disciplined by the test of profit and loss. The former have no discipline exerted upon them whatsoever. Indeed, ever since the vagaries and whims of statutory law and executive edict have replaced the far more predictable rules of the common law, government action has been notoriously fickle and free-wheeling, and hence particularly unpredictable. In the jostle and bustle of ever-changing pressures and political influence-seeking by organized pressure groups, there is not even a profit-and-loss restraint to keep government within definable bounds. (The American Constitution has long ceased to serve as any sort of definable limit, particularly on economic questions.) Furthermore, as far as

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[2]John Jewkes, "The Economist and Economic Change," in *Economics and Public Policy* (Washington, D.C.: Brookings Institute, 1955), p. 83.

[3]Peter T. Bauer, *Economic Analysis and Policy in Underdeveloped Countries* (Raleigh, N.C.: Duke University Press, 1957), p. 30.

forecasting mania goes, the American government has had a notoriously poor record even in predicting its *own* expenditures for the next fiscal year, let alone the remainder of the economic system.

Finally, on what basis does Professor Lowe hold it self-evidently desirable to have complete predictability? Such predictability would only be possible if men were will-less, robots and automatons; since they are not, their actions will ever be gloriously free from perfect predictability. Would we really have a better world if they were reduced to automatons, even if this anti-human act could be accomplished? But of course, as in all variants of philosophical determinism, the determinist himself and his colleagues have prepared for themselves an implicit escape valve. *Other* people will be coerced and rendered predictable; *other* people will be manipulated or forced into being automatons; while Professor Lowe and his political-economist colleagues will have the free will to impose their own conception of economic and social goals.

Another important question raised, but hardly satisfactorily treated by this book, is the entire problem of the relation of the scientific economist to public policy. On what basis can the scientific economist advocate goals, or indeed, endorse any public policy whatever? None of the authors comes to grips with this question. Most, such as Professor Lowe and his self-proclaimed follower in economics, Carl Kaysen, simply and lightheartedly assert that the economist must be an activist in pushing for, advocating and even enforcing his own goals and his own political prescriptions. Even Fritz Machlup, of all the contributors the only one to point out, albeit mildly and tangentially, the authoritarian implications of Lowe's position, concedes that the economist must advocate goals and policies. Machlup, for example, scorns the "purists among us [who] may cry, 'Unclean! Unclean!' whenever they see a piece of welfare analysis" (p. 124). But this misses the vital point. No "purist," and certainly not the present reviewer, would try to bar any economist from ever advocating any public policy. But what he *would say*, and insist upon strenuously, is that it is totally illegitimate for economists, including Lowe, the other contributors and the great bulk of the economics profession, to advocate any public policy or to express any value judgments whatever in an *ad hoc*, arbitrary and offhand manner. To put it more explicitly, if an economist offers a value judgment or advocates policy, it is incumbent upon him to offer, stand upon and defend an *ethical* system from which the

judgment or policy can be deduced. Anything less is arbitrary, unscientific and illegitimate, and simply amounts to the arbitrary imposition of an economist's personal set of values upon society. In that case, the economist simply becomes a propagandist, not of a defensible ethical system, but of his own unsupported caprice. (This position, of course, itself stems from an ethical system which condemns capricious social judgments.)

Let us illustrate by postulating a "political economist" with a very different set of values from those held by Professor Lowe. He lives in an unspecified underdeveloped country and he sees that a certain ethnic group, say the Lebanese, have risen to important entrepreneurial positions in that economy. In the course of his discussion, he offhandedly asserts that it is necessary to place special taxes, burdens, and so on, on the Lebanese in order to reduce their weight in the economy and in society. And then he goes on to other matters. Here he has, as a good "political economist" or "welfare economist," imposed his own set of goals, *ad hoc* and unanalyzed, as if they were self-evident and needed no groundwork in an ethical system. In this case we would surely respond that our economist's value lucubrations were not enough: that he has the responsibility of offering a defensible ethical system which would support the placing of special burdens upon the Lebanese ethnic group. But if that is true in this case, it is true in all; whenever an economist ventures into the realm of political ethics, he must support his viewpoint coherently and systematically. Yet this procedure is all too rare among economists today.

Just a few more *curiosa* need to be mentioned. The extent of Professor Lowe's grasp of elementary economics can be gauged from one of his examples of the alleged growing divergence of economic behavior from classical maxims: "nowadays, rising prices are often accompanied by rising demand and falling prices, rather than by the 'correct' response of falling demand and rising prices" (p. 13). Charitably setting aside the "falling prices" phrase as a typographical error, we are still forced to the conclusion that Professor Lowe cannot distinguish between shifts in the demand curve and movement along the curve, the *pons asinorum* of freshman economics.

Then there is the anomaly of Professor Gurwitsch's contribution. Gurwitsch, a philosopher of the New School, restates Lowe's position with far greater clarity than Lowe himself is able to muster. But he does so while claiming to base his position on the work of the late

Alfred Schütz, the phenomenological sociologist at the New School. Yet there is not a hint in Gurwitsch's article of the fact, evident in Schütz's brilliant *Phenomenology of the Social World*[4] of Schütz's closeness to the methodological and sociological views of Ludwig von Mises, the founder of praxeological economics and champion of *laissez-faire*. Mises's views are at the polar opposite from those of Adolph Lowe, and certainly some attempt should have been made by Gurwitsch to clear up this anomaly.

Finally, there is the contribution of economist Carl Kaysen. Remarkably, Lowe embraces Kaysen's article even though Kaysen makes not a single reference to the various methodological issues with which Lowe or the other commentators are concerned. Clearly, the affinity is simply ideological, for Kaysen's essay is essentially a list of the government controls that Kaysen would like to see placed upon the economy. Perhaps the most remarkable is Kaysen's willingness to embrace a policy of extensive monetary and fiscal inflation coupled with direct price and wage controls "to repress inflation," and to do this *solely* to reduce negro unemployment to zero. Apart from the questionable ethics of imposing meat-axe burdens on the bulk of the population in order to benefit a minority, there is not a hint in Kaysen of even the possibility of arriving at the same goal by what is, at the very least, the more efficient approach of lowering or eliminating minimum wage rates, union restrictions or welfare payments.

There is no more apt conclusion to a review of this book than to repeat the quote from Frank H. Knight which Fritz Machlup puts into a footnote in his contribution:

> In the field of social policy, the pernicious notion of instrumentalism . . . is actually one of the most serious of the sources of danger which threaten destruction to the values of what we have called civilization. Any such conception as social engineering or social technology has meaning only in relation to the activities of a super-dictatorship, a government which would own as well as rule society at large, and would use it for the purposes of the governors. (p. 128*n*)

[4]Alfred Schütz, *Phenomenology of the Social World* (Evanston, Ill.: Northwestern University Press, 1967).

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# Buchanan and Tullock's *The Calculus of Consent*

I am so out of sympathy with James M. Buchanan and Gordon Tullock's *The Calculus of Consent* that I don't think a particularly detailed critique to send to them would be worthwhile. I recognize that there are some merits to the piece: a searching for methodological individualism in political science, an emphasis upon unanimity rather than majority rule, and a harking back to the constitutional system of 1900 as better than the situation today. But these merits are, I believe, more *ad hoc* than integral to the main body of work. In considering the work as a whole, they are far overshadowed by the numerous flaws and fallacies.

In the first place, their repeated references to "unanimity" are, at first, appealing, but they are highly misleading. A "social contract" theory of government, as you know, can be used in two different ways, and this difference is extremely important: it can be used to set up an *ideal* toward which the government should be transformed (essentially the view of John Locke), or it can be used to place a stamp of approval on all, or most, of the actions of the *existing* government (for example, Rousseau). Thus, the theory of the divine right of kings began as a *check* on government, as an order to the King to stay within divinely-commanded laws; it was transformed, by the State, into a divine stamp of approval for anything the King might decide to do. While there are elements of both in Buchanan and Tullock, the major emphasis of the "unanimity rule" is *not* so

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Excerpted from a letter to Dr. Ivan R. Bierly of the William Volker Fund, August 17, 1960; James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962). Comments refer to a manuscript version of the book.

much to set up a unanimity ideal, as to put a stamp of approval on existing government actions as being "really" backed by unanimous consent. I have noted this before in Buchanan's writings.

How is this done? In many ways, some of which are so involved in their transparent rationalizations as to be almost absurd. The basic way is to set up a dichotomy between "constitutional decisions" and concrete decisions of government policy. Buchanan and Tullock admit that concrete decisions might represent conflict: A and B winning out over, and even at the expense of, C. But "constitutionally," which is a term that they use quite vaguely but which apparently means the rules for government decision-making, they assume that these rules are somehow "unanimously" agreed to, and therefore that, in a sense, the concrete political decisions are also unanimous. Thus, the unanimity rule, seemingly libertarian, actually turns out to be more of a fallacious support for the *status quo*—whatever the *status quo* happens to be—than a plea for libertarian principle.

Why all of us are supposed to be behind the constitutional decisions, Buchanan and Tullock do not really support. They say (as Buchanan did in his journal article last year) that a thief is *really* for a law against stealing so as to keep his own property, so that it can be said that even a thief in a way approves of his own punishment. I think this is absurd; a professional thief is clearly *opposed* to laws against stealing (it is a rule of honor among professional criminals not to run to the police for help—and also a wise precaution for them). How did Buchanan and Tullock manage to get into this trap? By blithely assuming that when the "constitution" is being considered, no one knows whether or not he will be able to benefit by the various rules in specific situations, so it is to everyone's self-interest to have rules, as it were, in the general interest. Now this appears to me to be completely insupportable; people do have certain interests, and they will be able to gauge to what extent a rule will benefit or not benefit them. (This is especially true because Buchanan and Tullock think of the "constitution" as continuing, rather than as the original writing.) The professional thief knows he is a professional thief, and therefore that the weakening of laws against stealing, or constitutional provisions against stealing, will benefit him, and so on.

Further, by unanimity Buchanan and Tullock by no means always refer to real unanimity; instead, they speak of "relative unanimity" or "80 percent unanimity," and so on. In short, when the chips are

down, they are willing to waive unanimity in order that the "costs of decision" for the group or society be minimized. "Relative unanimity" is obviously a misleading use of semantics.

In short, despite a lot of talk about unanimity being called for, the upshot of the discussion is that (a) unanimity is weakened by numerous qualifications and circumlocutions—and that (b) much of the existing structure of government is endorsed as being "really" unanimity! This, of course, is worse than simply adhering to majority rule, and comes perilously close to the "we owe it to ourselves," "we are the government" position of the Left.

The worst example of this, including the definite tendency to rationalize the existing situation as reflecting unanimity, is the concept of "income insurance" to justify actions of government that "redistribute" income. Now it is obvious that when government takes from A and deliberately gives to B, this can hardly be called a gesture of unanimity, or people voluntarily banding together to purchase a service from government. But Buchanan and Tullock try to say this, by asserting that the wealthy *really* favor being taxed more than the poor, because they are taking out "income insurance," knowing that when they will be poor, the government, like an insurance company, will help them. And, in another place, they say that people really want to be coerced so long as they are all coerced, so that, everybody is really *not* being coerced. Not only do I consider all this nonsense, but it is dangerous nonsense as well, because it provides new support for the idea that anything that the State does, no matter how blatantly coercive, is "really" backed by everyone.

The placing of the stamp of approval on the State as being really unanimous, furthermore, permeates the entire analysis of this book. For the whole point of the book, the "new contribution," is that Buchanan and Tullock treat the State as just another service agency, basically voluntary, supplying "collective goods" to everyone, minimizing "external costs" when it can do so, and so on. The State is assimilated into the rubric of just another voluntary agency (albeit with complications), and each individual therefore decides on his value scale how much to allocate to private agencies and how much to government. This, I say, is the nub of the entire analysis of the book, and I think it is utterly and absolutely wrong. A significant quote from Buchanan and Tullock will point this up:

> We view collective decisionmaking, collective action, as a form of human activity through which mutual gains are made possible. Thus, in our conception, collective activity, like market activity, is a genuinely cooperative gain. By contrast, much of orthodox political thought seems to be based on the view that the collective choice process reflects a partisan struggle in which the beneficiaries secure gains solely at the expense of the losers.

I think it quite evident that "orthodox political theory" is infinitely superior to the construction of Buchanan and Tullock, and that even though on concrete questions, Buchanan and Tullock will want to reduce to some extent the current level of government operations, the impact of their analysis—of the book itself—will be much more to place a stamp of approval on State action which even "orthodox theory" hadn't placed upon it.

The nub of the distinction between State and market is that, on the market, all parties gain and benefit from market actions, whereas, in State action, the gains of one group can only be *at the expense of* others. Buchanan and Tullock's concept would obliterate the most vital distinction between State and market activity.

Furthermore, Buchanan and Tullock are considerably inferior to the "orthodox" New Welfare Economists, who at least formally recognize, even though they try to get around it, that there has to be unanimity for them to make "scientific" statements of whether society is better off, without introducing their own ethical judgments. (The New Welfare Economists, following Pareto, have in this sense always paid formal obeisance to the unanimity principle.) But Buchanan and Tullock, believing that State action is, on the whole, "really unanimous," believe that they can go much further in making "scientific" pronouncements without bringing in their own value-judgments, and thus they sin more than the usual "welfare economists" in smuggling in their own ethical judgments as scientific statements. This is particularly true in their grandiose conception of how "social costs," where they proclaim that individuals all decide on the exact proportion of government activity in regard to which they can minimize "social costs"; but how can "social costs" be even discussed when some people are gaining *at the expense* of others? To say, for example, that it will lower "social costs" (and therefore, for some reason, it will be good) if the few holdouts in a community who don't want to build a road be forced to pay in taxes for the road, is

a fallacious conception—although this is involved in the whole analytic structure of Buchanan and Tullock. For it will undoubtedly minimize the costs of the impatient people who want to get on with the job without "obstruction"; on the other hand, it will greatly *raise* the "costs" of those who staunchly oppose the road and do not wish to be forced to pay for it. Why is the former, and not the latter, "society"? The upshot is, that despite much talk by Buchanan and Tullock of their staunch individualism, especially methodological individualism, they are not consistent individualists at all. They smuggle in, through the back door, societarian and organicist conceptions, namely, in their discussions of social costs.

There are also certain grave epistemological flaws in the book. For one thing, Buchanan and Tullock are, methodologically, confirmed positivists—which is one reason why their theoretical structure is so slipshod. It is bound to be slipshod when their methodological doctrine is that assumptions don't have to be true in order to work, that theory is arrived at by "testing hypotheses" against empirical fact, and all the rest of the positivist trappings which apply the methodology of physics to the sciences of human action.

And second—what is really a corollary—is their misapprehension of what political theory is all about. In modern times, political theory has abandoned *political philosophy*: that discipline that deals with the problem of the nature of the State, what the State should and should not do, and so on. (It has abandoned political philosophy because it has given up the idea that there is a rational discipline of ethics, of which political philosophy is, in a sense, a subdivision.)

Hence, they want to construct a value-free political theory. But while such a theory is important and meaningful in economics, where the theory is based on the fact that people use means to achieve ends—it is empty and sterile in *political theory*. For, after all, politics is a matter of concrete decisions, which in contrast to everyday decisions of consumers and business firms, should be based on general principles. Give up the idea that there *are* such principles—that is, give up political philosophy—and you are left adrift with no rudder, and no genuine political theory. This is what has happened; and we have been left with "political science," with all the positivist trappings, the value-free "models," the quasi-mathematics, the jargon, and so on. Buchanan and Tullock are in this sterile "political science" tradition. But in a sense they carry this unfortunate modern

tendency much further. For by blithely assuming that there is no real difference between the State and private institutions and actions, by assimilating government to private actions, they have really become "political philosophers"—and very bad ones. And from this stems their treatment of *political* action as if it were just another good or service like beans and apples, and which is simply valued, like beans and apples, on our value-scales. This "economic" approach to politics, far from the great new advance they think it is, as far as I am concerned, is the death knell of all genuine political philosophy.

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