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THE REVIEW OF AUSTRIAN ECONOMICS

Articles

Roger W. Garrison
The Federal Reserve: Then and Now 3

Don Bellante
Sticky Wages, Efficiency Wages, and Market Process 21

Walter Block
Total Repeal of Antitrust Legislation:
A Critique of Bork, Brozen, and Posner 35

Joseph T. Salerno
Ludwig von Mises's Monetary Theory in Light
of Modern Monetary Thought 71

David Gordon
Justice and Redistributive Taxation:
James Buchanan versus Ludwig von Mises..... 117

VOLUME 8, NUMBER 1 **1994**

Articles

The Federal Reserve: Then and Now

Roger W. Garrison*

A good friend of mine has two sons who, in their youth, were unusually mischievous. On one occasion, when my friend had just replenished his liquor supply in preparation for a cocktail party that evening, his sons decided that a liquor cabinet was a pretty good substitute for a chemistry set. They broke the seals and poured from one bottle directly into the next: scotch into rum; rum into gin; gin into scotch. And they added a little créme de menthe all around. When their father discovered the deed (not in time to save the evening guests from some innovative cocktails), he issued punishment in the form of reduced allowances and increased yard duties. The two boys accepted the punishment gracefully and promised never to do that again. "You know," my friend told me, "I believe them. They'll never do *that* again. The next time, it'll be something else."

And so it is with the Federal Reserve. Mischievous by its very nature, it rarely does the very same thing twice. Fed-watchers, always looking for a precise pattern in monetary aggregates, hoping to get an exact fix on the Federal Reserve's *modus operandi*, are almost sure to be disappointed. The enduring capacity of the Federal Reserve to exert a powerful influence on the course of economic events derives importantly from its adaptability. New trends in fiscal policy and modifications in the regulatory environment can change the nature and significance of Federal Reserve actions in ways that are difficult to perceive until after the fact.

In recent years, difficulties in perceiving just how the Federal Reserve is affecting the course of the economy have translated

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into doubts that the Federal Reserve has a significant effect—doubts even that money has much to do with the cyclical variation of employment and output. So-called real theories of the business cycle account for each departure from trend-line growth in terms of some real shock to the economy—which typically means a change in technology or in resource availability.[1] In turn, the focus on macroeconomically significant real shocks, which are relatively few and far between in comparison to monetary shocks, has caused many modern macroeconomists to believe that business cycles themselves are far less troubling than was once thought.[2] To similar effect, the increasing reliance on an analytical framework that reduces all macroeconomic phenomena to considerations of aggregate demand and aggregate supply has led textbook writers to emphasize the temporariness of cyclical variation rather than the pervasive discoordination and painful recovery that characterize boom and bust.[3]

Such treatments of cyclical variations and of the relationship between monetary and fiscal policy are fundamentally flawed. While important changes in the fiscal and institutional environment underlie the comparison between the Federal Reserve then (1920s–1930s) and the Federal Reserve now (1980s–1990s), the Federal Reserve's power to create money must figure importantly in the accounts of both periods. Understanding just how, though, requires an analysis that makes use of a level of aggregation much lower than that of conventional macroeconomics.

[1]Real business cycle theorists take the empirically demonstrated links between money and economic activity to be a result of "reverse causation": changes in the money supply are seen as the effect rather than the cause of changes in economic activity. For a critical account of this and other aspects of real business cycle theory, see Mark Rush, "Real Business Cycles," *Federal Reserve Bank of Kansas City Economic Review* 72, no. 2 (February 1987): 20–32.

[2]"Real cycle theorists question . . . the conventional wisdom, which asserts that business cycles harm the economy." Ibid. p. 26. Rather than causing the economy harm, minor changes in the economy's output are understood to be a consequence of an efficient market coping with minor (macroeconomically speaking) changes in underlying realities. (In this context, the Great Depression is seen as something of an "outlier" not well accounted for by this or any other theory of the business cycle.)

[3]Long-run aggregate supply, which reflects resource availabilities and technology, is invariant with respect to the price level and hence is represented by a vertical supply curve. Thus, the real effects of a money-induced change in aggregate demand, as would be measured horizontally, are strictly temporary, lasting only until the price level has become adjusted to the larger money supply.

From Textbook Macroeconomics to Macroeconomic Realities

Macroeconomic policy is conventionally divided into two categories: monetary policy, which is formulated and implemented by the Federal Reserve, and fiscal policy, which is the net effect of the many spending and taxing decisions made by Congress. Macroeconomic textbooks typically introduce monetary and fiscal policies in separate chapters and then deal with the interplay between the two by constructing multi-quadrant graphs in which the money supply, government spending, and the level of taxation, each represented in separate quadrants, have a combined economywide effect on the rate of interest and the level of income.

There is a certain logic to this policy decomposition. Inflating, spending, and taxing in the conventional macroeconomic framework have their own separate short-run effects on the interest rate and income level: expansionary monetary policy causes incomes to rise and interest rates to fall; expansionary fiscal policy (increased government spending or decreased taxation) causes both incomes and interest rates to rise. The effect of coordinated monetary and fiscal policy is simply the sum of the individual effects. Economic expansion driven by both the Federal Reserve and the federal budget, for instance, has a double-barreled effect on the level of income while leaving the rate of interest unchanged.[4]

Yet the relevance of such textbook treatments of policy hinges on several critical assumptions. By expanding the money supply, policymakers intend to affect output and employment rather than prices and wages. Any hopes for these intended real effects—as opposed to purely nominal effects—must be based on the assumption that prices and wages are somehow stuck above their market-clearing levels at the outset of the expansion and that the new money lent at lower interest rates is used only to mobilize otherwise idle resources. If, instead, pre-expansion prices and wages are fully adjusted to their market-clearing levels, then the effects of monetary expansion are only temporary. In the long run, real incomes return to their pre-expansion levels as prices and wages adjust upward; real interest rates return to their pre-expansion

[4]A typical textbook treatment of macroeconomic policy is contained in William J. Baumol and Alan S. Blinder, *Economics: Principles and Policy*, 5th ed. (New York: Harcourt, Brace, Jovanovich, 1991), chaps. 11 and 13 and *passim*.

levels as rising prices and wages build an inflationary premium into the structure of nominal interest rates. Similarly, expansionary fiscal policy, which increases real rates of interest, has only a temporary effect on incomes under conditions of flexible prices and wages. These assumptions and qualifications are acknowledged—though sometimes cryptically—in most modern macroeconomic textbooks.

But these treatments employ an exceedingly high level of aggregation, whereby "income" summarily measures both the total output produced in exchange for that income and the spending power capable of buying that output. This aggregation causes the phrase "temporary effects of fiscal and monetary policy" to seem innocuous or benign, seriously understating the actual effects of policy. The conventional wisdom is that policy in the form of such "stimulus packages" may temporarily push the activities of producing, earning, and spending beyond levels that can be sustained. At worst, the dynamics of policy-induced changes in macroeconomic magnitudes give scope for political chicanery as incumbent administrations resort to fiscal and monetary stimulants just prior to elections.[5]

According to an increasingly common view, cyclical movements in income and output—whether attributable to policy actions or to real factors—are considered harmful only in that the timing of consumption is slightly less than optimal. This assessment allows for a quantitative estimate of the welfare loss due to temporal suboptimality of approximately one tenth of one percent of total consumption—which translates into about $8.50 per person per year.[6] Disaggregating the economy's investment sector into policy-relevant patterns of investment, however, reveals that the temporary effects are not so benign. The scope for harm caused by monetary and fiscal stimulants can instead be seen in

[5]For early and non-trivial formulation and application of modern political business cycle theory, see William D. Nordhaus, "The Political Business Cycle," *Review of Economic Studies* 42, no. 130 (April 1975): 169–90 and Edward R. Tufte, *Political Control of the Economy* (Princeton: Princeton University Press, 1978).

[6]Robert E. Lucas, Jr., *Models of Business Cycles* (London: Basil Blackwell, 1987), p. 27. Despite his low estimate of the social cost of cyclical variation of output, Lucas rejects real business cycle theory on the grounds that the candidates for real shocks are too small to account for actual fluctuations. Ibid., p. 71. Textbook authors typically offer no quantitative estimate of the harm attributable to business cycles, but the fact that Baumol and Blinder's 900-page textbook devotes less than six pages—and nowhere more than two consecutive pages—to the subject of business cycles carries its own message.

terms of unsustainable changes in the pattern of investment. Even if the spending power of income earners equals total output in aggregate terms, a systematic, policy-induced mismatch between decisions in the investment sector and the underlying preferences of consumers and wealth holders can lead to severe economic downturns and painful recoveries.

By carefully identifying the relevant aspects of investment patterns in different cyclical episodes, we can identify both theme and variation in the story of boom and bust. We can find both similarities and differences, for instance, in comparing the experience of the 1920s and 1930s with that of the 1980s and 1990s. Further, we can show that the prolonged succession of policy-induced "temporary" effects, which has fundamentally changed the relationship between fiscal and monetary policy, has had permanent effects on the health of the economy.

Variation on a Theme

How strong are the parallels between the boom of the 1920s and the boom of the 1980s? How similar are the economic circumstances of the early 1990s to those of the early 1930s?

It may be tempting to try to account for our current macroeconomic plight by retelling the story of the interwar experience, changing only the dates and a few minor details. But the story doesn't fit that well. Credit conditions as judged by real rates of interest were relatively tight during the 1980s in comparison to credit conditions during the 1920s. And although the overall monetary expansion was actually greater in the more recent episode, the patterns of monetary growth in the two periods differs importantly. In the 1920s, the money growth rate peaked near the end of the decade as the Federal Reserve attempted with increasing resolve to keep the boom going; in the 1980s, the peak growth rate of M1 came at mid-decade, after which monetary growth fell to low single digits while the bull market continued. Adjusting the story by replacing the conventional money or credit aggregates with more narrow ones, such as the monetary base, or with broader ones, such as the Divisia index, does little to improve the fit. And given the intense Fed-watching in recent decades, it would in fact be surprising to learn that the Federal Reserve had nonetheless ignited and sustained an artificial boom for several years by simply repeating its misdeeds of the 1920s. There is, after all, a kernel of truth in the notion of "rational expectations"—as recognized by Ludwig von Mises

years before that term achieved currency in macroeconomic thought.[7]

Parallels can be found not in the strict sense of a replay but in the broader sense of variation on a theme. The story requires a recasting of the characters and some major changes in the plot. The Federal Reserve no longer plays the lead; it plays instead an indispensable supporting role. Banking legislation and fiscal policy are more central to the storyline. In accounts of both periods, however, we can say that unprecedented conditions allowed an artificial boom to go unchecked for a significant period of time. Unprecedented in the 1920s was a strong central bank bent on stimulating growth in a peacetime economy. Unprecedented in the 1980s was a banking industry operating in a dramatically altered regulatory environment and a federal government running deficits measured in the hundreds of billions.

Interest rates in the recent episode play an important role not so much because of considerations of time discount but because of considerations of risk. During the 1920s, the low time discount signaled by artificially depressed interest rates did not accurately reflect people's actual willingness to save; during the 1980s, the low risk premiums built into interest rates did not accurately reflect people's actual willingness to accept the risks of increasingly speculative investments—much less the additional risks attributable to the government's irresponsible fiscal policy. The boom of the 1980s was no less artificial, however, than the one in the 1920s. To see why, we shall have to shift our focus from the easy money provided by the Federal Reserve in the 1920s to the risk-free securities provided by the Treasury in the 1980s. But first let us highlight aspects of the 1920s that have identifiable counterparts in the 1980s.

The Federal Reserve played a leading role in the dramatic boom of the 1920s (and the bust of the 1930s). Artificially cheap credit provided by the Federal Reserve underlay the economic expansion that lasted through mid-1929. This credit expansion, in an economic environment largely devoid of Fed-watchers, drove a wedge between saving and investment. Guided by low rates of interest, investment outstripped saving in aggregate

[7]Ludwig von Mises, *The Theory of Money and Credit* (New Haven: Yale University Press, 1953; originally published in German in 1912). Mises fully recognized the strategic significance of expectations in his 1953 addendum entitled "Monetary Reconstruction." He expressed the limits to—and the short-run nature of—inflationary finance in terms of Lincoln's Law: You can't fool all the people all the time (see p. 419).

terms, and—more importantly—investment projects were excessively long-term. As the boom proceeded, low interest rates lured capital into relatively time-consuming production processes. That is, the timing of the output of these production processes was skewed toward the future in comparison to the intertemporal pattern of demand for output. While the intertemporal distortion of output is the essence of so-called real business cycle theory, it is only a symptom, in the view presented here, of a pervasive distortion in the economy's capital structure. The economywide inconsistencies—attributable to Federal Reserve policy—between investment decisions of the business community and the time preferences of consumers made the bust inevitable. The recovery, hampered by policies aimed at re-igniting the boom, consisted of extensive capital liquidation and a general intertemporal restructuring of capital.

Modern textbook treatments of the recent economic boom in comparison to the interwar boom hinge on a sharp distinction between monetary and fiscal policy. The earlier boom was driven by monetary policy; the later one by fiscal policy. It is true that the 1920s were characterized by (relatively) tight fiscal policy and loose monetary policy as each is conventionally measured, and that the 1980s saw a reversal in the relative strengths of the two policy alternatives. But the strict dichotomization between fiscal and monetary policy is badly overdrawn. In the 1980s, the significance of fiscal policy lay not in its augmentation of aggregate demand but in the private-sector risks and uncertainties that were attributable to chronic and dramatic federal budget deficits. This shift in focus directs attention to the Federal Reserve's critical supporting role throughout the decade and to the banking legislation at its beginning.

While irresponsible fiscal policy created additional risks and uncertainties to be born by the private sector, the Federal Reserve in its capacity to monetize Treasury debt kept the risk premium off Treasury securities. Further, while extensive changes in the regulatory environment faced by the banking industry led banks to take on increasingly riskier portfolios, the Federal Reserve in its capacity of lender of last resort—together with policies of the Federal Deposit Insurance Corporation (FDIC)—kept the risk premium off bank securities and minimized the worries of the banks' depositors. Although the story of the 1980s is institutionally complex, the general nature of the problems in the private sector is relatively simple. The regulatory and policy environment led the business community to take on risks that were

systematically out of line with the risk preferences of private wealth holders. This systematic discrepancy between risks undertaken and risk preferences, which provides the thematic link to the interwar episode, justifies the claim that the 1980s boom was artificial and that the bust was inevitable.

Deficit-Induced Uncertainties

It is not difficult to demonstrate that chronic and dramatic federal budget deficits create uncertainties in the private sector.[8] A numerical example can serve to illustrate. Suppose the government's anticipated rate of spending over the next several years is a trillion dollars per year and that it anticipates collecting $800 billion per year in tax revenues. The difference, the anticipated annual deficit, of $200 billion represents yet-to-be-funded government spending.

The business community understands that the government will appropriate a trillion dollars worth of resources each year. Tax codes stipulate the particular targets of eighty percent of the government's appropriation activities. Production plans can be made in the light of these codified taxing procedures. But there can be no plans that effectively take into account the other twenty percent, the anticipated deficit. In effect, the government is putting the private sector: "We are planning on appropriating another $200 billion worth of resources, but we are not saying just how, just when, and just whose."

The government may continue issuing new Treasury bills while holding the line on the money supply. This would mean continued strains on credit markets, real rates of interest higher than they otherwise would be, and continued trade deficits as the Treasury sells those bills both at home and abroad. Alternatively, the government may rely more heavily on money creation. The Federal Reserve may begin buying Treasury bills at an accelerated rate. This process of debt monetization would take the pressure off credit markets and strengthen export markets. It would reduce the real rate of interest (temporarily) but would build an inflation premium into the entire structure of interest rates. As still another alternative, the government may institute new taxes of some kind or raise tax rates in some yet-to-be-specified way. In

[8]Deficit-induced uncertainties underlie the arguments in Roger W. Garrison, "Public-Sector Deficits and Private-Sector Performance," in *The Crisis in American Banking,* Lawrence H. White, ed. (New York: New York University Press, 1992), pp. 29–54.

the meantime, a $200-billion cloud of "intent to appropriate in some unspecified way" looms large over the private sector.

There is no effective hedge against uncertainty of this kind. There are no probabilistic answers to the question of just how the government will appropriate the additional resources. Should long-term capital be shifted out of export industries because of the currently high foreign-trade deficit and correspondingly weak export markets? Or should it be kept in place by anticipations of—or hopes for—a change in fiscal strategy? Should long-term financial commitments be based on the current credit conditions or on the contingency of some unknown likelihood that the Treasury will borrow more heavily in domestic as opposed to foreign credit markets? Should land, durable assets, and even inventories be bought or sold at prices that reflect current inflation rate? Or should such transactions reflect accelerating inflation based upon some guess about the extent and timing of debt monetization?

Although the government's borrowing at irresponsibly high levels adds to the riskiness of private-sector activities, none of these risks are born by the holders of Treasury securities. This discrepancy between risk created and risk assumed can be directly attributed to the Federal Reserve in its capacity to monetize Treasury debt. Overextended borrowers in the private sector must pay a substantial default-risk premium in order to continue borrowing. Even overextended municipalities pay a default-risk premium as their bonds are downgraded by bond-rating agencies. The power to tax alone is not enough to protect municipal bondholders against default. But the interest rate paid by the federal treasury contains no default-risk premium at all. The Federal Reserve stands ready to monetize the Treasury's debt in circumstances that otherwise would require an outright default. It is true, of course, that *actual* monetization imposes costs in the form of price distortions and a general price inflation, but these costs are imposed on the economy in general—not just the holders of Treasury securities. Since a "monetization risk," unlike a default risk, is born by holders and non-holders alike, there is no monetization-risk premium—separate from the economywide inflation premium—built into the nominal yield on Treasury securities. The very potential for debt monetization is what breaks the link between fiscal irresponsibility and some corresponding risk premium.

The Federal Reserve, then, plays a critical supporting role in the pursuance of fiscal policy. Relieving the holders of Treasury securities of any risk burden increases the attractiveness of those securities and thus eliminates what would otherwise be a binding

market constraint on further Treasury issues. The increasing significance of *potential* debt monetization suggests that the magnitude of the Federal Reserve's influence is not to be detected in *actual* movements of monetary aggregates. The mere fact that the Federal Reserve stands ready to monetize debt gives the Treasury a much longer leash than it would otherwise have.

The Artificial Boom

Textbook treatments of fiscal and monetary policy recognize that the fiscal authority and the Federal Reserve can work together. The Treasury issues debt and the Federal Reserve monetizes it. So long as government borrowing has not been pushed to irresponsible levels, debt issue and monetization have short-run effects on output and incomes that reinforce one another and short-run effects on the interest rate that cancel one another. These effects of policy are derived straightforwardly from standard analysis which focuses on aggregate supply and aggregate demand. But when borrowing becomes excessive, considerations of risk become dominant. Going beyond the circumscribed focus of the textbook, we can recognize that the Treasury creates risk and the Federal Reserve externalizes it.

To say that the Federal Reserve keeps the default-risk premium off Treasury bills is not to say that the risk is actually eliminated. The burden of bearing it is simply shifted from the holders of Treasury securities to others. Borrowing and investing in the private sector becomes more risky than it otherwise would be. Holders of private debt and equity shares must concern themselves not only with all the usual risks and uncertainties of the marketplace but also with the risks and uncertainties attributable to changes in the way the federal deficit is accommodated. Selling Treasury bills in foreign credit markets, in domestic credit markets, or to the Federal Reserve can have major effects on the strength of export markets, on domestic interest rates, and on the inflation rate. The inability of market participants to anticipate the Treasury's borrowing strategy translates into unanticipated changes in the value of private securities.

If the additional risks attributed to federal budget deficits and imposed upon the private sector were allocated in some economically efficient way, there would have been no artificial boom arising from the irresponsible fiscal policy of the 1980s. The willingness to lend and to buy equity shares in the private sector would have been generally reduced, as wealth holders opted for

the artificial security provided by government debt; but the reduction in private-sector activity would have been minimized so long as the additional risks were assumed by those most willing to do so. This result, though, was precluded by institutional factors that hid the private-sector riskiness from those who were (unknowingly) financing risky undertakings. Again, the Federal Reserve plays a strong supporting role, as does the FDIC. Together, they enabled commercial banks and their depositors to finance risky ventures throughout the 1980s while being shielded either permanently or temporarily from the risks. This shield from risk bearing, like the low rate of interest in the 1920s, gave rise to an artificial boom and subsequent bust.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) dramatically changed the banking industry's ability and willingness to finance risky undertakings. Increased competition from nonbank financial institutions drove commercial banks to alter their lending policy so as to accept greater risks in order to achieve higher yields. The Federal Reserve in its long-established capacity of lender of last resort diminished the banks' concerns about possible problems of illiquidity while the FDIC absolved the banks' depositors of all worries about illiquidity and even about bankruptcy. Riskier loans, then, were only partially reflected in higher borrowing costs and lower share prices. In substantial measure, specific private-sector risks were transformed by DIDMCA, the Federal Reserve, and the FDIC into (1) the generalized risk of inflation in the event of excessive last-resort lending by the Federal Reserve and (2) the risk of a large and unbudgeted liability in the event of excessive last-resort closings by the FDIC. Thus, economic activity in the private sector was spurred on by the lure of higher yields, yet it was largely unattenuated by considerations of risk, which were effectively externalized and diffused.

The artificially low risk premiums stemming from the risk-externalizing effect of potential debt monetization in the 1980s paralleled the artificially low interest rates created by actual monetary expansion in the 1920s. What was without an earlier parallel, however, was the impact of deposit insurance in the post-DIDMCA period.[9] Throughout the 1980s, the FDIC continued

[9]For a treatment of the effects of FDIC policy, see Roger W. Garrison, Eugenie D. Short, and Gerald P. O'Driscoll, Jr., "Financial Stability and FDIC Insurance," in *The Financial Services Revolution: Policy Directions for the Future*, Catherine England and Thomas Huertas, eds. (Boston: Kluwer Academic Publishers, 1987), pp. 187–207.

to protect depositors while charging the banks a premium that was too low in general and, more significantly, that was unrelated to the riskiness of bank assets. This subsidy to risk-taking may have been significant enough, by itself, to create an artificial boom. There was no difficulty in finding risks to take. Banks could simply lend more heavily to overextended farmers, third-world countries, oil prospectors, and real estate developers; or they could find new risks such as those created by leveraged buyouts and the dramatic growth of the junk-bond market. It was the financial sector's demand for high-risk, high-yield securities, in fact, that gave junk bonds and other highly leveraged securities their buoyancy.

Although it is possible to think of the FDIC as having its own independent effect throughout the 1980s, FDIC policy was actually an integral part of the fiscal, monetary, and regulatory environment that created and externalized risks. The Treasury created risk; the Federal Reserve and the FDIC externalized it. After all, speculative lending such as for commercial real estate development or for highly leveraged financial re-organizations are risky in large part because of possible changes in such things as the inflation rate, interest rate, trade flows, and tax rates—the very things that can undergo substantial and unpredictable change when the federal budget is dramatically out of balance. The 1980s may best be understood, then, as a decade in which the policy-induced externalization of risk gave rise to a substantial but ultimately unsustainable economic boom.

The Bust

Potential debt monetization can keep Treasury bills risk free for the indefinite future; the reimbursement of depositors of failed banks can continue so long as the FDIC can be recapitalized out of general tax revenues. But the banking industry cannot be shielded from the consequences of excessive risk-taking forever. For almost a decade the banking industry and the speculative activities it supported were able to keep the economic expansion going. Although risk aversion normally characterizes sound banking, high-flying banks in the 1980s were able to indulge in risky lending despite the preferences of their depositors and to escape both market-imposed or government-imposed discipline until the cumulative effects of externalizing risk turned the undue risk-taking into a financial crisis. The Federal Reserve's routine functioning as lender of last resort, the FDIC's *de facto*

policy of forbearance in cases of problem banks, and the implicit acceptance of the doctrine of "too big to fail," all help to account for the length of the artificial boom. But neither increased last-resort lending and forbearing nor more overt inflationary finance, such as was pursued in the 1920s, could keep the boom going indefinitely. As with the artificial boom in the interwar period, an eventual bust was inevitable.

Like the time-consuming production processes that were out of line with time preferences, speculative loan portfolios that were out of line with risk preferences generated an artificial boom in the 1980s that belonged to the same general class as that of the 1920s. However, the distinction between economic activities that are excessively future-oriented and economic activities that are excessively speculative—together with some institutional considerations—allows us to see systematic differences between the 1930s and the 1990s.

First, the downturn at the end of the Bullish Eighties came in the form of a bank-led bust. A high rate of bank failures was experienced well before the general economic contraction. At the end of the Roaring Twenties, by contrast, the bank failures came after the economic contraction had begun. This difference in the timing of events is consistent with differences in the nature of the two expansions. Industrial borrowers in the 1920s were using newly created funds for excessively capital-intensive ventures that, in general, were not otherwise excessively speculative. It is true, of course, that there was heavy speculation in securities markets in the 1920s—much more so then than in the 1980s—but the cause-and-effect relationship in the recent episode was the reverse of that in the earlier one. That is, in the 1920s, monetary expansion, which allowed banks to support heavy industry, also fueled speculation in securities markets. However, because the risks of that speculation were born, in the first instance, by the buyers of the securities, there was no policy-induced externalization of risk to weaken banks even as the expansion continued. In the 1980s, policy-induced speculation, on the part of the banks themselves and their industrial borrowers, eroded bank capital, weakening the banks throughout the boom—so much so that the erosion of their capital base eventually turned boom into bust.

Second, while the idleness of plant, equipment, labor, and other resources that characterized the 1930s has its counterpart in the semi-idleness in the 1990s, the disposition of unprofitable assets is different now, largely because the recent bust was

bank-led. During the Great Depression, firms whose revenues did not cover operating costs simply closed their doors. Work on incomplete industrial projects whose present value had turned negative was simply discontinued. Although this form of market discipline was sometimes delayed by policies aimed at rekindling the boom, eventually resource idleness characterized those sectors of the economy that were most out of line with underlying economic realities, and liquidation could proceed apace.[10] In the current slowdown, many failing firms are first identified as nonperforming loans in the portfolios of failed banks. As insolvent banks are closed by the FDIC, the bad loans are transferred to the Resolution Trust Corporation (RTC), which functions as a caretaker until it can sell the assets. In many cases, the physical assets, such as franchised motels or restaurants, are not idled. Instead, the RTC contracts with an operating company to run the business. The contract allows the operating company to earn a profit while minimizing the cost to the RTC of maintaining the assets.

The existence of many such failed-but-still-operating businesses, including firms undergoing bankruptcy proceedings but still operating with the newly evolved debtor-in-possession (DIP) financing, helps to explain why the current recession is a relatively shallow one by conventional measures. What otherwise would be idle capital is partially masked by RTC policy as underemployed capital—analogous to the underemployed labor associated with 1930s-style make-work projects. "Zombie banks," banks that are allowed to continue operations after their net worth has turned negative, have their counterpart in RTC-owned or DIP-financed "zombie firms."[11]

While the underemployed capital in zombie firms limited the depth of the recession, it added to the length. Recovery consists of re-employing resources idled by the bust. As confirmed by

[10]On the role of government in adding to the severity of the Great Depression and delaying recovery, see Gene Smiley, "Can Keynesianism Explain the 1930s?: Reply to Cowen," *Critical Review* 5, no. 1 (Winter 1991): 81–114 and Richard K. Vedder and Lowell E. Gallaway, *Out of Work* (New York: Holmes and Meier, 1993), pp. 74–149.

[11]The term "zombie S&Ls" was coined by Edward J. Kane in the context of the savings-and-loan crisis, which was a precursor to the crisis in the banking industry and subsequent recession. See Edward J. Kane, "Dangers of Capital Forbearance: The Case of the FSLIC and the 'Zombie' S&Ls," *Contemporary Policy Issues* 5, no. 1 (January 1987): 77–83. For a healthy perspective on RTC policy and DIP financing, see Stephen Delos Wilson, *The Bankruptcy of America* (Germantown, Tenn.: Ridge Mills Press, 1992), pp. 81–96 and *passim*.

experience in the early 1990s, it would have been easier to draw resources out of idleness than to draw them away from the RTC. Asset managers of the RTC, trying to avoid spoiling markets that dumping real assets at fire-sale price would entail, stockpiled them instead, creating a huge "overhang" which added significantly to the uncertainties in the private sector. Also, solvent firms and would-be upstarts, who would have to raise their own capital to expand or enter the market, are not eager to compete with bankrupt firms or with privately operated but RTC-owned businesses whose revenues do not have to cover the costs of capital. Considerations of these sorts help to explain why the government's recent recourse to monetary stimulation in the form of exceedingly low discount rates has met with such little success.

Third, the unemployment currently being experienced has a distinctly different composition from that of the 1930s. It is widely reported that white-collar workers are disproportionately affected in the current recession as compared to earlier cyclical downturns. The time-preference/risk-preference frame of analysis makes this composition difference readily understandable. The boom in the 1920s involved resources allocated disproportionately to capital-intensive projects, such as steel mills and manufacturing plants. The labor complement to heavy industry tends to be predominantly blue-collar. The boom in the 1980s involved resources allocated to speculative development, such as commercial real estate and financial services. The labor complement to this kind of capital tends to be predominantly white-collar. In both episodes, the composition of unemployment matches the pattern of capital misallocation.

Finally, macroeconomic policy after the bust reveals a critical difference between the current situation and that of the 1930s. When further monetary expansion, which sustained the boom of the 1920s for nearly a decade, could sustain it no longer, both the monetary expansion and the boom came to an end. The public's increased demand for currency relative to checking-account money, coupled with the increased reluctance on the part of commercial banks to lend, swamped the Federal Reserve's efforts to re-inflate.[12] Despite the further padding of the monetary base, the dynamic of the bust itself was an effective check against continued monetary expansion. By contrast, when further deficit spending and risk externalization, which sustained the boom of

[12]See Smiley, "Can Keynesianism Explain the 1930s?" p. 88.

the 1980s, could sustain it no longer, the boom ended, but the deficit spending and risk externalization escalated. In fact, decreased tax revenues and increased payments of entitlements, both associated with recession, led to still more government borrowing. The dynamic of the bust, then, provided increased scope for the very kind of irresponsible fiscal policy that made the bust inevitable.

How Little "We" Know

The failure at the dawn of the last decade to extend deregulation to the provision of deposit insurance and the absence of any market check against the Treasury's fiscal excesses provide dramatic illustration of the general fallacy of the mixed economy. Privatized profit seeking coupled with socialized risk bearing undergirded both the bull market of the 1980s and the harsher economic realities of the 1990s. The risks assumed by lenders and borrowers, savers and investors, hedgers and leveragers are rendered inconsistent with the actual risk preferences of wealth holders in the marketplace by the FDIC subsidy to risk bearing and by the Fed-backed Treasury, whose power to issue risk-free debt imposes risks on the private sector.

Researchers at the Federal Reserve are just two steps away from recognizing the problem of deficit-induced uncertainties as evidenced by a recent article entitled "How Little We Know About Deficit Policy Effects."[13] Macroeconomic data as illuminated by several sophisticated modeling and econometric techniques have led two economists at the Minneapolis Federal Reserve Bank to conclude with confidence that "Deficit policies may matter, and then again they may not. Existing studies really don't tell us much about their effects."[14] The first step from this disturbingly limp conclusion to a healthy understanding of the deficit problem is to recognize that the "We" in the title of the article, intended to mean "We Economists," can be extended to mean "We Lenders-Borrowers-Savers-Investors-Hedgers-Leveragers" or simply "We Market Participants." Market participants do not know how deficit accommodation will affect future market conditions, so they have to make guesses. And if they guess

[13]Preston J. Miller and William Roberds, "How Little We Know About Deficit Policy Effects," *The Federal Reserve Bank of Minneapolis Quarterly Review* 16, no. 1 (Winter 1992): 1–12.

[14]Ibid., p. 8

wrong, they may lose big. The second step is to recognize that the "We" may also refer to the holders of Treasury securities. Accordingly, the title phrase should be amended to read "How Little We Know *or Care* about Deficit Policy Effects." The potential for debt monetization, as manifested by the Federal Reserve in its standby capacity, has absolved the Treasury's creditors of any inclination to care. Externalizing risk has precluded any possibility that the reluctance of creditors will provide an effective check against the excesses of the Treasury.

The tripling of federal government indebtedness since the beginning of the 1980s' bull market stands as testimony to the capacity of the Treasury to issue its artificially risk-free debt. The banking legislation of 1980 has shown us its capacity for blinding the banking industry and the private sector to the black cloud of debt gathering above it. Together, the actions of the fiscal and monetary authorities have demonstrated once again how public institutions ostensibly devoted to stability and prosperity are, in the end, responsible for crises and decay.

Sticky Wages, Efficiency Wages, and Market Processes

Don Bellante*

Mainstream macroeconomics is in disarray. Perusal of commonly used textbooks in macroeconomics will confirm that impression without much difficulty. Unfortunately, the same statement could have been made, and often was made, fifteen years ago. While in this sense little has changed in recent years, the disarray is now more fundamental and severe than at any time since the 1930s. Amidst this disarray a variant of Keynesianism identified as Neo- or New Keynesianism emerged in which the workings of labor markets are analyzed to a degree that is uncharacteristic of the orthodox Keynesian tradition. The key element in the New Keynesian analysis of the labor market is the concept of "efficiency wages." In what follows, the concept will be criticized, though criticisms that have been offered by mainstream economists will largely be ignored. Instead, this essay will focus on the criticism that follows from an Austrian perspective on entrepreneurship and the business cycle. It will be argued that the concept of efficiency wages provides an poor answer to the question of why wages are not sufficiently flexible so as to elminate fluctuations in unemployment, and that from an Austrian perspective the question is not all that relevant.

Historical Background

During the 1960s, when Austrian and other approaches were ignored and the major contention in the popular literature was between the Keynesians and monetarists, there appeared to be a common ground on which to contend. The mainstream perspective

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on the contention was in accord with Milton Friedman's: namely, "that the basic differences among economists are empirical, not theoretical."[1] Thus a common conceptual framework permitted Keynesians and monetarists, the two mainstream schools, to argue on each other's territory.

No longer does a common conceptual framework exist, even within the mainstream. There are at least three prominent variants of Keynesianism that are in important respects incompatible with one another: orthodox Keynesianism, Post Keynesianism, and the New Keynesianism.[2] Even within the so-called New Classical school, there are at least two general approaches that are at odds with each other. On the one hand, real business cycle theory emphasizes technological shocks to the supply side as the major cause of economic disturbances, despite the fact that technological shocks of the Schumpeterian sort are positive and thus can not by themselves explain recessions. On the other hand, those New Classical economists whose models are built on "Rational Expectations with Imperfect Information" attribute the business cycle to demand side shocks associated with unanticipated changes in the rate of growth of money, and have to contend with the empirical persistence of recessions beyond any amount of time that could reasonably be expected for the persistence of misinformation about the general price level. Nonetheless, the most significant factor that makes a simple comparison difficult is that some are based on a view of markets which sees them as clearing continuously, whereas others see the inability of markets to clear as the core problem, if not the virtual definition, of recession.

Clearly, Keynes and earlier orthodox Keynesians attempted to explain contractions as if markets, including the labor market, equilibrated without clearing. In almost any other context, equilibration and market clearing are seen as synonymous, but the possibility and likelihood of an "underemployment equilibrium" is the central message of Keynes. The device by which Keynes attempted to rationalize this semantical morass was the contention that the supply curve of labor is a function of nominal, not real, wages and is perfectly elastic at the current wage up to "full employment." Even so, the idea of a labor market in an economy-wide equilibrium with a genuine excess supply (involuntary

[1]The quotation is from Friedman (1971, p. 61), although he made similar statements on earlier occasions.

[2]These three variants are described in Bellante (1992).

unemployment) is nonsensical in terms of the usual definitions of "excess supply" and "equilibrium." This conception of the labor market is perhaps the weakest link in the Keynesian chain of logic. Economists after Keynes dealt with this problem in different ways. Patinkin, for example, argued that Keynes just was not using the usual definitions.[3] But the usual disposition of earlier Keynesians was to attribute the labor market's perceived inability to equilibrate to "sticky wages" while dropping mention of Keynes's attempts at explanation. Unemployment was treated as a residual effect once the equilibrium level of output is determined. The prior question of why wages should be "sticky" in the first place tended to be ignored, perhaps because Keynes's rationale was embarrassingly inconsistent with rational, optimizing behavior. Keynes, of course, did not indicate any personal embarrassment. He did not see as irrational the supply response of workers to the nominal wage instead of the real wage. His rationalization of this response is spelled out in chapter 19, "Changes in Money Wages," of *The General Theory* (1964, pp. 257–71). To Keynes's way of thinking, workers were more concerned with relative than absolute wages, and the way of maintaining relative wages was never work for less than the current money wage. Changes in the real wage brought about by changes in the purchasing power of money, however, did not disturb the pattern of relative wages, and so would not be resisted.

It is easy to see why Keynes's followers preferred to gloss over or ignore his treatment of the labor market. Nonetheless, this somewhat tortured line of reasoning enabled Keynes to see inflation as a more practical way out of a recession than the passage of time sufficient for markets to re-equilibrate. Further, Keynes did not see the idea of sticky wages as a crucial element in his model, as he strongly argued that even if nominal wages were flexible, reductions in nominal wages would not reduce unemployment.

Owing to Patinkin's pointing out the fallacy in this aspect of Keynes's exposition, orthodox Keynesian textbook treatments of the Keynesian model seem to accept the idea that sticky wages prevent a return to full employment that otherwise would occur, so that inflexibility of nominal wages becomes a crucial underlying but unexplained assumption of the model. The primary purpose of making the assumption of sticky wages was to dismiss out of hand the labor market behavior postulated in the classical

[3]Patinkin (1965, pp. 634–44 note K).

model; otherwise, the labor market and the actual processes by which labor markets functioned did not enter into the standard IS-LM model. Likewise, in monetarist models such as Friedman's (1971), the workings of the labor market were not taken into account.

Keynesian wage theory could be and was safely ignored for as long as Keynesian economics totally dominated the academic world. When the Keynesian hegemony began to crack in the 1970s, the behavior of labor markets again became a subject of macroeconomic discussion. From the monetarist side, Friedman (1976) eventually offered a description of the workings of labor markets in which fluctuations in the unemployment rate could be explained by a lag between the time of a change in the overall price level and workers' perception of that change. The supply of labor would be *temporarily* disturbed, for so long as that misperception remained. Combined with concurrent developments in the theory of search behavior, Friedman's description of the effects of unanticipated inflation suggested an explanation of cycles in unemployment that could be provided without resort to money illusion or disequilibrium in labor markets.

The Friedman perspective eventually both gave rise to, and was superseded by, the New Classical "equilibrium always" approach. Ironically, both the New Classical and primitive Keynesian positions attempted to portray markets strictly in equilibrium terms, despite the protestations of a minority of Keynesians (mostly European) to the effect that Keynes was really a disequilibrium theorist trying to write in language that Classical economists could understand.

Without doubt though, the Keynesian model that most American students find in standard textbooks is an effort at describing the possibility of an economy in equilibrium at less than full employment. So the analytical perspective of both Orthodox Keynesian and New Classical schools remains in fundamental contrast to the Austrian perspective which sees the business cycle as the result of policy-induced disequilibrium, particularly in terms of intertemporal coordination. However, the New Classical school's analysis results in the policy ineffectiveness conclusion, and such unemployment as is associated with business cycles is seen as the result of the intertemporal substitutability of labor. This rather implausible conclusion, particularly in severe depression, leaves the New Classical school with the most elegant but irrelevant model of cyclical activity among mainstream economists. But its irrelevancy has raised optimism among Keynesians

that they may reemerge from their eclipse. The New Keynesian economics is their hopeful path to reemergence, and the concept of efficiency wages is seen as rescuing the Keynesian model from non-Keynesian criticisms of their treatment of the labor market.

It is clear that the New Keynesians really believe that they are on to something that effectively rescues the Keynesian paradigm and places it again at the intellectual forefront of macroeconomic reasoning. Viewed by an outsider to this effort at resuscitation, the concept seems like an attempt to revive the Old Keynesian perspective on relative wages being the object of workers' desires, while dressing that perspective in the garb of more modern jargon. It is not that new a concept, but distorts the previous insights about labor markets from which it borrows. As partial equilibrium microeconomics, the concept yields a few simple insights to those economists who are lulled by the simplistic view of markets fostered by the perfectly competitive model. As a macroeconomic concept, it fails badly because it totally abstracts from the interrelatedness of markets and ignores some of the more significant aspects of competition as a market process. With the concept of efficiency wages, New Keynesians see themselves as having immunized their revision of the Keynesian model from the criticisms that so damaged earlier versions, by putting Keynes's inelegant analysis of the labor market on a sound microeconomic footing. Although it does not logically follow, New Keynesians believe that they have thus per force reestablished the soundness of the case for government management of the economy.

Our argument is that there is a lot of self delusion involved, and it revolves around a concept no more substantial than a soap bubble.

Efficiency Wages: Is That All There Is?[4]

In his textbook summary of New Keynesian economics, Robert J. Gordon has said that "If anything in the microeconomics of labor markets could be called the 'rage of the 80s,' it is efficiency wage theory."[5] Yet the concept, to those who have not joined the New

[4]A brief treatment of efficiency wage theory appears in Yellen (1984). Extensive treatments appear in Weiss (1990) and in Akerlof and Yellen (1986).

[5]Robert J. Gordon (1990a, p. 229).

Keynesian equivalent of a tent revival, must surely seem too simple and innocuous to set off a rage. The concept posits a relationship between wages and productivity that over some range is positive. Thus up to some point, raising wages may lower per-unit wage costs. Moreover, it is not so much the absolute wage that affects intensity of effort, the tendency to stay with the firms, and all other desirable consequences of high pay. What matters is the extent to which the wage in the firm in question exceeds opportunities elsewhere, i.e., the market wage, conditioned on the probability of obtaining it.

In the most mechanistic treatments of labor supply, the wage rate affects only the willingness to show up for work and matters such as intensity of effort are ignored for simplicity. In this respect, the efficiency wage argument incorporates more of the real world than those models that implicitly assume that the only aspect of worker behavior that is affected by the wage rate is the quantity (hours) supplied. Under what circumstances this is a worthwhile incorporation is a distinct question. It is surely a safe guess that all economists believe that the greater the advantages accruing to a worker in her present job, the harder she will try to keep the job, and the less likely she will be to quit it. In most circumstances, this observation is so obvious as to not require explicit mention, and it is quite safe to ignore it in most analyses. But in this obvious relationship, New Keynesians believe that they have found the key to the rescue of Keynes and to the explanation of involuntary unemployment. Simply put, if the firm faces a decrease in demand, it will not take advantage of the seeming opportunity to reduce its wage costs by offering a lower wage, because lowering the wage it offers will actually increase its per-unit-of-output labor costs.

In one sense, this is just one more reason for wages not adjusting so as to continuously providing full employment. But the literature from competing schools of thought has provided a large number of reasons, some of which are mutually exclusive and some of which are not, to explain why adjustment is not instantaneous, or why employers in some situations will find it optimal to pay higher wages than other employers do for seemingly similar labor.

Some of these explanations predate Keynes by more than a century. More will be said on this point later. What then, makes this particular angle so attractive to New Keynesians? Several reasons are usually mentioned. Foremost is the idea that the refusal of employers to cut wages is based on what is seen as

rational, profit-maximizing behavior. Second, the outcome is not at all based on money illusion or even temporary informational disequilibrium on the part of workers. It is for this reason that the efficiency wage argument is seen by its proponents as immune both from (a) the worker irrationality complaint leveled against Keynes and early Keynesians, and (b) the persistence problem that seems implausible in the New Classical and Friedmanite explanations that are based on misperceptions of the price level. Indeed, resulting unemployment is not the result of worker decisions at all. Workers' willingness to work at less than the going wage is of no consequence—in general, labor supply conditions do not matter at all. Thus, there can presumably be nothing voluntary about the resulting unemployment.

Last, in at least one formulation, the level of unemployment is not even affected by the shape of the demand curve for labor—only the average wage level is affected by its shape. This feature is seen as important because to its formulator it seems to resolve a paradox that is a paradox only to him: "This is an attractive property of the model. It is striking that real wages have doubled several times over the last century without having a large impact on average unemployment rates."[6]

A Few (But Not All) Criticisms of Efficiency Wage Theory

Much criticism of efficiency wage theory has been offered by mainstream economists. Again, it is not the purpose here to give a detailed accounting of those criticisms.[7] One of the remaining real puzzles of efficiency wage theory is with one of its fundamental premises: The model has all firms paying the same high *relative* wage; that is, they all pay a wage that is above the competitive wage. This premise can make sense for one or a few

[6]The formulation and the quotation are from Lawrence H. Summers (1988, pp. 384–85). The larger paradox is that a leading Harvard economist could somehow remain unaware of, or unimpressed by, the usual explanations of the enormous rise in real wages over this century. These explanations involve the effects of technological improvement and capital growth on equilibrium real wages and thus imply nothing about unemployment, involuntary or otherwise.

[7]Gordon (1990b) presents a fairly detailed critique of the New Keynesian economics with particular emphasis on efficiency wages and related concepts. His criticism focuses on the question of whether or not New Keynesian economics successfully builds a sound microeconomic foundation of wage (and price) stickiness. His judgment is for the most part negative.

firms, or perhaps even for a large sector of the market, but it cannot make sense for all firms.[8] If they all pay above-market wages, how is the market wage defined? Some strands of efficiency wage theory have an answer (sort of) to this question: The wage w to which workers compare their received wage is the wage rate elsewhere (also w), but discounted by the probability of receiving it, which is one minus the unemployment rate, u. In this manner, the wage w can be uniform across firms and workers still receive a wage premium that will induce them to avoid shirking and to stay with the firm! And in what is a remarkable sleight of hand, Summers (1988, p. 384) is able to make a connection between the productivity enhancing effects of the wage premium and the economy-wide equilibrium level of unemployment. Only in the allegedly implausible case in which the wage does not affect productivity does labor market equilibrium correspond to a zero unemployment rate. The sleight of hand comes from reversing the direction of causation that goes from the unemployment rate (which is first introduced as a given market datum) to the wage premium. In this particular formulation, nothing is done to explain this reversal of causation—it is simply the result of solving an equation for u, the "equilibrium" unemployment rate. Nowhere is a market process described, or hinted at, which will produce what this argument purports to produce; namely, an equilibrium unemployment rate the magnitude of which is positively related to the size of the uniform wage premium's effect on productivity.

Efficiency wage theory can be criticized on certain grounds if it is seen as one more reason why wages do not adjust so as to continuously eliminate disequilibrium, and along other lines if it is seen as permanently raising the unemployment rate. As an explanation of why wages are not perfectly flexible, it is a mere addition to reasons that have long been known to economists and, for that matter, non-economists with a respectable amount of common sense. All change involves cost, and we live in a world of uncertainty about the consequences of undertaking those changes. All of the other explanations that at various times have been offered, such as implicit contracting, staggered contracts, the effects of specific training, legal and institutional constraints,

[8]Public sector employers, for example, can pay wage rates that exceed those paid in the competitive private sector in order to provide rents to public employees for which they presumably will be grateful and will express that gratitude in the form of political support. Indeed, this possibility is explored in Bellante and Long (1981).

etc., have more to offer as explanations of sticky wages simply because they do not exclude the actions of workers themselves from consideration of how the labor market works.

In this regard, efficiency wage theory is inferior to the collection of explanations that preceded it. Even if one buys the claim that the efficiency wage theory rests on a firm microeconomic foundation, it still is just one more attempted explanation of wage stickiness. Piled on top of the others, it still does nothing to re-establish the case for demand management—a case which New Keynesians have merely asserted to exist without having demonstrated it. In any event, efficiency wage theory is much ado about very little: It is an open question whether the energy that went into producing the "rage of the 80s" might have been more usefully employed elsewhere.

If efficiency wage theory has a low marginal product as an explanation of wage stickiness, it has a negative marginal product as an explanation of equilibrium unemployment. Here the theory takes no account of likely entrepreneurial responses to efficiency wage theory. To see this point, let us grant for the moment that there are some firms that will pay-higher-than-market wages for reasons consistent with profit maximization. Additionally, let us assume that these firms do not employ all of the labor out there that would like to work at this wage. Are there no entrepreneurs that can find profitable ways to employ the abundantly available workers? And if the "market" wage is depressed by this abundance, won't this also lower the wage that "efficiency wage" employers need to pay in order to maintain the relative wage that is supposedly appropriate? And shouldn't this lowering of the efficiency wage increase optimal employment levels for the firms that pay efficiency wages? Haven't efficiency wage theorists thought about this? Apparently not: Efficiency wage theory contains a flaw that is often mentioned in criticism of the New Classical school—namely, excessive expository reliance on use of the "representative firm" as if all firms were representative. It is partial equilibrium analysis of a general equilibrium problem.[9]

[9]Stated otherwise, failure of some entrepreneurs to use available resources simply creates opportunities for others to do so on more favorable terms. The general equilibrium considerations are similar to those that apply to an economy composed of some unionized and some non-unionized firms: Unions may succeed in raising wages and lowering employment opportunities in unionized sectors. In proportion to their success, wages are lowered and employment is raised elsewhere. Any systematic effects on overall wages and employment are transitory.

A small dose of the Austrian appreciation for the interrelatedness of individual decisions and markets would go a long way here. Particularly useful would be an appreciation of how labor markets function in a world of heterogeneous firm technologies and circumstances, and of worker's subjective preferences. In this real world, a sorting and matching of workers and firms takes place along a multi-dimensional spectrum of wages and job conditions that is simply incompatible with the concept of identical "representative" firms paying a uniform wage permanently too high to provide full employment.[10] If efficiency wage theorists have contributed something to the microeconomic analysis of labor markets, it is the identification of yet another source of firm heterogeneity giving rise to equalizing pay differentials, namely variation across firms in the extent to which wage premia substitute for the expenses of monitoring worker effort. This contribution, however, yields no insights into the nature of unemployment or the business cycle.

The Misplaced Emphasis of Mainstream Macroeconomics

It is easy enough to conclude that efficiency wage theory does not provide or even contribute to an appealing answer to the question of why wages do not adjust continuously so as to prevent any deviation from full employment. But New Keynesians as well as their mainstream critics are not asking the most appropriate questions concerning the business cycle. Matters of wage and price flexibility are of secondary importance. Granted, they are not unimportant, but they relate to the problem that Austrians refer to as the secondary contraction and not the primary, causal events that initiate the primary contraction.

Austrians, and Mises in particular, have certainly given due attention to the role of wage stickiness in prolonging the secondary contraction. This attention provides the underpinnings of a telling empirical investigation, focused primarily on the Great Depression, by Lowell Gallaway and Richard K. Vedder (1987). The authors persuasively argue that wages were kept from achieving equilibrium levels during this period. Of course public policies initiated during this era aimed specifically at preventing

[10]This perspective combining the concept of equalizing pay differentials (which dates to Adam Smith) with the subjective value theory of Austrian economics is briefly outlined in Bellante and Porter (1990, pp. 659–62).

the fall of wages to their equilibrium levels and, combined with other New Deal measures, thoroughly impeded recovery. As Gallaway and Vedder documented, these policies were based on the notion that higher than equilibrium wages would actually increase the demand for labor. This notion of the "economy of high wages" had widespread appeal among the business elite of that era, most notably Henry Ford, but the notion is now thoroughly discredited.[11]

Concluding Remarks

It cannot be emphasized enough that analysis of wage stickiness cannot shed light on the nature of business cycles; at best it can provide a partial explanation of the length of the recovery phase. Perhaps too much attention has been given to the matter. In any event, to focus on the wage response issue is to miss the most important aspects of what Mises and other Austrians have had to say about business cycles in general and the Great Depression in particular.

The reason that mainstream economists focus in on the wage stickiness matter is clear enough: Modern mainstream macroeconomics has evolved into a method of analysis conducted as if aggregates actually interact with one another, as if capital were a homogeneous non-specific entity, as if relative prices and wages had no aggregate consequences, as if coordination across economic agents at a point in time were possible if only aggregate prices and wages were sufficiently flexible, and as if intertemporal coordination were no problem at all. With all of the important complexities of the real world thus misperceived, ignored, or assumed away, there is almost nothing else for mainstream economists to examine other than aggregate wage and price levels combined with autonomous shocks in their search for an understanding of the business cycle and unemployment.

Of all of these misperceptions, perhaps the most difficult impediment to understanding is the ignorance of the complexities of the capital structure. If the insights of Mises, Hayek, Rothbard[12]

[11]Interestingly though, Henry Ford's thoughts on pay have reemerged in the efficiency wage literature (Raff and Summers 1987) and have even found their way into at least one macroeconomics textbook Mankiw (1992, pp. 131–32). In this context, however, there is no mention of the imagined effects of wages on aggregate demand.

[12]Specific reference here is to the works of Mises (1971) and Hayek (1967) on the theory of the cycle in general, and to Rothbard (1983) on the specifics of the depression.

on economic instability, depression, and the impossibility of central management of the economy are to be appreciated, the mainstream's blindness to the nature and significance of the capital structure first must be overcome.

In all likelihood, those who find the New Keynesianism attractive are beyond reach. New Classical economists arrive at their policy ineffectiveness conclusion on the basis of a perfectly competitive, overly simplistic view of an economy in which markets are always in equilibrium. New Keynesians believe that any time they can find evidence that the real world is not perfectly competitive, not always in equilibrium, or otherwise not as simple as the New Classical economists' models portray it, they have somehow re-established a case for government intervention to improve the workings of the economy. Their apparent belief is a *non sequitur* of the first order. The vested interests of the intellectual world will ridicule the effort, but the task for Austrians is to demonstrate to the intellectually non-vested student that it just is not so.

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Total Repeal of Antitrust Legislation: A Critique of Bork, Brozen, and Posner

Walter Block*

The premise underlying laissez-faire capitalism is that the only actions which should be illegal are those which involve an initiation of aggression against another person or his property. Antitrust law is clearly in violation of this principle, because it prohibits business practices no one even alleges constitute such depredations.

The economists mentioned in the title of this paper are widely and properly celebrated for upholding the virtues of the free marketplace. However, there is one lacunae in their defense: antitrust legislation. Although they have done yeoman work in helping us to understand the beneficial effects of much commercial conduct which is prohibited by these enactments, their critique of this law is less than full. They each see a small but important role for the Antitrust Division of the Justice Department. They advocate reduction in the power and scope of this law, but not, unfortunately, total repeal.

It is as if they are a football team which has succeeded in bringing the pigskin to the three yard line, but can make no further progress. This paper is an attempt to help them over the goal line. To continue our football analogy, the present paper will not comment on the 97 percent of their work which is responsible,

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in large part, for the scholarly contribution to the cause of keeping antitrust law from being even more intrusive than it now is. In focusing on the 3 percent of disagreement, this paper may give the impression that there are large differences of perspective in public policy conclusions between these authors and their present critic. Nothing could be further from the truth.

Robert Bork

Merger

Robert Bork (1978) maintains that some entrepreneurial choices in the market lead to efficiency, while others merely serve to restrict output. His main thesis is that antitrust has thus far insufficiently distinguished between these two situations. This is important, he contends, because if consumer welfare is to be enhanced, the restriction of output must be prohibited, while wealth enhancing activities must be promoted (or at least allowed.)[1]

This can be shown by a consideration of Bork's "two vectors" hypothesis, representing, at least in the first instance, a merger. This is depicted in Figure 1.

As Bork explains:

> The diagram assumes that the merger reduces the long-run average costs of the two firms from AC_1 to AC_2 but that the increased market power created by the merger results in a restriction of output so that the rate moves from Q_1 to Q_2. We then see that consumers have lost output—for which they would have been willing to pay an amount above cost equal to the area labeled A_1—and have gained in resource savings an amount equal to the area A_2. Obviously, if A_2, the cost savings, is larger than A_1, the dead-weight loss, the merger represents a net gain to all consumers. If A_1 is larger than A_2, a net loss results.
>
> This diagram can be used to illustrate all antitrust problems, since it shows the relationship of the only two factors involved, allocative inefficiency and productive efficiency. The existence of these two elements and their respective amounts are the real

[1]Bork's discussion of "allocative efficiency" depends intimately on the "benchmarks" provided by the purely competitive model. But the entire notion of "output restriction" depends logically upon some reference point: "restriction" relative to *what*?" I owe this point to an anonymous referee.

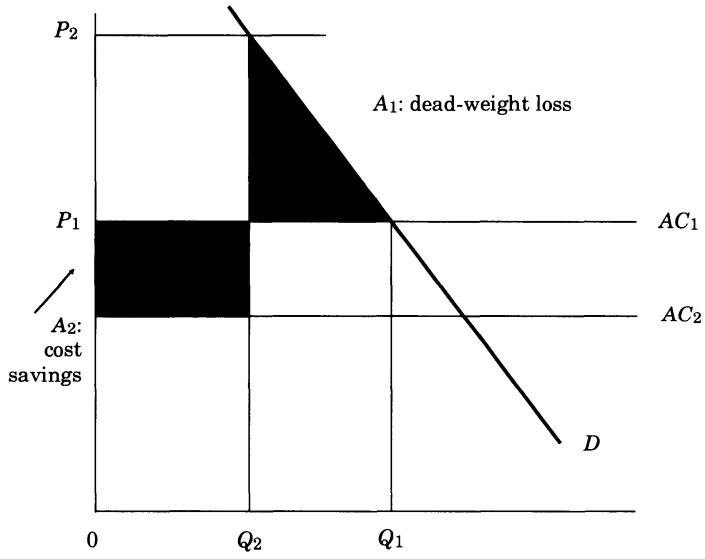

Figure 1

Source: Robert Bork, *The Antitrust Paradox: A Policy at War with Itself* (New York: Basic Books, 1978), p. 107.

> issues in every properly decided antitrust case. They are what we have to estimate—whether the case is about the dissolution of a monopolistic firm, a conglomerate merger, a requirements contract, or a price fixing agreement . . .
>
> It must also be remembered that there need not always be a tradeoff [between A_1 and A_2]. In most cases, in my opinion, economic analysis will show that one of the areas does not exist, and a decision of the case is therefore easy. Some phenomena involve only a dead-weight loss and no, or insignificant, cost savings. That is the case with the garden-variety price-fixing ring. Output is restricted so that Q_2 is to the left of Q_1, creating the area A_1, but there is no downward shift of costs, no line AC_2, and hence no area A_2. (p. 108; material in brackets added by present author)

One problem with the foregoing is that it pushes the courts into the role of determining whether or not any particular type of industrial organization or contract is or is not "cost saving." But the judiciary has no comparative advantage in making any such

determinations.[2] Its members are not selected on the basis of being able to do so. Their salaries and promotions are not in any way tied to success in distinguishing efficient arrangements from inefficient ones. Failures are not punished with demotions. Achievement is not automatically rewarded with promotion, or with the awarding of bigger, more important or precedent setting cases. Why, then, should we expect this behavior from the courts?

Indeed, if Bork himself is to be believed on this issue, jurists, all throughout the history of antitrust, have made findings which show them to be either unconcerned, or incompetent with regard to this issue. Says the author of this book:

> most of the mergers the Supreme Court strikes down and the "price discriminations" the Robinson-Patman Act is intended to stamp out . . . are examples . . . which involve only efficiency gain and no dead-weight loss. (pp. 108–9)

A second difficulty has to do with the interpretation of the demand curve. In Bork's neoclassical construal, the demand curve is seen as an existing entity. True, this author concedes that "we do not know the location of any of the sides of the triangular area A_1," (one of which is the demand curve), but this is only an inconvenience. "They are what we have to estimate" (p. 108) is the way to get around this annoyance. But this will not do.[3] Demand curves are not "out there," ready to be measured by the modern econometric tools of analysis. Rather, they are, except for one dot (P_2Q_2, in this case), hypothetical alternatives which never come into play. Demand curves answer the question, Suppose that everything else in the universe were exactly the same as it now is, with the one exception that price, instead of being at P_2, is at some other level; then, how much would the customer be willing to buy at that other price. In the event, the price however, was P_2

[2]This applies, in spades, to the administrative commissions which do the lion's share of antitrust work, such as the Federal Trade Commission. At least there is some check and balance on the former; they are subject to recall, and great scrutiny in the process of their initial appointments. These controls are greatly attenuated, if not virtually nonexistent, in the case of the civil service. I owe this point to an anonymous referee.

[3]Bork also states: "Passably accurate measurement of the actual situation is not even a theoretical possibility; much less is there any hope of arriving at a correct estimate. . . . Nobody knows these curves. Even the companies involved do not. The clarity of the graphs . . . misleads many people" (p. 108). In short, Bork himself *knows* that the demand curves are *not* "out there." The real mystery is why Bork conveniently forgets his own excellent, and essentially Austrian criticism when he addresses himself to policy issues. (I owe this point to an anonymous referee.)

and the consumer wished to purchase Q_2. That is all we know, or indeed, can know. The other points on this demand curve never come into play at all. They are contrary to fact conditionals. There is no sense in the notion that we can "estimate" them. There is no doubt that economists can look at other instances (other times, places, people) where different quantities of this item were purchased at different prices (and even attempt to control for the fact that the prices and quantities of substitutes and complements have altered, to say nothing of changing incomes, inflation, employment and even the weather) and in that way trace out a "demand curve." But this has little or nothing to do with what is depicted in that diagram. The point is, a demand curve is a unique non-repeatable hypothetical "event." All attempts to "measure" it are thus doomed to failure.

So far, we have been implicitly assuming that it is legitimate to make interpersonal comparisons of utility. It is now time to relax this assumption. In point of fact, this methodology is not tenable. It is perfectly reasonable to maintain that all trade benefits both parties in the *ex ante* sense. This is the reason they engage in such an activity, and this conclusion is part of the bedrock of the science of economics. It is quite another matter, however, to deduce from the failure of a trade to take place (in the free marketplace, Q_1Q_2 remains unsold, because it is not offered for sale) that had occured, the buyer's welfare would have exceeded the loss to the seller. This contrary to fact conditional implies that interpersonal comparisons of utility indeed can be made—without offering any evidence or reason for such an assertion—and moreover that the consumer's benefit exceeds the producer's loss. The latter contention would remain unproven even if interpersonal utility comparisons were valid in the first place. And yet, unless this assertion is true, the value of A_1 would be negative, not positive as claimed by Bork. If a "garden-variety price-fixing ring"[4] succeeds in raising prices from P_1 to P_2, there is thus nothing within the strict science of economics that can be used to show that this will reduce social (as opposed to consumer) welfare.

Still another fallacy of the two vectors approach lies behind the very drawing of the cost curves in this diagram, AC_1 and AC_2. There is nothing untoward about using them for textbook illustration purposes only. Bork, however, is attempting to justify

[4]The use of the "ring" in this context is rather pejorative; it is akin to describing the ancient and honorable profession of price fixing along the lines of a car theft "ring."

antitrust, a legislative enactment which can fine or even jail businessmen for the "crime" of price fixing, on the basis of this analysis. Under such circumstances it is reasonable to look more closely into these cost curves, an integral part of the analysis.

Cost, in economic theory, is not by any means limited to out of pocket expenses, even including implicit rent. These are part of the concept, but in its most sophisticated interpretation, cost is equivalent to the next best opportunity foregone by making any particular choice. As such, cost can only be a subjective notion (Buchanan 1969; Buchanan and Thirlby 1981; Mises 1963). The next best opportunity foregone by the choice to sell Q_1 need not be anywhere close to P_1. In any case, it can never be known by a third party, for example by the Antitrust Division of the Justice Department, the government bureau charged with punishing or incarcerating price fixers.

More radically, the cost of all saleable items is actually zero, and therefore can have no effect in any case. States Rothbard (1962, p. 604):

> there is no such thing as costs (apart from speculation on a higher future price) once the stock has been produced. Costs take place along the path of decisions to produce—at each step along the way that investments (of money and effort) are made in factors. The allocations, the opportunities foregone, take place at each step as future production decisions must be taken and commitments made. Once the stock has been produced, however (and there is no expectation of a price rise), the sale is costless, since there are no advantages foregone by selling the product (costs in making the sale being here considered negligible for purposes of simplification). Therefore, the stock will tend to be sold at whatever price is obtainable. There is no such thing, then as "selling below costs" on stock already produced.

One can go even further. Not only is the sale costless when it occurs, it may even occur at less than zero costs. For example, if I have piled up a horde of tomatoes, or shoes, or steel, or tires, and I cannot find a customer for them, then, at least in a strictly private property rights-no trespassing world (Rothbard 1973, p. 1082), I will have to pay for their removal. Under such conditions the costs of the sale will be negative. That is, if the disposal costs are $500 (I have to pay $500 to rid myself of this unwelcome

stock), then, *ceteris paribus*, I should be willing to sell it to a customer at any negative price above this level. For example, if I sell at $200, then I make a profit of $300. Even though I have to pay a customer $200 to cart away my merchandise, I am better off by $300 because the private sanitation hauler would have charged me $500.

Sovereignty

Yet another problem arises with regard to the issue of individual versus consumer sovereignty. Let us allow Bork to articulate this thesis in his own words. As far as consumer welfare is concerned, he states it as follows:

> (antitrust) can only increase collective wealth by requiring that any lawful products, whether skis or snowmobiles, be produced and sold under conditions most favorable to consumers. (p. 91)
>
> Productive efficiency, like allocative efficiency, is a normative concept and is defined and measured in terms of consumer welfare. (pp. 104–5)

But this rendition of the goal is problematic. Why should the goal of antitrust be to enhance *consumer* welfare alone? Why, for that matter, should the aim of any public policy be so narrowly defined? If it is taken for granted that some sort of welfare be maximized by legislation, why not attempt to maximize *total* welfare, that is, the welfare derived by *both* producer and consumer.

It is possible to employ a *reductio ad absurdum* in this regard. If we really want to enhance the welfare of consumers only, as opposed to both consumers and producers, all sorts of other enactments become justifiable which would not have been otherwise. For example, if there were any producer's surplus (economic rents earned by manufacturers) then these should be summarily seized, and handed over to consumers. Needless to say, however, no warrant for any such action has ever been given.

This policy, moreover, is internally inconsistent, for it will tend to counteract Bork's own goal of augmenting consumer welfare. We cannot safely ignore people as producers if we are attempting to maximize their well-being as consumers. People are people, and typically play a dual role as both consumers and producers. If we hurt them in one role, they are necessarily hurt in the other as well.

Rothbard's remarks (1962, pp. 560–61) seem to be addressed directly to the Bork hypothesis, although they were written almost two decades beforehand:

> We have seen that in the free market economy people will tend to produce those goods most demanded by the consumers. Some economists have termed this system "consumers' sovereignty." Yet there is no compulsion about this. The choice is purely an independent one by the producer; his dependence on the consumer is purely voluntary, the result of his own choice for the "maximization" of utility, and it is a choice that he is free to revoke at any time. We have stressed many times that the pursuit of monetary return (the consequence of consumer demand) is engaged in by each individual *only to the extent that other things are equal*. These other things are the individual producer's psychic valuations, and they may counteract monetary influences. An example is a laborer or other factor-owner engaged in a certain line of work at less monetary return than elsewhere. He does this because of his enjoyment of the particular line of work and product and/or his distaste for other alternatives. Rather than "consumers' sovereignty," it would be more accurate to state that in the free market there is *sovereignty of the individual*: the individual is sovereign over his own person and actions and over his own property. This may be termed *individual self-sovereignty*. To earn a monetary return, the individual producer must satisfy consumer demand, but the extent to which he obeys this expected monetary return, and the extent to which he pursues other, nonmonetary factors, is entirely a matter of his own free choice.
>
> The term "consumers' sovereignty" is a typical example of the abuse, in economics, of a term ("sovereignty") appropriate only to the *political* realm and is thus an illustration of the dangers of the application of metaphors taken from other disciplines. "Sovereignty" is the quality of ultimate political power; it is the power resting on the use of violence. In a purely free society, each individual is sovereign over his own person and property, and it is therefore this self-sovereignty which obtains on the free market. No one is "sovereign" over anyone else's actions or exchanges. Since the consumers do not have the power to coerce producers into various occupations and work, the former are not "sovereign" over the latter.

To this it may be added, in order to bring it into more direct relevance with Bork, that not only do the "consumers not have the power to coerce producers into various occupations and work," but in the free society they do not have the power to coerce the producers to locate at Q_1, as opposed to their preferred point, Q_2. How does Bork describe the distance Q_2Q_1? He claims that this is a quantity of product the consumers are willing to purchase, at a price above the costs of production, and yet, because of nefarious or at least questionable doings on the part of the seller, the customer is disappointed in this desire. The area between Q_2 and Q_1, above the cost curve AC_1 and below the demand curve is defined as $A1$, the dead-weight loss. This is the amount of welfare that could have been enjoyed by the consumer, but is not.

It is only by focusing on the buyer at the expense of the seller that Bork is able to characterize A_1 as a region of dead-weight loss. In order to see this, imagine for a moment that this author had subscribed to the notion of individual, not consumer sovereignty. If so, then how could we most accurately characterize the distance Q_2Q_1? No longer can we depict this merely as an amount of quantity that the consumer wishes, but is unable to buy. For under our present assumptions, there are two sides to this transaction, not just one. Now we can more accurately delineate Q_2Q_1 as a quantity that the consumer wishes to purchase, alright, but also as an amount that *the manufacturer does not wish to sell.* Similarly, our description of A_1 can no longer be one of unambiguous "dead-weight loss." Now, it must be characterized as an amount of welfare contended over by two different parties. If the sale takes place at Q_1, yes, Bork is correct[5]; the consumer will gain this amount of welfare. But the producer will also lose (presumably, he is unwilling to sell any more than Q_2 because past that point, his marginal revenue lies below his marginal cost). So, it is by no means an unambiguous dead-weight loss A_1 which must be set against a clear gain in cost savings of A_2; rather, A_1 is a loss only to one side of the trade, but a gain to the other.

It is possible for the Borkian side of this debate to articulate several objections to the Rothbard perspective on individual versus consumer sovereignty. First, it might be maintained, following Hutt (1940), that producers are themselves consumers. For example, whenever a seller acts in a way other than to maximize

[5]Subject to further objections to be made below.

money returns, he is really "buying" services from himself. Therefore, the concept of consumers' sovereignty is wide enough to incorporate both producers and consumers.

If we adopt this way of looking at the matter, there are now two sets of consumers. The first, call them the consumer-consumers, are the people for whom Bork drew his demand curve. These are the ones who are purportedly suffering from the output restriction from Q_1 to Q_2. The second, call them the producer-consumers, the ones engaged in this (unwarranted, improper, according to the neoclassical school) restricting of output. These two sets of consumers, according to Bork, are acting incompatibly with one another.

As Rothbard (1962, p. 562) trenchantly states,

> In the aforementioned general sense, "consumption" rules in any case. But the critical question is: *which* "consumer?" The market consumer of exchangeable goods who buys these goods with money, or the market producer of exchangeable goods who sells these goods for money?

The point is, noticing that the producer, too, engages in consumption does not help one bit in determining whether we should force, through the majesty of the law, the producer-consumer to locate at Q_1 instead of Q_2, in behalf of the consumer-consumer. Rather, it sets up an infinite regress.

A second possible objection Bork could resort to was used by Hutt. As Rothbard notes (quoting Hutt), this is to distinguish between

> when a producer withholds his person or property out of a desire to use it for enjoyment *as a consumers' good*" . . . in which case it . . . "is a legitimate act, in keeping with rule by the consumer. On the other hand, when the producer acts to withhold his property in order to attain more monetary income than otherwise . . . then he is engaging in a vicious infringement on the consumers' will." (Rothbard 1962, p. 563)

This, too, however, has been answered by Rothbard. He notes that it is not difficult, but rather impossible, to distinguish between these two motives. Secondly, the only reason more profit can be earned at P_2Q_2 than at P_1Q_1 is because of the inelasticity of demand between the two points. But this arises out of consumer (consumer-consumer, that is) choice! If the consumers were unhappy with this state of affairs, they could

> easily make their demand curves *elastic* by *boycotting* the producer and/or by increasing their demands at the "competitive" production level. (Rothbard 1962, p. 564)[6]

Predation

If it is impossible, not merely difficult, to distinguish between psychic income and profitability as motives for "withholding," this applies as well to that between "deliberate aggression" in order to drive rivals from the market and in order to profit maximize. Here are Bork's views (p. 144) on the subject:

> Predation may be defined, provisionally, as a firm's deliberate aggression against one or more rivals through the employment of business practices that would not be considered profit maximizing except for the expectation either that (1) rivals will be driven from the market, leaving the predator with a market share sufficient to command monopoly profits, or (2) rivals will be chastened sufficiently to abandon competitive behavior the predator finds inconvenient or threatening.

But the employment of the word "predation" is surely another illegitimate abuse of a metaphor taken from another discipline. Predation is what the lion does to the zebra. Strictly speaking, there can be no such activity in the free economy. For there is not even the hint of a charge, in Bork or anywhere else, that the business firms who have in this way gained the attention of the Antitrust Division have initiated violence against their competitors. If "predation" is to be given a commercial implication, it would be reasonable to confine it to such activities as fraud, theft, extortion, or "making him an offer he cannot refuse" in the parlance of a Mafia Godfather. The contrast between this and the acts of the Borkian "predator" are stark indeed. The latter "deliberately aggresses" against his competitors by offering his *customers* a better deal than they can obtain elsewhere. If this is predation, then the consumer, for whom Bork seems to have an unlimited regard, would presumably ask for more of it.

Our author lists three forms of predation. They are price cutting, disruption of distribution patterns, and misuse of gov-

[6]Rothbard (1962, p. 562) seems to have fully anticipated Bork when he talks of an economist who "hold(s) up 'consumers' sovereignty' as an *ethical ideal against which the activities of the free market are to be judged.* Consumers' sovereignty becomes almost an Absolute Good, and any action by producers to thwart this ideal is considered as little less than moral treason."

ernment processes. Only the second is important to discuss, and we shall concentrate our remarks on it. This is because of the first, price cutting, Bork spends thousands of words (pp. 144–55) showing that neither economic theory nor economic history give support to the contention[7] that this is an efficacious way of engaging in predatory behavior.[8] As to the third, this is indeed "predation" of the sort mentioned above. Here, Bork properly castigates the initiation of frivolous lawsuits "in order to harm an actual or potential business rival" (p. 159). But the answer is not antitrust; it is the awarding of severe damages to those victimized by this practice. Under this rubric we can also add false and fraudulent advertising. This, too, is a legitimate role for the forces of law and order; but it cannot be used to justify the continued existence of a Federal Trade Commission, most of whose activities are aimed at suppressing legitimate commercial endeavors.

What, then, is "disruption of distribution patterns?" Bork (p. 156) explains:

> In any business, patterns of distribution develop over time; these may reasonably be thought to be more efficient than alternative patterns of distribution that do not develop. The patterns that do develop and persist we may call the optimal patterns. By disturbing optimal distribution patterns one rival can impose costs upon another, that is, force the other to accept higher costs. This may or may not be a serious cost increase, but if it is (and the matter can only be determined empirically), the imposition of costs may conceivably be a means of predation. The predator will suffer cost increases, too, and that sets limits to the types of cases in which this tactic will be used for predation. There is a further complication, moreover, in that the behavior involved will often be capable of creating efficiencies. Thus, the law cannot properly see predatory behavior in all unilaterally enforced changes in patterns of distribution.

There are several difficulties here. First, Bork must have in mind an exceedingly static world. That is the only situation in

[7]However, he does note that (p. 154) "These considerations do not demonstrate that price cutting could never under any circumstances be a successful method of predation."

[8]However, according to the logic of the argument, it should still be prohibited. Failing attempts at murder (rape, robbery, etc.) are still properly illegal, even though they do not accomplish their goals.

which his scenario could even roughly approximate the truth. Pattern persistence, however, is surely impossible in the modern day, under a regime of even limited economic freedom, where people are able to introduce new products (e.g., computers), implement new selling strategies (e.g., supermarkets), initiate new forms of business organization (e.g., franchising). Further, just because a distribution pattern has "persisted" in the past does not mean that it is optimal today, and certainly not tomorrow (Kirzner 1973).

Second, the "further complication" is problematic. If this pattern of disruptive behavior is "often . . . capable of creating efficiencies" how then can we distinguish between those alterations in business procedure which emanate from "predation," and those which come about due to enhanced efficiency? The empirical determination called for in this regard is no comfort; without any criterion for distinguishing between these phenomena, number crunching for the sake of number crunching will amount to nothing more than a full employment bill for out of work econometricians.

Third, there is no such thing as a "unilateral" change in the market. The market is no more and no less than the concatenation of all voluntary trades which take place in a given area. But all commercial exchange is, by its very nature, bilateral, not unilateral. It takes two to tango, and it takes two to trade.

Fourth, there are no "enforced" changes in patterns of distribution, or of anything else for that matter with regard to the market. If there is any initiation of physical force or violence, it is necessarily not part of the market (Rothbard 1962).

Another disappointment with Bork's treatment of this subject is that he offers only two instances of disruption of distribution patterns that can be predatory, and there are difficulties with each. First is the use of exclusive dealing contracts. But he undermines this example with the concession that (p. 156) "it is far more probable that . . . exclusive dealing is more efficient and has (been) adopted . . . for that reason." Further undermining this case is the statement (p. 157):

> The law can usefully attack this form of predation only when there is evidence of specific intent to drive others from the market by means other than superior efficiency and when the predator has overwhelming market size, perhaps 80 or 90 percent."

The problem is not that it is difficult if not impossible to attain evidence of such specific intent. It is, more radically, that *all*

commercial endeavors are, in effect, an attempt to drive others from the market through superior efficiency. The drawback to this perspective is that Bork refuses to define "efficiency" broadly enough so as to include producer's welfare as well as that of consumers.

The second example vouchsafed to us is that of the board of trade. Boards of trade, it would appear, can act capriciously. But such organizations are, at bottom, only private clubs. They have no special legal dispensations. If members do not like the way that board of trade A is handling its affairs, they are free to set up another, competing, board of trade, B. This threat will usually serve to compel the extant trade board to act reasonably.

Apart from these specific difficulties with Bork's theory of predation, there is the underlying philosophical problem[9] that it attempts to make distinctions where there are no discernable differences. Let us, in order to illustrate this point, attempt to construct several new analogues to economic "predation" in other, unrelated, fields.

The bottom line for Borkian "predation" is that it is legitimate to actively compete in order to earn profits; even "deliberate aggression" is allowed. However, one must act so as to earn profits directly; one may not indulge in business practices that sacrifice present profits, the sole purpose of which is to bankrupt a competitor, in order to earn profits later on, in the absence of the competition which would otherwise have been supplied by it.

Right now, in football, the goal is to move the pigskin in a forward direction, in order to score points. This is analogous to earning profits. If we were to adopt Bork's philosophy to this context, we would have to ban any and all actions which undermine this end, in the short run, such as the quarterback dropping back (and *losing* valuable territory) in order to pass. Even the handoff from the center to the quarterback would have to be re-evaluated in the light of this legal philosophy. And what are we to make, in this context, of the sacrifice fly in baseball, or the bunt to advance a base runner. Surely, the purposeful loss of a valuable commodity (one of the three outs) even for the long-run good purpose of scoring an extra run would have to be regarded as illegal. Similarly, the sacrifice of a queen or some other valuable piece in chess would have to be ruled out of court. Is there really that much difference between such short-run counter-productive

[9]For a complementary critique of Bork which discusses dynamic and non-equilibrium considerations, see High (1984-1985).

behaviors in the sporting world and their counterparts in the world of commerce such as local price cutting[10] or selling some goods at a loss (loss leaders) in order to attract customers into the store?

Take another case. You are the author (composer, producer) of book (song, movie) A, I am the author of book B. These books are on the same subject; they are rivals, or competitors. I am in this for the money; I have written this book in order to maximize profits. I have been asked to review your book in a newspaper, magazine, or journal. I give it a sharply critical negative review. An implication of Bork's analysis is that this act of mine ought to be proscribed by law, for it is "the employment of a business practice that would not be considered profit maximizing except for the expectation . . . that [a] rival will be driven from the market." Surely the implication which arises from Bork's analysis is intolerable; just as assuredly, it follows the logic of his interpretation. Did I not have a competing book in the market, I would not have so denigrated your effort; thus, my review would not have been profit maximizing but for the expectation that I could thereby entice potential book buyers from you to me.

Generalizing still further, from business to the world of interpersonal relations, what are we to make of the man who denigrates his rival for the affections of a woman? In the ordinary course of events, if Roger tells Elaine that Joe is a cad, a blunderer, a lazy incompetent moocher, we would just write it down to the rights of free speech. But the Borkian perspective applies here as well, provided that Roger would have said no such thing were Joe not competing with him for Elaine's hand in marriage. But if this scenario applies, again we have a case where there is

> deliberate aggression against one or more rivals through the employment of (interpersonal) practices that would not be considered profit maximizing except for the expectation that (1) rivals will be driven from the (marriage) market, leaving the predator

[10]Price cutting is illegal because it can be part of a strategy aimed at monopolizing. Raising prices is illegal because it is a way of cutting back on production; it is monopolistic withholding, e.g., the move from P_1Q_1 to P_2Q_2. The third alternative, selling at the same price as everyone else can also be held against the law on the grounds of collusion. This highlights yet another intrinsic difficulty with antitrust no matter how circumscribed and limited in application: any law which prohibits all possible choices is not compatible with the rule of law (Hayek 1973). It is, rather, an aspect of totalitarian dictatorship—in this case, paradoxically to some, on the part of the democratic majority.

> with (the object of his desires), or (2) rivals will be chastened sufficiently to abandon competitive behavior the predator finds inconvenient or threatening.

Yale Brozen

Proper targets

Yale Brozen (1982), while not so vociferous in his defence of antitrust as Bork, clearly sees a positive role for this "curious institution." In his view (p. 14):

> The antitrust agencies should be devoting themselves . . . to detecting and prosecuting the types of explicit collusion that restrain output. In devoting investigatory and prosecutorial effort to persistently concentrated industries, increasingly concentrated industries, and dominant firms, the agencies selected exactly the wrong targets. They are themselves restraining output and the growth of productivity.

This statement embodies the theme of the book. The Antitrust Division should not be rescinded. It should not be eliminated, root and branch. Rather, it has a legitimate role to play. If it could but free itself from concern with the red herring of high concentration, and focus instead on "explicit collusion," and "output restraint," it could make a positive contribution to society.

The problem with this perspective is not that Brozen has failed to put his finger on an egregious policy (attacking concentration); he has, in a thorough going and incisive way. This course of action has lead to a far poorer and less efficient economy than otherwise would have obtained. The difficulty is, rather, that there are *good* targets that the trustbusters should instead be aiming their fire at, in his view.

We have already discussed the issue of restraining output in the context of interpersonal comparisons of utility. But we can also call into question Brozen's opposition to "restraining output and the growth of productivity" under the rubric of welfare economics. Why should these goals be the *sine qua non* of economic public policy? G.D.P., physical output, and productivity growth, however important, are, still, themselves derivable from a principle even more consequential: individual choice. If the economic actor wishes, say, to pursue leisure instead of money income, human welfare will be better enhanced by allowing that decision to stand than by rescinding it, even for the persons "own good," and by coercively bringing about a situation where there are more

goods and services in the economy than are compatible with his initial determination.

This is precisely what has occurred on the part of the those chosen as proper targets for the Antitrust Division by Brozen. They are guilty of no more than explicitly agreeing, among themselves, to produce less than Brozen, an outside observer, would compel them to produce.

Concentration

The next bone of contention to be raised has to do with concentration. There is hardly a commentator more critical with regard to the way in which concentration ratios are used in U.S. jurisprudence than Brozen. For example:

> In order to find Alcoa guilty of violating the antitrust laws, Judge Learned Hand had to find that Alcoa "controlled" the secondary aluminum market, despite the production of secondary aluminum by many suppliers, as well as that it had a "monopoly" of primary aluminum. But he never considered whether aluminum competes with galvanized sheet metal, copper, magnesium, zinc, tinplate, glass, tin, and other materials used for some of the same purposes as aluminum. (p. 46)

And again:

> The measure commonly used is total shipments from plants "assigned" to an industry by the Bureau of the Census. A plant's entire output is assigned to the industry whose products make up the plurality of total shipments from the plant. If a plant belonging to a leading firm produces trucks and refrigerators, and more than half the value of its shipments is trucks, all the plant's shipments are assigned to the motor vehicle industry. That firm will then show a higher share of motor vehicle industry shipments tha[n] its actual share. (p. 50)

Here is a further example:

> Industry definitions are generally based on technology or on inputs employed, not on markets. Separate concentration ratios are reported for beet and sugar cane refiners, for example. But since beet and sugar cane refiners compete with each other for the same customers, these ratios mean little in market terms. Their outputs are indistinguishable. In addition, glucose, dextrose, and fructose sugars are produced by the corn wet milling

> industry. Maple syrup and honey are produced by still two more industries. Artificial sweeteners are produced by still another industry. There is no concentration figure reported for the sweetener market. Although cane refiners compete with beet refiners and both compete with corn millers, maple sap boilers, beekeepers and chemical firms, no account is taken of this in measuring concentration. (p. 51)

But the case is even worse than this. For artificial sweeteners *also* compete against the Jane Fonda Workout Tapes, against vacations at fat farms, and indeed, against just about everything else, such as chess sets, shoes, paper clips and light bulbs, in the sense that the family budget can stretch only so far, and thus any increased expenditure on practically *anything* means a reduction in spending on virtually everything else.

Unfortunately, Brozen's criticism of concentration measures is limited to such Census Bureau practice. He does not take the more radical step of condemning the logical coherence of concentration ratios *per se*.

In order to define a concentration ratio, an "industry," "line of commerce," or relevant "market" must first be defined. In the view of Brozen, and indeed, of virtually the entire economics profession,[11] this can be accomplished in a non-arbitrary manner through the use of cross elasticities. But these statistics are not objective "facts" of economics; they are not constants, akin to gravity in physics. Rather, they are necessarily limited as to scope and time dimension, and this leads to intractable problems. For example, it is well known that the greater the length of run, the higher the elasticity. If the price of x rises, the quantity demanded of substitutes cannot rise by very much, if at all, immediately; in the short run, it can rise by more; in the long run, and particularly in the very long run, it can increase by a very much greater amount. So, which is the "proper" length of run? Merely to ask this question is to see the utter arbitrariness of any answer, and thus of any such measure.

Even if this objection can somehow be answered, there is still the problem of the limited nature of any and all cross elasticity measures. A spurious objectivity is lent to the whole enterprise by stating that the cross elasticity of y with respect to x is 3.0. A more meaningful way of articulating this information is to say something along the lines of "In Ohio, in 1967, allowing a length

[11]Exceptions are Rothbard (1962), Armentano (1972; 1982; 1991), High (1984-1985), Block (1977).

of run of one year, the cross elasticity of y with respect to x was found to be 3.0." The former allows for easy generalizability; not so, the latter.

Conspiracy

On numerous occasions throughout his book, Brozen attacks conspiracy. For example, if express conspiracy occurs, present laws are adequate, and there is no need to outlaw concentration to make this actionable (p. 140).

"Antitrust should focus its attention on improper exclusionary devices rather than on concentration or dominance *per se*. . . . [I]t should seek out trade restraining, explicit collusion" (p. 405).

This author (p. 147) also characterizes price fixing as "commercial conspiracy." Apart from being rather excessive, this verbiage amounts to mere emotivism. For a conspiracy is nothing more than an agreement opposed by the speaker. Bertrand Russell once said "I'm firm, you're stubborn, he's a pig-headed fool." Cognitively, these three expressions all mean the same thing; they only have different emotional content. Similarly, we can now say, "I [straightforwardly] agree, you [disreputably] connive, he engages in [criminal] conspiracy." There's not a dime's worth of difference between these three modes of expression on the factual plane; emotionally, they are worlds apart. The point is, *every* agreement or contract of which the speaker disapproves can be a conspiracy; the term is without intellectual or cognitive merit.

Brozen (1982, p. 151) even goes so far as to describe price fixing as a "defrauding" of customers. But why should this be so? I own a widget; Joe owns a widget. Each of the two widgets is the private property of myself and Joe, respectively. We agree (connive? conspire?) not to sell our own widgets, those over which we each have legitimate control, at less than $1 each. We do not compel other sellers to go along with this plan. Even less do we compel buyers to make purchases at this price. Why should this be considered a fraudulent act—a veritable act of theft—upon our customers?

Perhaps this point can best be made in another context. Our author correctly analyzes advertising, and defends this practice from the charge of being an illegitimate barrier to entry. In the following passage (p. 159), each time the word "advertising" is mentioned in the text, "conspiracy" has been added in parentheses. Try the mental experiment of substituting the latter for the former:

> The essence of the argument that advertising (conspiracy) constitutes a barrier to entry is that a new firm finds it difficult to gain customers because advertising (conspiracy) ties them to existing firms. A new entrant, it is argued, faces the "prohibitively" expensive task of advertising (conspiring) to offset the prior advertising (conspiracy) of existing firms. This view is naive and, in some of its renditions, moralistic. Presumably, firms advertise (conspire) because it is in their interest to do so. But advertising (conspiracy) is expensive to existing firms as well as to potential entrants. It must be productive in some way to be justified. It is not a net social loss; if it were, other firms could provide the same service without advertising (conspiracy) and charge less. If a new firm finds it necessary to advertise (conspire), it is because whatever advertising (conspiracy) does, customers want done.

This exercise can also be performed substituting "collude" or "price fix" or "horizontally merge" for "advertise." If so, the chief conclusion reads as follows: If a new firm finds it necessary to price fix (horizontally merge), it is because whatever price fixing (horizontally merging) does, customers want done.

Richard Posner

Posner's (1986) contribution to the case for antitrust is truly remarkable. In most instances, authors who favor this public policy content themselves with marshalling the strongest arguments they can in its behalf, usually leave criticism of the points they make to their intellectual opponents. Our present author, in contrast, not only makes as strong a case for government intervention in this regard as anyone else, but, very unexpectedly, also furnishes us with some of the sharpest criticism of it to be found anywhere. At the end of the day, the careful reader is forced to conclude that Posner is indeed an enthusiastic supporter of government meddling with the free enterprise system, but cannot help but wonder exactly why this should be so.

At the outset, however, before we deal with his brief in behalf of government bashing successful business (for that is what, at bottom, antitrust is all about), let us attempt to anticipate Posner's reaction to our characterization of his work. This will provide a good introduction to his treatment of antitrust, insofar as he employs the same methodology in the one instance as in the other: after stating his thesis, he undermines it himself.

In his view:

> Monopoly . . . and other unhappy by-products of the market are conventionally viewed as failures of the market's self-regulatory mechanisms and therefore as appropriate occasions for public regulation. But this way of looking at the matter is misleading. The failure is ordinarily a failure of the market *and* of the rule of the market prescribed by the common law. . . . The choice is rarely between a free market and public regulation. It is between two methods of public control—the common law system of privately enforced rights and the administrative system of direct public control—and should depend upon a weighing of their strengths and weaknesses in particular contexts. (p. 343)

In other words, it is improper for the present author to characterize Posner as an interventionist because of his justification of the antitrust system. Why? Because public policy always[12] involves one or the other method of public control. Notice how neatly, with this highly unusual definition, Posner retires one of his harshest critics from the field: the economist who insists upon the efficacy of the laissez-faire capitalist system. One in which there is no public control whatsoever, neither in defining the rights of person or property, nor in defending them. (For examples, see Benson 1989, 1990; Friedman 1989; Hoppe 1989, 1992a, 1992b, 1992c; Rothbard 1970, 1973, 1982.)

But this simply will not do. It is one thing to reject a philosophy due to its flaws. It is quite another matter to make it a definitional issue. Despite Posner, we continue to maintain that in addition to his two methods of public control, there is a third option: no public control at all. This is at least a potentially viable option, which should sink or swim based on its own merits. It does not deserve to be ruled out of court, definitionally, before the process of analysis even begins, as Judge Posner would have it.

Our best authority for this stance, somewhat paradoxically, is Posner himself. That is to say, he, on numerous other occasions, does make the more usual distinction between free markets and governmental meddling in them. He allows for a third alternative, apart

[12]If we can ignore Posner's "rarely," which appears to be a rhetorical flourish. This we can safely do, since he vouchsafes us no example of a case where the choice *is* between a full free market and public regulation. Indeed, he denies this possibility outright.

from the "two methods of public control—the common law system and the administrative system" mentioned above, namely, full free enterprise. He must do so, otherwise government meddling is an impossibility. All intervention must fall into one or the other of these two categories.

Consider the following:

> The problem . . . with using one government intervention in the marketplace (subsidizing workplace injuries and illnesses) to justify another (regulating workplace safety and health {through OSHA}) is that it invites an indefinite and unwarranted expansion in government. (p. 312)

> [or,] if as generally assumed, the private sector is more efficient than the public. (p. 493)

Based on his statement of p. 343, on monopoly, this is incomprehensible. How can the private sector be more efficient than the public sector (or the reverse) if there is no distinction between public and private because there are, really, only two different kinds of public sectors? How can there be government intervention into the economy, if "this way of looking at the matter is misleading?"

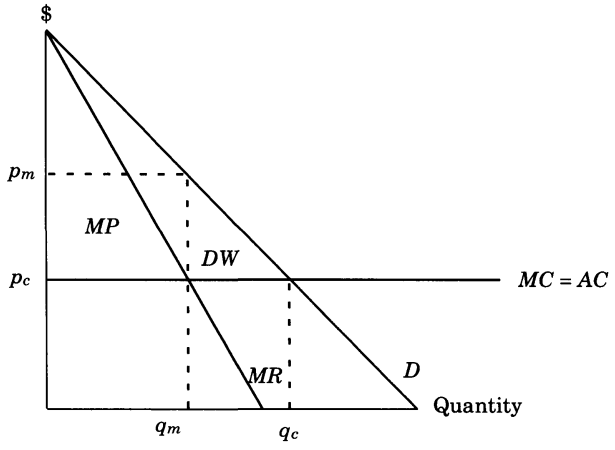

Figure 2

Source: Richard Posner. *Economic Analysis of Law*, 3rd ed. (Boston: Little Brown, 1986), p. 256.

With this brief introduction, we are now ready to consider the rather weak Posnerian argument for antitrust, and then, paradoxically, his very strong and emphatic intellectual rejection of it, and on the basis of it, somehow, his championing of this public policy.

Our author starts off with the same overused diagram, used by virtually all neoclassical economists. We are treated, once again, to the specter of the downward sloping demand, an *MR* curve which lies below *AR*, a flat *MC=AC*, on the basis of which we derive the dead weight loss due to "monopoly."[13]

But no sooner does Posner make this traditional presentation than he begins the process of subtly undermining it. He says one thing in one place, and the contrary in another, sometimes stating the thesis and the antithesis on virtually the same page. At the very outset, even before the introduction of his analysis, Posner states,

> the monopoly price . . . is the price that a firm having no competition or *fear thereof* would charge. Competition would make the price untenable. (p. 252, emphasis added)

The problem with this is that it is the rare businessman, "monopolist" or not, who has not even the *fear* of competition, let alone some actual competition or other itself. If attainment of "monopoly" price is restricted to such people, it really is an "academic concept" (p. 253) with little or no practical implication. Further, Posner enhances this criticism by conceding that "the establishment of a monopoly price creates an incentive for new sellers to come into the market" (p. 270). However, no sooner has he entertained the point that antitrust may be of only academic interest, but that he reverses field and takes it all back:

> The possibility of entry may seem to make monopoly an academic concept. But sometimes entry takes a long time, or is forbidden, or the new entrant is not able to produce at so low a cost as the exiting firm. (p. 253)

For our purposes, we may safely ignore the case where entry is forbidden. In the modern context, entry can only be prohibited

[13]This word appears in quotation marks to indicate the present author's view that real monopoly is always and ever part and parcel of government grants of special privileges. Fake monopoly, or neoclassical "monopoly," in contradistinction, is solely related to sellers facing downward sloping demand curves. See also Posner (1976).

by the state, and if this occurs, we are clearly no longer in the realm of laissez-faire capitalism, the institution we wish to defend against the Posnerian attack.[14]

As well, the worry about entry taking a long time is also without merit. If all Posner wants to do is to show that the market does not always rationally allocate resources,[15] he need not resort to "monopoly." All he need do is point to the fact that the market is rarely if ever in even partial equilibrium, to say nothing of general equilibrium. But unless it is, there are always opportunities for reallocation of resources which are wealth enhancing (Kirzner 1973). If so, then by stipulation the market misallocates resources continuously. The only problem with this approach is that it gives no reason to expect that any system can do better. And indeed, if we have learned anything from the demise of the Soviet Empire, it is clear that some systems do far worse.

But we may be doing Posner an injustice here.[16] Assume (as neoclassicals do) that price conspiracy has no redeeming virtues for consumers or for anyone else. Also assume that such agreements tend to fail over time. The issue, then, is: how *long* does it really take? If the law can put an end to an activity (without redeeming virtue) *immediately*, then why wait for the "market to work?"

There are two responses to this. First, the less radical argument, which is highly compatible with the neoclassical world view: the market works faster than government. The government typically suffers from bureaucratic and political arteriosclerosis: hearings must be held, rent seeking bribes arranged, sometimes political votes or referenda must be conducted. Even without unusual postponements, the market functions more quickly than the state. If we have learned anything from Hayek (1973), it is that a price system is by far the best communicator known to man.

The more radical response must leave the neoclassical realm and enter that of the Austrian. Here, we must withdraw the previously made assumptions. We can no longer accept the view

[14]For a critique of patents, the restriction of entry typically defended by neoclassical economists, see Rothbard (1962, pp. 652–660).

[15]That is, that the allocation of resources deviates from perfection, or could have been improved were we smarter, or had more time, or were somehow guaranteed arrival at equilibrium.

[16]I owe the inclusion of this point to an anonymous referee.

that "conspiracy" has no redeeming social values. On the contrary, we assert, all commercial agreements between two consenting parties benefit the both of them, at least in the *ex ante* sense.

Of the three grounds mentioned by Posner, he is on the firmest foundation with regard to cost, the subject to which we now turn. On this subject Posner states: "The conclusion that *DW* in figure 2 is a net social cost rests on the assumption that a dollar is worth the same to consumers and producers" (p. 256).

Note the position in which this supposition places the analysis. The whole—neoclassical—case against "monopoly" is that it misallocates resources. Deadweight loss is Exhibit A in the brief. But the existence of net social costs rest upon the claim that "a dollar is worth the same to consumers and producers." But what is the status of this claim? It is a mere "assumption." Not a scintilla of evidence is given in its behalf. Not only is this claim merely assumed, not proven, it is not even discussed. Further, it is called into question in a different context by its very author, who states, "the shape and height of people's marginal utility curves are unknown, and probably unknowable" (p. 436).[17]

Let us be clear on what is being said. We are not claiming that Posner has committed a blatant contradiction here. He is not saying in one place that marginal utility is unknowable, and in another that we know it well enough at least to fashion public policy on the basis of it. Nor does he hold that interpersonal comparisons of utility are, and elsewhere also are not, possible. However, what he does, is, if anything, even more problematic.[18] For surely knowledge of interpersonal comparisons of utilities are more risky and difficult than about the size and shape of a single person's marginal utility function. Posner throws up his hands in defeat at the prospect of obtaining information on the less complex of this pair, and bases his justification of antitrust policy on the more complex. The laws of logic would appear to indicate that if proposition A (interpersonal comparisons of utilities) is less secure than proposition B (the size and shape of a single person's marginal utility function), and if public policy cannot be grounded on the basis of B, then it certainly cannot be founded on the basis of A.

[17]"Probably unknowable" is curious. Does Posner believe that one day, with advanced scientific techniques, we will discover the shape and height of these curves?

[18]Alternatively, we could interpret Posner's statement (p. 436) as a claim about interpersonal comparisons of utility, in that it is couched in the plural. If so, there is the great danger of an incompatibility in the two views.

Nor does this exhaust the incompatibilities between Posner's defense of antitrust and his statements in other contexts. In the former case, he relies heavily on the existence of an objective, presumably measurable set of cost curves. What then, are we to make of the following quotes:

> Yet it would be difficult for a court to compute the firm's marginal cost. (p. 286)
>
> Suppose a firm makes many different products, and some of the inputs—the time of its executives, for example—are the same for the different products. If the firm cuts the price of just one product, how should executive salaries be treated, in both the short and the long run, in deciding whether the price cut is predatory? (p. 288)
>
> An important but invisible cost of a natural resource such as gas is the foregone opportunity to use it in the future. (p. 338)

These statements present difficulties. This is because foregone opportunities are, by their very nature, subjective. No one can know, judging from actions[19] what the next best alternative was to any decision. If a man buys A at the cost of $1, we know he preferred this item to the money he paid for it. But we don't know his alternative cost: what he would have done with this financial resource had he not just purchased A. Would he have put it in the bank? bought B instead? purchased a stock or bond? placed it under his mattress? Only the man himself can know anything about this contrary to fact conditional.

And yet Posner (and all neoclassicals) makes bold to draw cost curves of other people, purportedly based on their foregone opportunities. But he can never know these even in principle! Does this stop him from weaving apologetics for government intervention on the basis of these curves? Not a bit of it.

States Posner: "Theft is also 'just' a transfer payment; the victim's loss is the thief's gain." But this is not true, unless it can be shown that the subjective evaluation placed on the item by the thief and his victim is identical, a manifest impossibility. Given that there are no utils (they are only a figment of the imagination of the neoclassical economists) and thus that there is no way of

[19]Human actions (Mises 1963) and their implications are the only reliable way of ascertaining truth in economics. Merely asking an economic actor to specify the next best alternative foregone as the price of making any given choice is hardly a guarantee of determining it. He could be lying.

comparing the satisfaction of two different people, the thief and the property owner, Posner's statement cannot be true. He asks (p. 258 n. 4), "Is this clearly so when the theft is of a good other than money?" It would appear that the implication here is that it is true that the victim's loss equals the thief's gain, when the good is other than money. If this is what Posner has in mind, he is quite correct. If the thief takes a bicycle or an oxygen tent, for example, he and the victim might place quite different evaluations on the good in question. But, contrary to Posner, the same analysis applies to money. Suppose the thief steals $100. Then, to be sure, the victim loses the $100, and the criminal gains an identical amount. But they may have used these funds for very different purposes, and derived very different amounts of satisfaction from this money, for all we know. We as outside third parties are in no position to distinguish between alternative uses. Suppose that the victim (the thief) were to use the $100 for successful cancer research—this $100 is the straw that breaks the back of the problem and uncovers a cure—and the thief (victim) for tying one on. Can we assert that the former brings about more utility than the latter? Not unless there are utils which may be interpersonally compared.

We have seen no reason to suppose that there is anything on the market deserving of the appellation, "monopoly." The revenue and cost curve argument, and the geometry upon which it is based, has been found wanting. Nevertheless, we must now leave the realm of high neoclassical theory for the moment, and turn to the practical question of how to determine whether "monopoly" power exists in certain specific circumstances. That is, we now assume, just for the sake of argument, that Posner's analysis of the economics of monopoly was correct, and our own critique either non-existent or fallacious.

The basic answer given to this practical question is elasticities. To put this in biblical terminology, by their elasticities shall thee be able to distinguish the "monopolistic" sheep from the competitive goats. In particular, cross elasticities of demand tell all. They indicate how competitive is one good with another. Thanks to them, we can give a non-arbitrary definition to the extent of an industry, without which concentration ratios, market shares, "monopoly" "power"—and all the other accouterments of modern antitrust philosophy—would all become unintelligible.

There are several problems with this tidy scenario. For one thing, elasticities are slippery characters. It is by no means clear which of the many alternative definitions is reasonable. Once

again we are aided in our quest to undermine Posnerian economics by Posner himself, who instructs us as follows: Just as in the case of "the calculation of variable cost and therefore of marginal cost," elasticities, too, are "highly sensitive to the time period" (p. 287). In the very short run, elasticities are small and hence "monopoly" is easy to perceive. As the length of the run under consideration increases, however, so does the elasticity, and with it the likelihood of finding "competitive" markets.

So which should be used? There are problems for the Posner thesis either way. In the long run then, elasticities are high, and the finding of "monopoly" unlikely. If our interests are confined to the short run, a determination of "monopoly" is attained more easily, but at the cost of relevance. That is, "monopoly" is only a short run or temporary problem. Posner admits as much, in the context of yet another discussion, this one not on "monopoly" but rather "monopsony." In his view,

> monopsony is a problem only where an input consumes resources that would be less valuable in other uses. Normally this condition is fulfilled only in the short run. (p. 292)
>
> And again, "monopsony pricing would have only short run effectiveness. (p. 293)

We must conclude, then, that either "monopoly" is non-existent, or it presents no serious problem, hardly a ringing endorsement for antitrust policy.

There is yet another criticism of elasticity criterion. It arises even if we could somehow overcome the intractable difficulty of length of run: this measure does not have the attributes of a constant in the physical sciences, such as gravity. Rather, elasticity is merely a shorthand numerical summation of an act which took place in a specific geographical locale and at a certain point in history. In other words, we are never entitled to say that the cross-elasticity of y with regard to x is 4.7. At best, we can only say something along the lines[20] of "In Cleveland, in 1991, the cross elasticity of y with respect to x was 4.7." In Posner's view, we should fine people, and perhaps haul them off to jail,[21] on the

[20]Posner (p. 281 n. 1) cites Eric A. Hanushek and John M. Quigley, "What is the Price Elasticity of Housing Demand?" *Review of Economics and Statistics* 449 (1980). A more accurate title for this article would have been "What *was* the Price Elasticity of Housing Demand?"

[21]Cf. the electrical case, where businessmen were actually incarcerated on the basis of this law; in the more ordinary case of treble damages, there is still the threat of a jail sentence if the fine is not, or cannot be paid.

strength of a statistic, measurement of which has all the likelihood of success as in nailing jello to a tree.

There is also the problem of a "chilling effect" concerning the victims of the anti- "monopoly" law. These businessmen, who have been more successful in attracting customers than deemed appropriate by the Posnerites, will tend to have diminished enthusiasm for a whole host of economically productive practices.[22] Lowering prices, improving product quality, more reliable delivery, better insurance, etc., will all tend to increase consumer satisfaction. But they will also invite the negative attention of the trust busters.

There is also the possibility of mistakes, ordinary human error, either in defining the markets, or calculating the elasticities, or in interpreting them. Again, Posner himself leads the way in pointing out the risks:

> As one might expect, errors are frequent in attempting to define the market for antitrust purposes. A good example is the celebrated cellophane monopolization case, in which the Supreme Court held that cellophane was not a relevant market because there was a high cross elasticity of demand between cellophane and other flexible packaging materials. (p. 281)
>
> The courts have often mishandled economic evidence in antitrust cases. For example, in the U.S. Steel monopoly case, the Supreme Court, in ruling for the defendant, was impressed by the fact that U.S. Steel's market share had declined steadily after the combination of competing steel manufacturers to form the corporation (and that its competitors had not complained about its competitive tactics). The Court failed to recognize monopoly behavior. (p. 270)

One would think that this would give him pause for thought. If we couldn't rely upon the courts "to do the right thing" in this case, from whence springs the optimism that they will do so in future? And yet, the bottom line for Posner is that upon this foundation of sand it is reasonable, it is responsible, to erect a policy affecting virtually the entire economy of the country.

Elsewhere, Posner launches a devastating critique of:

[22]Given that businessmen know the elasticity - market share test to which they will be subjected, they will be able, to some degree at least, to act so as to alter these statistics. Surely, this is a misallocation of resources. Yet from the private perspective of businessmen, they will do so as long as the costs are less than the possible losses which result from fighting off antitrust law suits.

> direct regulation—which itself may be radically imperfect. For one thing, it tends to be more costly than common law regulation, because it is continuous; the common law machinery is invoked only if someone actually is hurt. . . . For another thing, direct regulation tends to be more politicized than common law, because it relies more heavily on the public sector and because judges, although public officials, are more protected from political reward and retribution than administrators are. . . . A related point is that regulation involves serious information problems. If accident victims have nothing to gain from bringing an unsafe condition to the government's attention, the regulators may have difficulty finding out what exactly the problem is. (p. 345)

But why doesn't Posner realize that antitrust too constitutes "direct regulation?"

As far as information costs are concerned, our author gives an additional reason for preferring "monopoly":

> An individual margarine producer may be reluctant to advertise the low cholesterol content of his product because his advertising will benefit his competitors, who have not helped defray its expense. (p. 349)

Yet another series of Posner's remarks—this time on the cost reducing proclivities of "monopoly"—undercuts his argument in behalf of antitrust:

> Sometimes monopoly will persist without any legal barriers to entry. Maybe the monopolist's costs are so much lower than those of any new entrant that the monopoly price is lower than the price that a new entrant would have to charge in order to cover his costs. (p. 262)

> The conditions of supply and demand in a market may be such that one firm can supply, at lower average cost than two or more firms, the entire output demanded; or one firm may have a superior management in whose hands the assets of all the other firms would be worth more than they now are. Either situation could lead to a monopoly through merger that might generate cost savings greater than the costs of the monopoly pricing that would result. *Unfortunately, it is exceedingly difficult to distinguish situations of this kind from the case of a merger to create a monopoly that involves few or no cost savings.* (p. 278; emphasis added)

> It is hard to base any conclusions on market share alone, even ignoring the substantial probability that if a firm has grown to a large size other than by recent . . . mergers, it probably is more efficient than its competitors, and its lower costs may outweigh the social costs resulting from its charging a monopoly price. Indeed, its monopoly price may be lower than the competitive price would be. (p. 283)

Further argument given by Posner to undermine his antitrust contention concerns potential competition:

> We know that the higher the elasticity of demand facing a firm, the less market power it has; and we also know that if an increase in price will evoke new output from other firms, i.e., if the elasticity of supply is positive, then the firm's elasticity of demand will be higher than it would otherwise be. This suggests, however, that there is no need for a separate doctrine of "potential" competition. All that is necessary is to define markets broadly enough so that they include firms that, although they do not currently sell in the market in question, would do so if price rose slightly. (p. 284)

But no sooner does he call for a way of incorporating potential competition into the antitrust analysis, on the very same page, he offers a succinct and well chosen criticism of it:

> since collusion is largely a short run phenomenon, . . . maybe the elimination of such (new entry) threats is not important enough to warrant antitrust concern, especially since it will be difficult to compute market shares for firms that do not yet have any productive capacity. Indeed, it will be quite difficult to identify which firms are likely to build productive capacity to enter the market if the market price rises above the competitive level. (p. 284)

In summary, let us be clear on what is being said here. We do not claim that these quotes from Posner contradict his case in behalf of antitrust. In his own mind, whether antitrust is justified or not depends upon a "balancing" of the grounds for and against; his conclusion is that the former outweigh the latter. The point being made here is that the support he gives for the case against antitrust is so strong, and in its behalf so weak, that despite his own explicit conclusion, the burden of his analysis vitiates this law.

There are two discernible hypotheses concerning antitrust which may be found in the *Economic Analysis of Law*. First, the neoclassical one given by Posner in those sections of his book dealing with the subject: the market is inefficient, veering off to "monopoly," in all too many cases. The function, purpose, motive, and result of antitrust is to negate this market failure, thereby increasing wealth, efficiency and economic welfare.

Despite the overwhelming popularity of the foregoing thesis in the journal and especially textbook literature, there is actually a second perspective which has some currency within the profession, that of rent seeking.[23] This alternative, in the tradition of the public choice school, tends to be somewhat underplayed by Posner, at least in those sections of his book dealing with "monopoly." It would be unfair to claim, however, that he is unaware of it. Consider the following:

> The deficiencies of public utility regulation viewed as a method of regulating profits, the degree to which it seems deliberately to maintain inefficient rate structures, and the frequency with which it has been imposed in naturally competitive industries and also used to discourage competition in industries that have some, but not pervasive, natural monopoly characteristics (railroads, for example) may lead one to wonder whether the actual purpose of public utility regulation is to respond to the economist's concern about the inefficient consequences of unregulated natural monopolies. Maybe instead regulation is a product, much like other products except supplied by the government, that is demanded by and supplied to effective political groups. Under this view there is no presumption that regulation is always designed to protect the general consumer interest in the efficient supply of regulated services. (p. 339)

[23]This is a misnomer, and a very misleading one. Literally, apart from what landlords do, rent seeking applies to the seeking after economic rent, e.g., the difference between the price someone would have been willing to sell for (buy at) and the price at which the deal was actually consummated. To be sure there are "rent seekers" in this sense, zillions of them, because all one has to do to be one is to be an entrepreneur. The real "rent seekers," the ones who attempt to use government and regulatory means for their own ends (and, unfortunately, all too often succeed) would better and more accurately be categorized as booty seekers, or as thieves who work through the political process. Examples of such legalized theft include agricultural land reserves (theft from farmers), heritage preservation laws (theft from owners of hold homes), tariffs (theft from traders), minimum wages (theft from unskilled workers and potential employers), rent control laws (theft from landlords).

No, the problem with Posner is not that he is unaware of the public choice thesis; it is, rather, that he chooses not to apply it to antitrust policy. As we have seen, he has waxed eloquent about the court's many shortcomings in this regard (e.g., U.S. Steel, cellophane, etc.). One would think, then, that he would apply the same public choice analysis to antitrust law in general, as he does to public utility regulation, one particular aspect of this legislation. Tragically, he does not.

Why not apply this insight not only to public utility regulation, where it is very apropos, but also to antitrust, where it is equally applicable? Indeed, there is an important literature which views anti- "monopoly" legislation, and the attendant law suits, as nothing but the despoilization of, or takings (Epstein 1985) from, private property owners (Kolko 1963).

Posner, instead of calling for the repeal of antitrust, recommends that cartel contracts not be enforced (p. 266). Actually, he goes further than that, characterizing this as an inadequate remedy, and advocates even more stringent controls. Nevertheless, he may have overlooked a better means to the end he favors. It is possible, that is, that strict enforcement will do more to undermine cartel agreements than non-enforcement.[24]

Consider the following. Suppose that the cartel fixes its price, through contract, at a level higher than "normal." This will necessitate an agreement to cut back on quantity, according to some agreed upon formula. If this plan is enforced by law, all will be well for the cartel provided that no outsider comes in. (The cheating cartel member is now little or no problem because, we may suppose, there are very stiff penalties for such behavior written into the contract.) But if one does, and can bribe at least one of the members of the cartel to insist that its cutback provisions be adhered to,[25] all members of the cartel can be put into serious jeopardy of bankruptcy. For if newcomers enter, even without undercutting the price, the first instinct of the cartel will be to produce more, thus lowering prices, in order to meet the competition. But if they are prevented from doing so by one "Trojan

[24]Nothing stated herein should be taken to indicate agreement with this goal of reining in cartel agreements. From the perspective of the present author, these arrangements, as in the case of all other "capitalist acts between consenting adults" such as the trade of $1.00 for a newspaper, enrich the parties who take part in it, at least in the *ex ante* sense (why else would they agree to do so).

[25]We assume that if the members of a cartel unanimously wish to end it, no contract enforcement will deny them this right.

Horse" member of the cartel, the new entrants may be able to sweep all before them.

But this scenario will be anticipated by all firms thinking of signing on with a cartel. It will put a serious crimp in all such arrangements. These organizations may still spring up, but an extra cost will clearly be imposed upon them. They will be disadvantaged by having to act so as to exclude the "Trojan Horse," or any member who can be converted into this status by being bought out.

Conclusion

We have discussed the works of three eminent, conservative, "free market" oriented economists. Certainly, they constitute a reasonable sample of this universe of discourse. We have found that however profoundly they defend market institutions in other contexts, they fail to do so in the case of antitrust. Why this lacunae should exist on the part of people otherwise concerned with economic freedom is for another day's analysis. But that this is so is the only conclusion that may be fairly drawn from the discussion above.

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Ludwig von Mises's Monetary Theory in Light of Modern Monetary Thought

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Ludwig von Mises's contributions to the development of the technical methods and apparatus of monetary theory continue to be neglected today, despite the fact that Mises succeeded exactly eight decades ago, while barely out of his twenties, in a task that still admittedly defies the best efforts of the most eminent of modern monetary theorists, viz., integrating monetary and value theory. Such a unified and truly "general theory" is necessary to satisfactorily explain the functioning of the market economy, because the market economy, or any economy based on social cooperation under the division of labor, cannot exist without monetary exchange and calculation.[1]

Mises's work on monetary economics is not only ignored by the roiled mainstream of neo- and "new" Keynesians, monetarists, and new classicists, it is also considered *passé* by many Austrian-oriented economists and policy analysts, especially those whose primary influence is the post-World War II writings of Mises's former student F. A. Hayek. A typical example of this flippant and uncomprehending dismissal of Mises's monetary thought is provided by a review of *The Gold Standard: An Austrian Perspective*, which appeared in the publication of a free-market think tank (review of The Gold Standard 1986, pp. 14–15.) In commenting on this edited volume of mainly Misesian papers

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[1]The first to make this point was Ludwig von Mises ([1920] 1990) in his classic article demonstrating the impossibility of economic calculation under socialist central planning. For recent reviews and elucidations of the socialist calculation debate from a Misesian perspective which emphasize the same point, see Rothbard (1991); Salerno (1990a, pp. 45–49; 1990b).

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on the gold standard, the anonymous reviewer opined that "large parts of the book are unsatisfactory when considered as contributions to modern economic theory. Many of the essays have a strongly anachronistic flavor and do not succeed in integrating their arguments with the (often relevant) debates in modern monetary theory." *Mirabile dictu*, the reviewer then goes on to endorse as superior to the gold standard bizarre "laissez-faire" schemes such as the issuance of private fiat moneys and the separation of the unit of account from the medium of exchange, which have been resurrected under the rubric of the "New Monetary Economics" but which still emit the unmistakable musk of their association with obscure and long-dead monetary cranks.[2] Had the reviewer enjoyed even passing familiarity with Mises's regression theorem, he would have instantly realized the untenability of these schemes.[3]

But the problem goes beyond Hayekian epigones laboring as policy analysts in think tanks. Prominent economists, too, in the wake of the collapse in rapid succession of the Keynesian and then monetarist paradigms, have been recently casting around for non-gold, "laissez-faire" alternatives to central bank manipulations of the money supply. There is, of course, Hayek's proposal for the issue of private fiat currencies; and recently Milton Friedman (1992, pp. 126–56) endorsed bimetallism as superior to a mono-metallic gold standard, while the plan coauthored by Yeager and Greenfield (1983) to dissolve the link between the monetary unit of account and the medium of exchange has recently been endorsed by another former monetarist, Richard Timberlake (1991), himself a former advocate of a parallel gold standard.[4] Even the supporters of a gold-based free-banking system, such as Lawrence White and George Selgin, who drew their initial inspiration from Mises, who himself advocated such a system because he believed it would severely restrain the issue of fiduciary media, now argue that such a system would give rise to an "invisible-hand" maturation process that eventually culminates in the complete and "spontaneous" withering away of the monetary gold base to yield a fiat bank money.

[2]For an overview of the forerunners of the New Monetary Economics by two of its proponents, see Cowen and Kroszner (1987).

[3]A critique of Hayek's scheme for privately issued paper fiat currencies is provided by Rothbard (1992b, pp. 2–5).

[4]For a critique of the Timberlake twist on the Greenfield-Yeager proposal, see Rothbard (1992a); Timberlake's earlier, and much sounder, proposal is evaluated by Salerno (1982, pp. 16–18).

Unfortunately, all such schemes are based on a failure by their authors to perceive money as an outgrowth and driving force of "micro" market processes, a perception that can only be gained from Mises's monetary theory with its unification of real and monetary analysis. What is urgently needed then, and what I will attempt to supply in this paper, is a fresh evaluation of Mises's monetary theory and a clarification of its relationship to modern monetary thought. With this endeavor, I hope to demonstrate to Austrian-oriented and other economists that Misesian theory provides fresh and relevant answers to the seemingly intractable problems still confronting modern monetary economists.

In 1985, James Rolph Edwards (1985) published an insightful and stimulating work in which he attempted a doctrinal assessment of Mises's contributions to monetary theory. As I shall indicate in detail below, while Edwards shed important light on Mises's originality as a monetary theorist and brilliantly defended him against some modern detractors, he failed in his main effort to portray Mises as the prototypical modern monetary economist, with an analytical tool kit that included an asset demand for money, the natural-rate hypothesis, the accelerationist view of lagged adjustment of nominal wages during inflation, a consistent modern monetary approach to the balance of payments and the exchange rate, rational expectations, etc. Nonetheless, Edwards's book does provide a useful framework, which I will employ for comparing Misesian with modern monetary theory. Specifically, I will use Edwards's topical development in organizing my own paper and employ some of his comments on Mises's theory as a point of departure for my own evaluation.

In the next section, "The Nature, Development, and Supply of Money," I address Mises's approach to defining money, classifying its different forms and components, and measuring the money supply. I also briefly discuss Mises's development of a consistent ordinalist approach to value theory as a foundation for his monetary theory. The following section, "The Regression Theorem and the Demand for Money," deals with Mises's formulation of a cash-balance demand for money, a supply-and-demand explanation of the determination of money's purchasing power, and his arguments in favor of the non-neutrality of money. It concludes with a consideration of Mises's regression theorem and its defense against criticism by Don Patinkin and others. In the concluding section "The Monetary Adjustment Process: The Inter-Spatial Equalization of the Value of Money, and the Determination of Exchange Rates," I focus on Mises's approach to the

inter-spatial equalization of the purchasing power of a single money and the determination of the exchange rate between independent but co-existing moneys. In the case of the former, I significantly elaborate on Mises's view that the market's arbitrage processes rapidly re-establish monetary equilibrium after it has been disturbed, while demonstrating the importance to monetary analysis of Mises's methodological devices of the plain and final states of rest. I also draw attention to important methodological contributions by Philip Wicksteed and Arthur Marget which facilitate a better analytical grasp of the monetary adjustment process. In the discussion of exchange-rate determination, I carefully distinguish between the Misesian version of the purchasing-power-parity theory and the Casselian version adopted by modern economists, explaining why the former version is immune to many of the criticisms commonly raised against the latter.

The Nature, Development, and Supply of Money

In chapter two, Edwards (1985, pp. 29–43) reviews Mises's Brobdingnagian, though unhappily neglected, efforts in preparing the conceptual groundwork necessary to a full statement of the theory of money. These include the development of a purely ordinal theory of subjective value and of marginal utility more than two decades before the celebrated "ordinalist revolution" of the 1930s, which ended up totally and erroneously expunging the very concept of marginal utility from economics. As Edwards (ibid., p. 34) points out, compared to the equilibrium condition yielded by the indifference curve analysis embraced by the later Anglo-American ordinalists, which assumes infinitely divisible goods, the equilibrium condition derived from Mises's approach is "more general and correct," because "real trade more often than not [I would say "always"] involves discrete goods." Unfortunately, despite Mises's clear doctrinal priority in formulating a purely and consistently ordinal theory of value and in completely eliminating the notion of measurable utility from economics, "To this day the major historians of economic thought appear unaware of Mises's contributions here."[5]

[5]This oversight is just beginning to be redressed in the mainstream economic literature. See, for example, High and Bloch (1989) for recognition of Mises and other neglected Austrian forerunners of the ordinalist revolution of the 1930s.

As Edwards (1985, pp. 31–32) points out, Mises built on Carl Menger to develop a theory of the nature and origin of money. As the most generally saleable good in society or "the general medium of exchange," money emerges step by step from an evolutionary market process driven by the actions of individuals consciously striving to obtain the maximum benefit from their cooperation in exchange and the division of labor. All other functions of money, e.g., as a "store of value," "unit of account," "standard of deferred payments," etc., are and must remain subsidiary to money's primary function as a medium of exchange. As we will see below, Mises's regression theorem goes beyond Menger in demonstrating that, logically, money can only come into being as a product of voluntary catallactic processes.

Under the rubric of "Definitions and Components of the Money Stock," Edwards (ibid., pp. 36–38) draws attention to Mises's original and indispensable taxonomy of money, which yields a statistical definition of money that is consistent with the one employed by modern economists. Before Mises wrote, economists generally distinguished between bank notes and token coins on the one hand and demand deposits or checking account balances on the other.[6] The former only were included along with specie in the category of money. Mises rejected this distinction as useless for the purposes of economic science. Mises's repudiation of the older classification accords with his staunchly Mengerian "essentialist" approach to economics, which finds expression in his dictum that "The greatest mistake that can be made in economic investigation is to fix attention on mere appearances, and to fail to perceive the fundamental difference between things whose externals alone are similar, or to discriminate between fundamentally similar things whose externals alone are different" (Mises [1953] 1971, p. 62).

In formulating a new and more useful classificatory framework, Mises draws a distinction between standard money—whether of the "commodity," "credit," or "fiat" variety—and

[6]This is true even of such allegedly revolutionary monetary theorists as Irving Fisher, hailed by Milton Friedman as the "greatest economist that America has ever produced." While Fisher ([1913] 1985, pp. 47, 53) identified bank deposits as an "excellent substitute" for money, he insisted that they "are not money." Even Edwin Cannan, who was one of the pioneers in formulating the demand for money as an asset or stock demand and whom Mises (1990a, pp. 23, 172) referred to more than once as "the great British economist," maintained a rigid distinction between bank deposits and money. See, for example, Cannan (1929, pp. 64–85); a good survey of Cannan's contributions to monetary theory can be found in Gregory (1927).

"money substitutes," defined as perfectly secure and immediately convertible claims to money, such as bank notes and demand deposits, which substitute for money in individuals' cash balances. Within the class of money substitutes, Mises further distinguishes between "money certificates," or notes and deposits fully covered by reserves of the standard money, and "fiduciary media," which denote uncovered money substitutes. Mises employs the term "money in the narrow sense" to denote the aggregate stock of standard money in the economy, corresponding to what is today called "the monetary base." "Money in the broad sense" is Mises's term for the monetary aggregate equal to standard money plus money substitutes minus bank reserves or, alternatively, equal to standard money (including reserves) plus fiduciary media. This latter aggregate is roughly approximated by the current definition of M1.[7]

In noting the similarity between Mises's broader definition of money and modern M1, Edwards commits minor errors of commission and omission, but they are worth noting because they elucidate Mises's essentialist approach to theoretically defining money and identifying its empirical counterpart. Respecting the

[7]Lawrence H. White (1986, p. 314 n. 23) criticizes Mises's use of the term "money substitutes" to designate secure and instantaneously redeemable claims to money, i.e., money certificates plus fiduciary media, as "confusing" because the term suggests "nonmoneyness." But it is precisely Mises's point in using such a term to indicate that claims to the standard money, e.g., gold, whether fully backed by gold or not, as long as they are perceived by the issuing institution's clients as instantaneously redeemable for gold at face value, are *not* money in themselves, because their value is not determined by a valuation process independent of that which determines the value of gold. In contrast, in suggesting as replacements for Mises's "money substitutes" and "money-in-the-narrower sense" the terms "inside money" and "outside money," respectively White himself might be charged with sowing confusion for implying that the instantaneously redeemable bank notes and deposits he denotes by "inside money" constitute a separate money whose value is determined independently of the value of the money commodity. But if we look more closely at White's free banking position, we discover that this is precisely what he intends to imply. For the free bankers, from the very moment of their first issue, bank notes and deposits are considered a fiat money in embryo, whose "invisible-hand process"-driven by evolution to maturity will result in the full and final expulsion of gold from its monetary role. Thus, the contractual suspension of specie payments and option clauses that free banks allegedly will negotiate with their clients, when they are implemented or even if they are widely expected to be, will establish "bank money" (another favored term) as an independently-valued credit money. Eventually, in the "mature free-banking system," according to White and Selgin ([1987] 1989, p. 235), there would emerge a situation in which, "At the limit, if inter-clearinghouse settlements were made entirely with other assets . . . and if the public were completely weaned from holding commodity money, the active demand for the old-fashioned money commodity would be wholly nonmonetary," and the public would presumably be finally freed from its shackles of gold to enjoy the virtues of an invisible-hand-generated private fiat money.

first error, Edwards (1985, p. 38) states that "in modern times, money consists of fiat currency, token coins, and *credit money* with fractional reserves." The error here is that checkable deposits, to which the words I emphasized clearly refer, are not considered by Mises to be credit money, but fiduciary media, a subclass of money substitutes. Credit money, on the other hand, as noted above, is one of the three categories of standard money, which also includes fiat and commodity money. Mises ([1953] 1971, pp. 61–62) defines credit money as "a claim against any physical or legal person [which] must not be both payable on demand and absolutely secure. . . . Credit money . . . is a claim falling due in the future that is used as a general medium of exchange." Generally, credit money emerges when an issuer of fiduciary media suspends redemption of these media for a definite or indefinite period of time.

The essential economic distinction between the two resides in the fact that the value of a money substitute, considered as a perfectly secure and instantaneously redeemable claim to money, is completely dependent upon and always equal to the value of the sum of standard money to which it entitles its holder. In contrast, the value of credit money is established by an "independent process of valuation" (Mises ibid., p. 61). For example, Bank of England notes denominated in gold pounds were money substitutes during the periods of their unqualified convertibility prior to 1797 and after 1821, while they circulated as credit money for the duration of suspended specie payments from 1797 to 1821. As we would expect of credit money, during the latter period, the purchasing power of the paper pound fluctuated independently of the purchasing power of the quantity of gold which corresponded to its original definition. The fact that the prospects and timing of future redeemability influenced these fluctuations marked the currently inconvertible notes as credit rather than fiat money.

A proper understanding of the concept of credit money is important, because Mises seems inclined to classify most historical instances of non-commodity money as credit rather than fiat money. For example, in *Theory of Money and Credit*, which was translated from the second German edition published in 1924, after the German hyperinflation had run its course, Mises (ibid., p. 61) writes: "It can hardly be contested that fiat money in the strict sense of the word is theoretically conceivable. . . . Whether fiat money has ever actually existed is, of course, another question, and one that cannot off-hand be answered affirmatively. It

can hardly be doubted that most of those kinds of money that are not commodity money must be classified as credit money. But only detailed historical investigation could clear this matter up." Even as late as 1966 in the third edition of *Human Action*, Mises (1966, p. 429) stops short of categorically affirming the historical existence of fiat money, declaring that "It is not the task of catallactics but of economic history to investigate whether there appeared in the past specimens of fiat money or whether all sorts of money which were not commodity money were credit money."

The omission in Edwards's discussion—partly explained by his narrow focus on *Theory of Money and Credit*—involves a failure to recognize Mises's ambivalent attitude toward the inclusion of saving deposits in his broader definition of money. A strong case can and has been made for the view that saving deposits in the contemporary U. S. economy constitute "perfectly secure and immediately convertible claims to money" and, therefore, according to Mises's own criterion, are to be identified among the components of money in the broad sense.[8]

As early as 1924, Mises ([1953] 1971, p. 270) recognized that institutional developments had led banks "to undertake the obligation to pay out small sums of savings deposits at any time without notice." This circumstance, according to Mises (ibid.,

[8]This case has been made by Rothbard (1978) and Salerno (1987), who argue for inclusion in the money supply of all currently spendable dollars in the economy, i.e., those immediately obtainable without penalty or risk of capital loss. As reported by the Federal Reserve Bank of Cleveland (1992, p. 3) recently, Shadow Open Market Committee member William Poole has endorsed a monetary aggregate, MZM (for "money of zero maturity") which seeks to identify and capture those dollars "immediately available without penalty or risk of capital loss" and which comes close to the TMS (for "true money supply") aggregate developed by Rothbard and Salerno. The main difference between the two is that TMS excludes, while MZM includes, all Money Market Mutual Fund shares; both include, in addition to items in M1, savings deposits and Money Market Deposit Accounts, at the same time excluding small time deposits. White (1986), on the other hand, beginning from a Misesian medium-of-exchange definition of what constitutes money, similar to Rothbard and Salerno's, arrives at a much narrower empirical measure of the money supply which excludes non-checkable demand deposits, such as, passbook savings accounts, on the grounds that the passbooks themselves do not literally pass from hand-to-hand in the payments process. Israel M. Kirzner (1976), in a critique of Rothbard, raises the same objection as White to the inclusion of non-checkable deposits in the money supply, and then goes further to express skepticism of any attempts to produce a statistically unweighted aggregate of the nominal stock of money. It is ironic that Kirzner's thoroughgoing commitment to subjectivism should lead to his rediscovery of and support for a Divisia-type monetary aggregate in advance of its modern reintroduction into mainstream monetary economics in the 1980s. For a brief critique of the White-Kirzner position on excluding non-checkable demand deposits from a monetary aggregate based on the medium-of-exchange definition of money, see Salerno (1987, pp. 2–3).

p. 270), induced some people, for example, "small business people and not very well-to-do private individuals," to utilize these deposits as "current accounts" notwithstanding their technical status as "investment deposits." Thus Mises implies that at least some portion of saving deposits function economically as money substitutes and warrant inclusion in his broad concept of money.

During the 1920s and into the 1930s, there was tremendous growth in the volume and economic significance of savings deposits both in the U. S., due to Federal Reserve policies, and throughout the world economy (Phillips, McManus, and Nelson [1937] 1972, pp. 29, 95–103; Rothbard 1975, pp. 92–940). In an important but neglected article written in the early thirties, Mises ([1933] 1990) places much of the blame for the financial and exchange-rate instability of the early 1930s on the pandemic treatment of savings deposits as money substitutes, a development actively sought and encouraged by the banks. As Mises (ibid., pp. 528–29) argues:

> The bank which receives [saving deposits] has to lend it to business. A withdrawal of the money entrusted to it by the saver can only take place in the same measure as the bank is able to get back the money it has lent. As the total amount of the saving deposits is working in the country's business, a total withdrawal is not possible. The individual saver can get back his money from the bank, but not all savers at the same time. . . . Since the saver does not need the deposited sum at call or short notice it is not necessary that the savings banks or the other banks which take over such deposits should promise repayment at call or at short notice. Nevertheless, this is what they did. And so they became exposed to the dangers of a panic. They would not have run this danger, if they had accepted the saving deposits only on condition that withdrawal must be notified some months ahead.

Mises also demonstrates that it was the egregiously inflationary and foredoomed attempt made by central banks to insure the instantaneous redeemability of saving deposits promised by the commercial banks, and not the spontaneous and generalized "capital flight" that is usually alleged, which was the root cause of the destructive exchange-rate gyrations of the 1930s. Writes Mises ([1933] 1990, pp. 108–9):

> Capital invested in real estate or industrial plants or in shares of companies holding property of this nature cannot fly. You can sell such property and leave the country with the proceeds. But—unless

> there is no expansion of credit—the buyer simply replaces you. . . . One person or another can withdraw his capital from a country, but this can never be a mass movement. There is only one apparent exception, *i.e.,* the saving deposit which can be withdrawn from the bank at once or at short notice. When the saving deposits are subject to instant withdrawal and the bank of issue renders the immediate withdrawal possible by advancing credits for these savings to be withdrawn, then credit expansion and inflation cause the exchange ratio to rise [the domestic currency to depreciate]. It is obvious that not the flight of capital but the credit expansion in favor of the savings banks is the root of the evil. . . . If the Central Bank were to leave [the banks] to their fate, their peculiar embarrassment would not have any effect on the foreign exchanges. That the additional issue of great amounts of bank notes for the sake of the repayment of the total amount or of a great portion of a country's saving deposits makes the foreign exchange go up is easy to understand. It is not simply the wish of the capitalists to fly with their capital, but the expansion of the circulation, that imperils monetary stability.

Despite his brilliant and pathbreaking analysis of the causes and effects of the progressive transformation of saving deposits into de facto money substitutes, Mises was still unprepared in 1966, in the third edition of Human Action, to include these deposits in his broader definition of money. There Mises (1966, p. 460 n. 23) refers to them as "demand deposits not subject to check," but then inconsistently denies that they are money substitutes. Instead, he identifies saving deposits as foremost among "secondary media of exchange," a category encompassing highly marketable financial assets, such as government bonds and blue chip stocks, which permit their owners to economize on the holding of cash balances. Unlike money substitutes, secondary media of exchange "must first be exchanged against money or money substitutes if one wants to use them—in a roundabout way—for paying or for increasing cash holdings" (Mises 1966, p. 461). Uncharacteristically, Mises never addresses the momentous institutional fact, clearly recognized in his 1933 article, that, unlike stocks and bonds whose exchange values in terms of money fluctuate according to market forces, saving deposits are "exchanged" on a market in which their money "price" is virtually fixed (at par value) and guaranteed by the practically inexhaustible resources of the central bank.

The Regression Theorem and the Demand for Money

Murray N. Rothbard (1988, p. 179; 1977) has characterized the regression theorem as the "*pons asinorum*" for critics of Mises's monetary theory and as the "keystone of monetary theory" in general. And, as Edwards (1985, p. 49) points out, Mises himself "considered the integration of monetary and value theory by the application of marginal analysis to be the central problem, and his solution to be the most important contribution of [*The Theory of Money and Credit*]." In this spirit, Edwards (ibid., p. 24) refers to the third chapter of his own book, which comprises trenchant defenses against critics of Mises's regression theorem and approach to the demand for money, as "perhaps the heart of the study."

Against the allegation of Patinkin (1965, p. 79) and, later, Laurence S. Moss that Mises confused the marginal utility of holding money with the marginal utility attaching to the goods for which it exchanges, Edwards (1985, p. 53) definitively demonstrates that the confusion is the critics' and that "The entire context of Mises's discussion unequivocally bears on the derivation of the individual and market demands for money to *hold* as *stock*." While Edwards (ibid., p. 65, n. 35) affirms that Patinkin and Moss are "respectful in their treatment of Mises's contributions," one would surely be hardpressed to identify a single instance in the history of economic thought in which an eminent economist's position was interpreted less sympathetically than in the present case, especially when one considers Patinkin's unsurpassed scholarship in the history of monetary theory.

Edwards also neatly disposes of the absurd charge by "real balance" theorists such as Howard S. Ellis (1934, p. 163) and Moss (1976, p. 32) that Mises conceives the demand for money as a demand for nominal units of money without regard to the purchasing power or exchange value of these units. As Edwards (1985, pp. 53–54) argues, "If a unit of money has a value, then the individual can, for an additional unit of money income, compare the marginal utilities of the additional present or future goods obtainable with that of adding that unit's worth of purchasing power to his/her cash balance, and it is precisely the magnitude of *real* balances that Mises is talking about determining by such a marginal calculation. The individual simply expresses that demand by demanding nominal units of money with a given purchasing power each."

Indeed we may go further than Edwards and turn the tables on those who insist that money demand analysis must proceed via a "real value calculus" and in terms of the utility of "resources held in the form of money." In his outstanding but unduly neglected tome on monetary theory, which includes an encyclopedic review of the development of the cash balance approach to the demand for money, Arthur W. Marget ([1938–42] 1966, 1, pp. 414–83) conducts a remarkable running defense of the Menger-Mises-Cannan "money balance" variant against the claims of the Walras-Pigou-Keynes "real balance" variant. First, Marget argues that the real balance approach is unrealistic, because it rests on the assumption that the holders of cash explicitly utilize an index number to "deflate" their money balances. According to Marget (ibid., p. 446 n. 88), "The real issue, so far as the question of realism is concerned, is whether the element of price change enters the 'calculations' of the cash-balance administrator as a matter affecting 'his prospective receipts and payments in monetary units,' as Hawtrey [as well as Mises] holds, or whether it enters as part of a kind of 'deflation' process—in the statistical sense of 'deflation'—represented by the division of a cash balance by a price index. The question . . . is whether, from the standpoint of realism, it is helpful to think of cash-balance administrators as taking 'express account of any index number relating their cash to its equivalent in products.'"

Marget's second objection to the real balance approach stems from the fact that "demand for 'resources in the form of currency' which is held to determine the price level, needs, in order that a given amount of 'money' may be translated into 'real' terms, a 'price-level' which assigns to 'resources in the form of currency' a given 'real' value" (ibid., pp. 450–51 n. 99). Without dated price levels, *à la* Mises's regression theorem, however, exponents of this approach, which was developed as a means of escaping the so-called "Austrian circle," are themselves trapped in a logical circle. Finally, Marget (ibid., p. 451) contends that, in deflating money balances to their "real" equivalent in terms of products, many real balance theorists equate "the utility of a cash balance" to "the utility of the goods that might be purchased by the expenditure of the cash balance." The result is that these theorists are unable to explain why anyone should ever choose to hold cash instead of other forms of wealth, given that equal utilities generate indifference among alternatives.

Edwards successfully counters another criticism advanced both by Ellis (1934, p. 164) and Moss (1976, p. 32). The latter argue that Mises's theory of the demand for money yields a

demand curve that is drawn as a rectangular hyperbola in nominal cash balance space. A demand curve of this shape, they note, is logically inconsistent with Mises's repeated and vigorous denials that an addition to the stock of money—even when this increment is distributed so as to equi-proportionally increase all individual cash balances—causes an equi-proportional increase of all prices. Edwards (1985, p. 55) thoroughly demolishes this criticism by demonstrating that it rests on a clearly erroneous interpretation of Mises's theory "as saying that the individual values units of money only with a view to maintaining a predecided and given level of purchasing power, and that utility calculation is not applied to the level of real balances. From this perspective they find his non-proportionality argument contradictory. It does not occur to them that his non-proportionality argument is evidence *against* their interpretation of his theory of the demand for money."

Edwards (1985, p. 56) himself falls into error, however, when he charges Mises with "a failure to step from a non-rectangularly-hyperbolic demand for nominal balances to the rectangularly-hyperbolic market equilibrium curve." Edwards initiates his criticism by concurring with Mises that an equi-proportional addition to cash balances, let us say a doubling, will not lead *initially*, i.e., immediately prior to the first round of spending of the excess balances, to an inversely proportional variation or halving of marginal utilities of money on individual value scales. Thus, as Edwards recognizes, the overall elasticity of Mises's "instantaneous" demand curve for nominal balances, which is derived from instantaneously existing marginal utility schedules for goods and money, may properly take on (absolute) values less than, greater than, or equal to unity. Or, in other words, the instantaneous demand curve for money only fortuitously traces out a rectangular hyperbola.[9]

[9]Rothbard's analysis of the demand for money implies that it tends to be basically inelastic due to the high inelasticity of what he calls the "exchange" or "pre-income" component of monetary demand, which is distinguished from the "reservation," "cash-balance" or "post-income" component. The former is expressed in the exchange for money of the services of the original productive factors, land, and labor, and of existing inventories of capital and consumer goods, for which the reservation demands of their producers are usually highly inelastic. See Rothbard ([1962] 1970, 1, pp. 662–67; 2, pp. 350–56). The inelasticity of the exchange demand for money is similarly accounted for by Herbert J. Davenport ([1913] 1968, pp. 267–73). Davenport (ibid., pp. 301–3, 316–21) also provides a surprisingly modern account of the reservation demand for money, as a short-run, speculative phenomenon, but ultimately fails to integrate the two components into a satisfactory overall theory of the demand for money.

Edwards (ibid., p. 56) proceeds to argue, however, that Mises erred "in assuming that it followed that prices would not rise proportionately with M. This would occur because, as prices increased, real balances would decline, reversing all of the initial wealth effects, until equilibrium was attained at the initial level of real balances, *ceteris paribus*." Edwards is here contending, *à la* Patinkin, that, notwithstanding the non-unitary elasticity of the "instantaneous" demand curve for money, real balance effects generated by an increase of money will initiate a dynamic adjustment process that culminates in an equi-proportional increase in overall prices. But Patinkin's demonstration that an increase in money accomplished via an equi-proportional increase in everyone's cash balances brings forth an increase of all prices in the same proportion rests either on his arbitrary assumption of the constancy of the real data, i.e., relative prices and real wealth, during the transition from one Walrasian equilibrium position to the next, or on his equivalent simplifying assumption that "prices rise during the *tatonnement* in an equi-proportionate manner" (Patinkin 1965, p. 44).[10]

In contrast, the very time-embracing "step-by-step" method which Mises (1978a, p. 59) consistently applies in analyzing monetary phenomena leads inevitably to a denial that the real data of the system could, under any conceivable initial set of circumstances, remain unaltered during a disequilibrium adjustment or *tatonnement* process. For Mises (1966, p. 414), "The process is always uneven and by steps, disproportionate and asymmetrical." In fact, Mises ([1953] 1971, pp. 141–42) rigorously demonstrates the long-run nonneutrality of money even under the most stringent and highly unrealistic assumption that new money is injected into the economic system in a way that does not disturb the pre-existing relative distribution among individuals of total wealth.

Writing in *Human Action*, Mises (1966, pp. 412–13) concludes that

> Changes in the supply of money must necessarily alter the disposition of vendible goods as owned by various individuals and firms. . . . We may, if we like, assume that every member gets a share of the additional money right at the moment of its inflow into the system, or shares in the reduction of the quantity of

[10]On the key role played by the assumption of the constancy of relative prices for deriving the neutrality of money in Patinkin's system, see Rousseas (1972, pp. 53, 72).

money. But whether we assume this or not, the final result of our demonstration will remain the same. This result will be that changes in the structure of prices brought about by changes in the supply of money available in the economic system never affect the prices of the various commodities and services to the same extent and at the same time.

The main fault of the old quantity theory as well as the mathematical economists' equation of exchange is that they have ignored this fundamental issue. *Changes in the supply of money must bring about changes in other data too.* The market system before and after the inflow or outflow of a quantity of money is not merely changed in that cash holdings of the individuals and prices have increased or decreased. There have been affected also changes in the reciprocal exchange ratios between the various commodities and services which, if one wants to resort to metaphors, are more adequately described by the image of price revolution than by the misleading figure of an elevation or a sinking of a "price level." (Emphasis added)

Thus for Mises, "real balance effects" are inextricably bound together with "distribution effects." The very process by which the market adjusts the (positive or negative) excess demands for money of individuals necessarily "revolutionizes" wealth positions and the price structure. And this is the case even if these (nonzero) individual excess demands sum to zero in the aggregate. Writes Mises (1966, pp. 417–18):

Every change in the money relation alters—apart from the effects on deferred payments—the conditions of the individual members of society. Some become richer, some poorer. It may happen that the effects of a change in the demand for or supply of money encounter the effects of opposite changes occurring by and large at the same time and to the same extent; it may happen that the resultant of the two opposite movements is such that no conspicuous changes in the price structure emerge. But even then the effects on the conditions of the various individuals are not absent. Each change in the money relation takes its own course and produces its own particular effects. If an inflationary movement and a deflationary one occur at the same time or if an inflation is temporally followed by a deflation in such a way that prices finally are not very much changed the social consequences of each of the two movements do not cancel each other. To the social consequences of an inflation those of a deflation are added. There is no

reason to assume that all or even most of those favored by one movement will be hurt by the second one, or vice versa.

Edwards (1985, p. 56) also argues that Mises's "nonproportionality argument" contradicts Mises's own no less vigorously stated position that an increase in the aggregate money stock would leave human welfare unchanged, because "a change in M would result in a proportional change in P." Edwards here implies that Mises derives his proposition that money always yields to society its full utility as a medium of exchange from a "process" analysis of the effects of a change in the quantity of money on a given economic system. For Mises, however, the proposition regarding the welfare effects of additions to the money stock is derived from a purely "comparative static" analysis of two simultaneously existing but unconnected economic systems which are based on identical real data and differ only in the magnitudes of their nominal money stocks. While the discussion by Mises which Edwards cites to support his interpretation is admittedly ambiguous on this point (Mises [1953] 1971, p. 85), elsewhere in the same work Mises (ibid., pp. 142, 145) draws a clearcut distinction between the two forms of analysis:

> the level of the total stock of money and of the value of the money unit are matters of complete indifference as far as the utility obtained from the use of the money is concerned. Society is always in enjoyment of the maximum utility obtainable from the use of money. Half of the money at the disposal of the community would yield the same utility as the whole stock, even if the variation in the value of the monetary unit was not proportioned to the variation in the stock of money. But it is important to note that it by no means follows from this that doubling the quantity of money means halving the objective exchange-value of money. . . .
>
> If we compare two static economic systems, which differ in no way from one another except that in one there is twice as much money as in the other, it appears that the purchasing power of the monetary unit in the one system must be equal to half that of the monetary unit in the other. Nevertheless, we may not conclude from this that a doubling of the quantity of money must lead to a halving of the purchasing power of the monetary unit; for every variation in the quantity of money introduces a dynamic factor into the static economic system. The new position of static equilibrium that is established when the effects of the fluctuations thus set in motion are completed cannot be the same as that which

> existed before the introduction of the additional quantity of money.

In the course of rebutting Moss's astounding contention that Mises "saw the demand for real balances as constant and given by the state of the world . . . [and] did not apply subjective cost and benefit considerations to the demand for real balances," Edwards (1985, p. 57) himself seriously misconstrues Mises's position on the relationship between the demand for money and the interest rate. Edwards correctly characterizes Mises's overall approach to the problem as "the classic one of long-run interest rate neutrality, based on a view that the rate of interest and the demand for money had essentially different determinants."[11] This, Edwards (ibid., p. 57) implies, accounts for the fact that Mises "did not generally regard interest foregone as the cost of holding money." This is incorrect on both exegetical and logical grounds.

First of all, Mises identified three basic categories of opportunity costs which may be incurred in the decision to hold cash balances. These include "interest foregone" as well as the foregoing of "instantaneous consumption" and of "plain saving" i.e., the accumulation of stocks of durable consumers goods.[12] That the foregoing of an interest return is one of the potential "costs" of holding money is logically implied in the very application of marginal utility theory to the explanation of the purchasing power of money. In this approach, the opportunity cost of allocating a sum of money to cash balance is the renunciation of the marginal utility of the most highly valued alternative use of this money, which may or may not be the investment of the sum in interest-bearing securities. The assertion by Edwards (1985, p. 57) to the contrary, this is readily deducible from Mises's analysis in *Theory of Money and Credit* of the manner in which individuals adjust to a disequilibrating influx of newly-created money into their cash balances. Writes Mises ([1953] 1971, pp. 139, 134–35):

> For these persons, the ratio between the demand for money and the stock of it is altered; they have a relative superfluity of money and a relative shortage of other economic goods. The immediate consequence of both circumstances is that the marginal utility to

[11]For a recent, vigorously-argued vindication of this position, see Hans-Hermann Hoppe (1992).

[12]On the nature of plain saving as distinguished from capitalist saving, see Mises (1966, pp. 530–31).

> them of the monetary unit diminishes. This necessarily influences their behavior in the market. . . . He who has more money on hand than he thinks he needs, will buy, in order to dispose of the superfluous stock of money that lies useless on his hands. If he is an entrepreneur, he will possibly enlarge his business. If this use of the money is not open to him, he may purchase interest-bearing securities; or possibly he may decide to purchase consumption goods.

If we assume that one of the individuals in Mises's example does in fact allocate his increment of new money to the purchase of interest-bearing securities—assuming that his value rankings of the utilities derived from the various uses of the money have remained constant—it is to be inferred from this purchase that the foregone interest on these securities constituted the opportunity cost of holding an equal-sized unit of money *prior* to the infusion of new money into his cash balance.

Mises (1966, p. 430) is even more explicit on this point in *Human Action*, where he states that:

> The keeping of cash holding requires sacrifices. To the extent that a man keeps money in his pockets or in his balance with a bank, he forsakes the instantaneous acquisition of goods he could consume or employ for production. In the market economy these sacrifices can be precisely determined by calculation. They are equal to the amount of originary [or pure] interest he would have earned by investing the sum. The fact that a man takes this falling off into account is proof that he prefers the advantages of cash holding to the loss in interest yield.[13]

Not only does Mises conceive the interest rate as a potential cost of holding money, he also recognizes that it is a monetary phenomenon in a real and important sense. That is, in a barter economy, where monetary calculation does not exist, it would be impossible to even conceive the difference in value between present and future goods as a unitary rate. The reason, as Mises (1990b, p. 65) points out, is that "Only within a money economy can this value difference be comprehended in the abstract and separated from changes in the valuation of individual concrete economic goods. In a barter economy, the phenomenon of interest could never be isolated from the evaluation of future price movements of individual goods."

[13]Also see Mises (1966, pp. 404, 463), for similar statements.

Of course, recognizing that the interest rate is an outgrowth of monetary exchange and calculation expressible only in monetary terms and that, as an element determined within the system of interdependent money prices, it functions as an opportunity cost of holding money does not imply that "real balances [are] a function of wealth and the interest rate." That Edwards does not fully comprehend this point is attributable to his failure to appreciate that Mises's methodological approach is worlds apart from the neoclassical methodology of mutual determination that Edwards himself apparently espouses. The analytical framework of Mises's monetary theory is the general interrelationships and interdependencies of the system of market prices. Within this framework, there are multifarious opportunities for money expenditures on consumer goods which, in addition to the opportunity to hold ready cash, compete with opportunities to invest money at interest. Thus it might be argued that a fall in the interest rate, *ceteris paribus*, lowers a given individual's cost of currently consuming, let us say, apples. But it is an impermissible leap of logic from this formally unexceptionable statement to the conclusion that the interest rate is one of the functional determinants of the demand for apples.

Edwards does make an important contribution, however, in his defense of Mises's regression theorem against Patinkin and his demolition of the latter's alternative "Walrasian solution" to the circularity problem in monetary analysis. Employing the methodology of simultaneous mutual determinism, Patinkin is able to formally demonstrate that no specific prior value of money need be assumed in deriving a market demand schedule or "excess demand function" for money. Moreover, Patinkin's demonstration implies that if economic agents form their subjective valuations of cash balances on day two with reference to the unique purchasing power of money prevailing on day one, as Mises assumes, the outcome is not a schedule of quantities demanded of money at varying purchasing powers but a single quantity demanded. Thus Patinkin (1965, pp. 115–16) concludes that writers such as Mises who believe that there is a circularity problem to be addressed in explaining the determination of the purchasing power of money fall victim to a "basic misunderstanding of the theory of price determination" and to an elementary "confusion of 'demand' with 'amount demanded.'"

In defending Mises, Edwards argues that, before Patinkin's "individual-experiment" can proceed, i.e., before each individual can establish his indifference map for goods and (nominal) money

balances, money itself must have utility and therefore a known and pre-existing purchasing power, because the very existence of indifference curves implies that the individual is able to maintain a given level of utility by substituting at the margin determinate quantities of goods for determinate quantities of money. Edwards's insightful argument on this point is worth quoting at length (Edwards 1985, pp. 59–60):

> note that [Patinkin's] method of generating a demand curve for money assumes the indifference curves to exist and have the normal properties. Yet, translating into modern terms, the whole essence of the problem, as recognized by all parties to the [circularity] debate at the time, was precisely that without some specific value of money *no* such indifference curves could even *exist*. Consider: we have goods on one axis, with a given intercept (the endowment), and money on the other. But money is only money when it is a medium of exchange, that is, when it has a value (purchasing power) in terms of other goods. Then it can be valued for storage purposes and the utility curves can exist.
>
> We might place pieces of paper with a number on them on the axis, but if they have no nonmonetary utility and no purchasing power they would have no utility. The indifference curves can only exist when we place a budget line on the graph, that is, postulate a goods price of money, and that is precisely Mises's point. . . . Mises would argue that since the indifference curves cannot exist until the budget line does, the latter is logically prior. His interpretation of such a graph would be that the budget used is yesterday's exchange value of money, while the indifference curves embody today's subjective valuations of money.

Presumably, Patinkin would counter this critique by arguing that the temporal and causal approach to explaining the demand for money followed by Mises—referring as it does to a particular value of money—would be incapable of generating more than a single point on a demand curve in nominal money space. Edwards's reply to this objection, although it points us in the right direction, is not completely satisfactory. Thus he argues, somewhat tentatively, that the Patinkinite charge "is not quite correct," because, while the formation of individuals' subjective valuations for money with reference to "some *particular* prior value of money" yields only a single quantity demanded, "there is an infinite number of such possible prior values, and if their tangencies with individual's [sic] existing indifference curves were plotted,

demand functions of the normal shapes would result" (Edwards 1985, p. 66 n. 47).

But the point that Edwards should have made is that market participants, in deciding upon the size of their cash balances, are interested in the future purchasing power of money. In attempting to forecast the future structure of prices, which is the inverse of the purchasing power of money, they resort to the prices of the immediate past, let us say, yesterday. They do not mechanically project the realized prices of yesterday into the future, but use them as the basis for appraising the structure of prices which will emerge and prevail today as a result of the anticipated changes intervening in yesterday's constellation of the qualitative economic data.

Based on their appraisements of money's prospective purchasing power and their anticipated uses for a general medium of exchange today, market participants rank units of money on their subjective value scales and thus establish the marginal utilities that underlie today's market demand for money. For each individual, the marginal utility of money will decline as successive units of a given purchasing power are added to his cash balance. Consequently, an increase in the total stock of money, ceteris paribus, will lead to a decline in individual marginal utilities of money and this will translate into a rightward shift in demand curves in goods markets and higher money prices offered and paid, i.e., a decline in the purchasing power of money. In other words, the instantaneous demand curve for money that emerges from Mises's analysis is multi-valued and negatively-sloped and interacts with the vertical line representing the current stock of money to determine today's purchasing power of money.

Contrary to Patinkin's assertion, then, in Mises's analysis, the demand for money is not logically constrained to a single quantity dependent on a specific realized purchasing power, but describes a schedule of quantities that responds inversely to variations in the current purchasing power of money. To illustrate this, if we assume that the total quantity of money that market participants desire to acquire and hold, based on their forecasts of the future purchasing power of money, is insufficient to completely absorb the current stock of money, then there will result a temporal process involving variations in total money expenditures on goods and services, i.e., "real balance effects," that drive the price structure and therefore the purchasing power of money to the level at which the stock of and demand for money are equated. Abstracting from distribution effects, the inverse response of the

amount of money demanded to the alterations in its purchasing power, which occurs during this adjustment process, will trace out a segment of the instantaneous demand curve.

Summing up the differences between the Misesian and Patinkinite methods for solving the circularity problem, Edwards (1985, p. 60) sees a distinct advantage in the Misesian method, because it allows for the possibility of disequilibrium occurring between the actual and desired stock of cash balances and the operation of an adjustment process that eventually restores equilibrium. In contrast, the Walrasian solution offered by Patinkin effectively precludes the emergence of monetary disequilibrium and a dynamic adjustment process. As Edwards (ibid., p. 61) argues: "Where demand and excess demand functions are derived using given preferences and hypothetical alternative values of money, and the value of money determined by the market demand and supply functions determines the actual quantities demanded simultaneously, the individual is always at equilibrium. . . . The solution to a simultaneous equation set *never* yields anything but equilibrium values."

The Monetary Adjustment Process: The Interspatial Equalization of the Value of Money, and the Determination of Exchange Rates

In chapter four, Edwards (1985, p. 69) examines Mises's contributions to international monetary theory, and, in the process, goes a long way towards establishing that Mises anticipated "every major element of the modern monetary approach to international adjustment (MAIA)." Indeed, Edwards (ibid., p. 133) argues that "This is true to such an extent that Mises might justly be designated the founding father of the MAIA in the twentieth century."

The central proposition of the modern monetary approach is that "the balance of payments and currency exchange rate changes are essentially monetary phenomena equilibrating the stock demands for and supplies of national currencies" (ibid., pp. 69–70). Proponents of this approach have traced the roots of the MAIA back to the writings of classical monetary theorists including David Hume and British "bullionist" pamphleteers John Wheatley and David Ricardo. Edwards argues, however, that in their eagerness to identify and credit the classical forebears of the monetary approach, doctrinal historians have given a partly distorted account of its development, which completely overlooks

Mises's unquestioned precedence in formulating important elements of the uniquely "modern" version.

As Edwards (ibid., pp. 77–78) points out, before Mises, proponents of the monetary-oriented classical and neoclassical approaches to balance-of-payments adjustment, including prominent cash-balance theorists such as Alfred Marshall and Knut Wicksell, explained the international distribution of the money commodity using a macro "expenditure flow" concept of the demand for money. According to this conception, each nation's equilibrium share in a given global stock of money is determined, given the payments habits of its population, by the relative volume of business it transacts at the exogenously given level of world prices. Or, in terms of the Fisherian Equation of Exchange, a nation's demand for money is conceived as a demand for a flow of money payments (M x V) needed to support an aggregate expenditure flow (P x T).

Mises, in contrast, builds up his explanation of the distribution of the stock of money among nations from the Mengerian (and modern) conception of the individual's demand to hold a *stock* of the general medium of exchange. For Mises, individuals' subjective value rankings of money and goods hold the ultimate explanation for the allocation of the global stock of money among individual cash holders and thus among nations, obviating any reference to disembodied averages and aggregates such as a nation's velocity of circulation of money or total volume of business transactions. Thus in Mises's view, as in the modern MAIA, "international monetary *flows* (that is, deficits and surpluses in the balance of payments) act to equilibrate the stock demands and supplies of money" and, therefore, assuming a fixed global monetary stock, "only changes in the *demands* for money (resulting in net excess demand, positive or negative) can produce a surplus or deficit" (Edwards 1985, p. 77). Conversely, "If the state of the balance of payments were such that international movements of money were required *independent of any altered estimation of money on the part of those involved* (that is, in the absence of change in the stock demands), operations would be induced to restore equilibrium" (ibid., p. 76).

Unfortunately, in his own eagerness to establish Mises's rightful and preeminent position in the MAIA tradition, Edwards glosses over several significant differences between the Misesian and the rational expectations-based modern approaches. These differences are important enough to warrant critical comment.

Edwards (ibid., pp. 70–71, 73–74) points out that Mises, like the modern proponents of the monetary approach, holds that "the law of one price" applies to money as well as to commodities. In other words, in the case of a single money, the purchasing power of the monetary unit tends to be geographically uniform. For adherents of the modern monetary approach, such as Laffer and Miles (1982, p. 232), this means that, assuming profit maximization and no barriers to trade, "All commodities' prices should be fully arbitraged in each and every numeraire at each and every moment in time." This concept of instantaneous arbitrage for an individual good then "can be extended to the overall price indexes of two countries by taking a weighted average of the prices of goods consumed in both countries" (ibid., p. 232).

But the rational expectationist conception of instantaneous arbitrage is inconsistent with the step-by-step method employed by Mises in his analysis of the monetary adjustment process. As Mises (1978a, p. 59) emphasizes, "The step-by-step analysis must consider the lapse of time." Moreover, Mises ([1953] 1971, pp. 187–94; 1966, pp. 219–23) criticizes and deliberately eschews the use of price indexes to measure changes in the purchasing power of money, except for rough historical estimates.[14] Therefore, when Mises ([1953] 1971, p. 176) states that "The purchasing power of money is the same everywhere," he is *not* referring to a tendency to equalization of national price indexes, as Edwards (1985, p. 77) seems to imply at one point. For Mises, interspatial equalization of the value of money refers to an equilibration of the vast and unaveraged array of alternative quantities of goods which are purchasable by a unit of money.

Furthermore, from Mises's perspective, equilibration of money's purchasing power array cannot necessarily be expected to yield equality between the prices of physically identical goods available in different locations, let alone between the arbitrarily selected and weighted price indexes of different nations or regions. The reason is to be found in Mises's pathbreaking subjectivist

[14]Even the practical usefulness of index numbers for judging day-to-day variations in the purchasing power of money is severely limited. As Mises (1966, pp. 222–23) points out, "A judicious housewife knows much more about price changes as far as they affect her own household than the statistical average can tell. She has little use for computations disregarding changes both in quality and in the amount of goods which she is able or permitted to buy at the prices entering into the computation. If she 'measures' the changes for her personal appreciation by taking the prices of only two or three commodities as a yardstick, she is no less 'scientific' and no more arbitrary than the sophisticated mathematicians in choosing their methods for the manipulation of the data of the market."

insight that the situation of a good in space may affect its perceived usefulness and thus its subjective value in satisfying human wants.[15]

Edwards (1985, p. 74) properly recognizes the implication of this insight for the case in which a "good has a subjective value as *consumption* good where it is, and a different one as *production* good in those places to which it may be transported." The good available at its place of production, for example, coffee-in-Brazil, is evaluated by coffee drinkers in New York City as a capital good which must be combined with further complementary capital goods, that is, the means of transportation, before it can attain the (higher) subjective value of the consumption good, coffee-in-New York. As Edwards (ibid., p. 74) also notes, Mises distinguishes money from nonmonetary commodities in this respect, because, in the case of the former, the use of money substitutes and clearing systems operate to render its position in space indifferent to economic agents. For Mises, then, stocks of money, wherever they may be situated within the unitary market area, for all practical purposes, comprise a perfectly fungible commodity whose transference between market participants is virtually costless. Thus the Law of One Price fully applies to money, and Edwards (ibid.) concurs with Mises's conclusion that "the purchasing power of money is the same everywhere, only the commodities offered are not the same."

Edwards defends Mises against Ellis's criticism that Mises has only proved the international equalization of "utility flows per unit of purchasing power" rather than of the purchasing power of money itself (Ellis 1934, p. 224). However, Edwards's defense itself rests on a failure to comprehend the full scope of Mises's insight regarding the influence of the spatial element on the quality of (nonmonetary) goods. Thus, in response to Ellis's critique, Edwards (1985, p. 74) upholds Mises's proposition that the objective value of money tends to equality and supports this position with the following example: "Consider a good sold in any number of locations in different directions from the factory, and at distances and elevations such that their transportation costs are the same. On Mises's assumptions it is clear that though such physically identical goods are at different locations they are *economically* the same and their prices would not differ in equilibrium."

[15]Mises arrived at this insight independently of Nassau Senior, whose work containing the treatment of this problem was not published until 1928. On this point and for a discussion of Senior's contribution, see Wu (1939, pp. 126–28); also see Bowley ([1937] 1967, pp. 205–8).

Edwards's conclusion is not fully consistent with Mises's conception of the spatial quality of goods, because this conception does not merely embrace the pure distance between the location of the consumer and the location of the good, but also the consumer's positive or negative psychic response to the very location of purchase or consumption. For example, the same brand of men's shirt may simultaneously sell for a significantly higher price at a mall boutique than at a downtown clothing store, because, at the margin, consumers are prepared to offer a higher price for the good purchasable at the more accessible and pleasant location. Or consider that alcoholic beverages consumed in a restaurant situated atop one of the towers of the World Trade Center, which offers a breathtaking view of Manhattan and its surroundings, command much higher prices than drinks mixed with the same ingredients and imbibed in a street-level pub located a few blocks away. Surely, we do not expect would-be bar patrons at the World Trade Center to react to knowledge of such price discrepancies by a mad scramble to the elevators in order to take advantage of the higher purchasing power of money at ground level. This is not to deny, of course, that whenever consumers are neutral between stocks of a technologically identical good ready for consumption or purchase at two different locations, the spatial equilibration of the purchasing power of money will imply the complete eradication of inter-local price differences.

The proper response to Ellis's critique is to point out that, for Mises, the equilibration of the purchasing power of money is accomplished within the same process that gives rise to the structure of relative prices. This process culminates in a state in which, barring further change in the data, mutual gains from further exchange between any two market participants are impossible, because the ordinal value rankings of equal units of the various goods and money are identical for all those possessing them. This state also reflects the *absolute* equalization of the objective exchange value of money between any two locations, because it implies both that inter-local differences between prices of technologically identical goods do not exceed their costs of transportation (abstracting from time in transit) between their consumption and production centers, and, more generally, that no individual can achieve a more desirable outcome from the exchange process by diminishing his expenditures on goods available at one location and substituting expenditures on goods, whether physically indistinguishable or not, offered at alternative locations.

Thus, contrary to Ellis, interspatial equalization of the *objective* value of money can only exist when there also exists common *utility* rankings for goods and money on the individual value scales of all market participants or, less accurately, when "utility flows per unit of purchasing power" are equalized.

It is instructive to analyze in more detail the market adjustment process which produces the tendency to the interspatial equilibration of the purchasing power of money, because it elucidates the reasons for Mises's insistence, as against Wieser, that such a tendency strongly and rapidly reasserts itself amid the ceaseless fluctuations of the underlying economic data (Mises [1953] 1971, pp. 173–75). Or, more loosely speaking, it explains why monetary equilibrium is much more quickly established than the final equilibrium position of the real sector of the economy. This analysis also permits us to answer the question of whether the occasional unqualified statements by Mises (ibid., pp. 201, 210) to the effect that "the purchasing power of money is the same everywhere" are intended as merely polemical flourishes or represent what Mises believed to be a close approximation to the actual moment-to-moment situation in the economy, as when we speak of "the" market price for wheat or for oil.

Mises's analysis of the market process is predicated on the indisputable premise that the process has an unavoidable spatial, as well as temporal, dimension, because the individual sellers and buyers whose actions constitute it are spatially diffuse and possess different capacities for forecasting, learning of, and adapting to the ceaseless change that characterizes human life (Mises 1966, p. 328). At each moment in time, the unitary market process produces a structure of money prices which is determined by consumer valuations (including, of leisure and of present versus future goods) and entrepreneurial price appraisements interacting with the currently existing total stocks of goods of various orders. The exchanges which take place as a result of these subjective valuations and appraisements produce a situation in which no individual perceives that he can improve his situation by further exchange at prevailing prices, because the marginal utility of any good he might offer exceeds the marginal utility of the good he will receive in exchange. On every market in the economy, therefore, the situation is the same as it is at the close of Böhm-Bawerk's famed horse market (Böhm-Bawerk 1959, pp. 217–30). This "momentary equilibrium," as Böhm-Bawerk (ibid., p. 231) refers to it, or "plain state of rest" (PSR), as it is designated by Mises (1966, p. 244), will persist only so long as

the prevailing state of valuations of the marginal pairs in each market remain constant. But these valuations are bound to change precisely because, in many cases, they are formulated on the basis of inaccurate forecasts and incomplete information regarding market opportunities. The result is that the actual market prices which we observe are always in disequilibrium in two related but logically distinct senses. First, the array of realized prices embodies inter-local discrepancies in the exchange value of goods and money, which present the opportunity for arbitrage profits, whether in terms of money or of enhanced consumer surplus.[16] Second, for many of the goods exchanged, the prices that clear the market exceed or fall short of their respective monetary costs of production, including an interest return to time preference, thereby generating pure or entrepreneurial profits and losses.

In analyzing adjustment of the first type of disequilibrium, we must abstract from the inevitable changes in production decisions that will be initiated by capitalist-entrepreneurs consequent upon their experience of pure profits and losses. The analytical device which is ready made for our purpose is Wicksteed's country fruit market in which the stocks of the various (perishable) commodities as well as consumer valuations are fixed for the duration of the "market day," during the course of which buyers exercise their demands. This market is, moreover, assumed to be "imperfect" in two senses. First, buyers and sellers are spatially constrained and, hence, neither group is instantaneously and fully informed of current transaction prices at all locations or "stalls." And second, neither buyers nor sellers have perfect knowledge of what Wicksteed calls the "ideal market" or "equilibrating" price for any commodity, which, when once established, will not vary for the remainder of the market day.[17]

[16]I am using the term "consumer surplus" in a purely psychic sense to denote the ordinal difference in value ranking between a good and its monetary purchase price. This is the sense in which Mises (1966, p. 388) uses the term.

[17]The classic discussion of the country fruit market can be found in Wicksteed ([1932] 1967, 1, pp. 219–28). A very good analysis of a pure exchange economy can also be found in Kirzner (1963, pp. 105–35). In contrast to Wicksteed's methodological focus on an isolated "market day" in a full production-and-exchange economy, however, Kirzner (ibid., p. 106) begins his analysis with an "imaginary economy" in which he assumes "*no production is possible*"; all commodities are obtained costlessly by natural endowment. Unfortunately, Kirzner's methodological construct is inferior to Wicksteed's, because it serves to divert attention from the vitally important point that the analysis applies just as fully to the real-world economy of continuing and costly production, since the market's pricing process always proceeds on the basis of stocks of goods that have already been produced and are therefore fixed or in inventory for the given moment.

In the absence of these imperfections of knowledge about the current and future state of the market, the prices established for the first set of transactions of the market day would invariably result in a PSR characterized by spatial equality in the purchasing power of money: the same commodity would have the same price at different stalls and each and every buyer would allocate his income among the different commodities available at different locations so that, at prevailing prices, no alteration in his spatial pattern of expenditures would result in an increase in his "total utility" or the utility-ranking of the aggregate collection of goods he purchases. Until sellers' stocks are completely exhausted and the market comes to a close, this identical "Wicksteedian state of rest"[18] (WSR) will be repeatedly disrupted and then re-established as each new group of perfectly informed buyers arrive and undertake transactions at the prevailing equilibrium set of prices.

However, the inescapable spatial and temporal constraints on market participants would prevent the initial pricing process from culminating in a WSR. Aware of the deficiencies of their information and foresight, both buyers and sellers arrange the temporal pattern of their exchanges according to speculative anticipations of the course of actual market prices. Buyers seeking psychic arbitrage profits devote time to comparison shopping and forego purchases offering a consumer surplus in one location while speculating on the availability at another location either of a higher-ranked good for an equal monetary expenditure or of the same good for a lower price. On their side, sellers may exercise a speculative reservation demand for their own commodities. Thus, the constellation of actual market prices that emerges at any moment early on in the market day will diverge from the equilibrating constellation as a result of ignorance and speculative errors. During the PSR which succeeds each set of transactions undertaken at "false" prices during the early going, market participants begin to discover spatial inequalities in the purchasing power of money and to exploit these opportunities for arbitrage profits. (For analytical convenience, we are assuming; as Wicksteed did, that trading at false prices does not alter the structure of market demand.) As their experience of the market grows during the course of the day, the continually revised transaction

[18]Although this construction of a fully-arbitraged, but not final, state of rest is implicit in much of Mises's monetary theorizing, he never formally analyzes it, as he does the PSR.

plans of buyers and sellers come to reflect more accurate and complete information and eventually give rise to the equilibrium set of prices. The lull or WSR which succeeds this latter set of transactions describes a situation in which the spatial divergences in the purchasing power of money have been completely eradicated and the prices of all goods fully arbitraged. For the rest of the market day, each successive set of transactions takes place at equilibrium prices and thus generates a momentary WSR until the arrival of the next group of buyers on the scene.

Wicksteed's analysis, with its assumptions of given consumer value scales and fixed stocks of goods and money, thus allows us to disentangle the complex phenomena of entrepreneurship and production from those of arbitrage. It also serves to emphasize that the determination of money's purchasing-power array is a pure exchange phenomenon: since everyone is a "dealer" in money and money is always "in inventory," a perfectly adequate explanation of the actual exchange ratio between money and goods may be made without reference to problems of production. In the same way, the Böhm-Bawerkian and Wicksteedian explanation of actual, moment-to-moment market prices of individual nonmonetary goods completely and correctly abstracts from production phenomena, due to the fact that the exchanges taking place at any moment in time are determined exclusively by the stocks of goods in existence and prevailing subjective valuations. As Böhm-Bawerk (1959, p. 229) has written: "I do really believe we have here hit upon the simplest and most natural, and indeed the most productive manner of conceiving exchange and price. I refer to the pricing process as a resultant derived from all the valuations that are present in society. I do not advance this as a metaphorical analogy, but as living reality." And, as Mises (1966, p. 245) himself stresses, "The theorems implied in the notion of the plain state of rest are valid with regard to all transactions without exception. . . . The notion of the plain state of rest is not an imaginary construction but the adequate description of what happens again and again on every market."

Perhaps the most powerful defense of the analysis of momentary positions of rest and of their relevance for monetary analysis was presented by Marget. According to Marget ([1938–42] 1966, 2, pp. 222, 240):

> The ultimate goal of any theory of prices [theory of indirect exchange], like that of any part of economics which undertakes to explain economic reality, is to explain why *realized* prices are

> what they are. "Quoted prices," the prices which are included in the "*ex ante*" schedule of the general theory of value [theory of direct exchange], "expected" prices, "equilibrium" prices (in most of the senses of the concept of equilibrium), or any kind of prices other than *realized* prices are to be introduced into the argument only insofar as they help to explain why prices actually realized on the market are what they are. . . .
>
> In a fully developed monetary economy, a realized price represents the passage of money for an article sold for money. And the "passage of money for articles sold for money" is precisely what constitutes the subject matter of those aspects of the theory of money and prices which undertake to explain why the dimensions of the stream of money which "passes" for a given commodity or group of commodities is relatively large at one time and relatively small at another. . . .
>
> But it also constitutes the subject matter of that part of the "general" theory of value which is built upon the proposition that any realized price is what it is as a result of the conformation and position of the market demand curve and market supply curve prevailing at the moment the price is realized.

Or, as Marget ([1938–42] 1966, 2, pp. 239–40) summarizes it, "the prices which we must ultimately explain are the prices 'realized' at specific moments in clock time [and] the only demand and supply schedules which are directly relevant to the determination of these 'realized' prices are market demand and supply schedules prevailing at the moment the prices are 'realized.'" The only sense in which Margetian "realized" prices may be characterized as "equilibrium" prices is in the sense of an "equality between demand price and supply price for a given quantity of a commodity *in all cases in which prices are actually realized in the market for this quantity of the commodity*" (ibid., p. 253).

With respect to the "market" demand curves, whose variations account for "changes in realized money prices," Marget (ibid., p. 176) conceives them as instantaneous curves, whose shape and position are influenced by forecasting errors and incomplete knowledge of arbitrage opportunities. Thus, each such curve represents "a set of 'plans' by prospective purchasers of a given commodity at the time that they reach the decision to purchase or refrain from purchasing that commodity at a given price. [And] the mere fact that these plans may themselves change between successive realized decisions to purchase or not

to purchase does not alter the further fact that *the actual purchases themselves may be assumed to be based on calculations whose results are embodied in 'plans' the resultant of which is the decision to purchase a given amount if the price is at one level and another amount if the price is at another level*" (Marget [1934–42] 1966, 2, p. 177).

Analogously, Marget (ibid., pp. 255–56, 553–56) construes the "market" supply curve, which interacts with the market demand curve to yield realized prices, as the momentary, Wicksteedian "curve of reserve prices," which is the reversed portion of the general demand curve representing sellers' reservation demand for the existing stock of the good. As Marget (ibid., pp. 554, 556) points out, the concept of sellers' reserve prices embodies recognition of the element of expectation and of the all-important distinction between "amount supplied" and "amount produced," which is necessary when "accounting for prices *realized and the amount of sales realized* within a given historical ('clock-time') period."

The analytical significance which Marget assigns to momentary (disequilibrium) positions of rest is not intended to belittle the usefulness of equilibrium analysis, nor does it imply a lack of interest in market adjustment processes unfolding over time. To the contrary, it is precisely because the experienced outcomes of the market process do not coincide with expected outcomes that the participants are induced to revise their expectations and plans during each succeeding lull in the market process, thereby precipitating another round of realized transactions. Assuming the underlying data are unchanged, the Wicksteed-Mises-Marget approach yields a coherent explanation of how, as information becomes more complete and speculation more accurate, PSRs succeed one another until the intermediate equilibrium situation represented by a fully-arbitraged state of rest (or WSR) is brought into being. Thus as Marget (ibid., pp. 235–36) argues:

> without the use of [instantaneous] market demand and supply curves . . . it is impossible to explain either (1) why, of a given range of *possible* "ex ante" prices, only one is "realized" in a given market situation; or (2) how the *goals* of dealers and consumers, even when these goals are short-period goals, are approached (if they are approached at all) through successive realized market transactions. And without a conception of an "equilibrium" price, even over a period as short as [Marshall's market day], it is in many cases impossible to understand what these goals are, and

> therefore why the successive market demand and supply schedules show the direction and the type of change that they do, and therefore lead to the successive realized prices actually registered in successive market transactions.

It should be added that the "short-period" equilibrium implied in Marget's dealer-consumer market is the WSR, which, as I argued above, is appropriate to analyzing the short-period arbitrage processes and nonproduction speculative activities involved in the adjustment of the purchasing-power array of money. The WSR must not be confused with the concept of what Mises (1966, pp. 246–47) calls the "final state of rest" (FSR), which is an imaginary construction of the position of the economy when prices and production have been completely and finally adjusted to a given alteration in the economic data, including a change in the quantity of money. Any account of the economy's approach to the FSR must refer to the specific function of the capitalist-entrepreneur or "promoter" who actively seeks to profit by allocating factors of production among time-consuming, capitalist production processes, a function which is ignored in the pure exchange analysis of the WSR, dealing as it does with fixed stocks of goods. But, as Marget teaches, the analysis of the temporal path to the FSR must also refer to the successive realized price structures that emerge momentarily and then are displaced by a successor as the equilibrating changes occurring in production continually alter the available stocks and marginal utilities of goods until production has been fully adjusted and the structure of "final" prices emerges.

The usefulness of the imaginary construct of the FSR in monetary theorizing and its relationship to the concepts of the PSR and WSR is illustrated when we trace out the consequences of a change in the quantity of money. To fully analyze this adjustment process, we must completely abstract from all other exogenous changes and processes of adjustment, and so we must begin our analysis from an FSR in which not only the distribution of cash balances and the value of money but also relative prices and production have been fully adjusted to the existing economic data. An unanticipated increase in the total stock of money will disrupt the prevailing FSR as the initial recipients of the new money suddenly discover their cash balances to be in excess of their needs. On the very next market day, they begin to disgorge the excess money balances by increasing their demands for various goods and services according to their subjective marginal

utility rankings of additional units of money and goods. If we maintain our assumption that arbitrage processes work themselves out over the course of the Wicksteedian market day, the final set of transactions of the day yields a fully-arbitraged purchasing power of money. Not only will this purchasing-power array be lower than that existing at the end of the previous market day, it will also embody a different relative price structure, which reflects the altered pattern of relative demands caused by money's nonneutrality and which, to the extent that it has not been anticipated, results in entrepreneurial profits and losses.

Thus, while the purchasing power of money has been interspatially equalized, it is far from being fully equilibrated by the end of the first market day. The second round recipients of the additional money—those sellers who are the first to be favored by the inflation-fueled increase in the demand for products and services—seeking to rid themselves of their excess cash balances, return to market the next day with their own increased demands for goods and this brings about another revolution in the price structure, with yet a new WSR emerging by the end of the day. Each succeeding market day likewise will dawn with a revised structure of demands for goods and will terminate in a WSR featuring an altered purchasing power of money, until all prices and incomes have been affected to a greater or lesser extent by the injection of the new money. As noted above, however, the permanent redistributions of income and wealth brought about by the sequential nature of the monetary adjustment process, constituting what Mises (1966, pp. 416–19) calls money's "driving force," will result in a permanently altered structure of relative demands for consumer goods as well as permanent alterations in the structure of individual time, liquidity, and leisure preferences. But even after the newly-injected money has percolated throughout the entire economy and exhausted its driving force in a general but uneven increase of prices, the adjustment process will not be complete, because it will take additional time for the production processes and capital structure of the "real" economy to be fully adapted by capitalist-entrepreneurs to the money-induced changes in consumer demands, time preferences, etc. It is only after the complete adaptation of production that the monetary adjustment process comes to an end and the "final" price structure and purchasing power of money emerges.

A Misesian analysis of the monetary adjustment process hence depends upon a number of concepts of rest or equilibrium.

The PSR explains the purchasing power of money prevailing at any moment and embedded in the structure of "realized prices." The WSR is an imaginary construct which serves to isolate and illuminate the arbitrage and speculative forces that are constantly propelling the market to rapid convergence upon a single price for each and every commodity (taking into account differences in spatial quality) and a geographically uniform value of money. While the overall economy is unlikely to ever come to rest in a fully-arbitraged state, historical insight leads to the conclusion that arbitrage processes run their course relatively rapidly in clock time, especially where there exist professional arbitrageurs and commodity speculators, organized commodity and retail markets, sophisticated communications and transportation, and consumer advertising. Thus, the interspatial equalization of the purchasing power of money does not wait upon the culmination of the overall monetary adjustment process, which may take years, but is a powerful tendency exhibiting itself at every step of the process. For Mises ([1953] 1971, p. 174) not only is such a tendency deduced "from the principles of the theory of prices," it is "clearly demonstrated day by day in the market." Therefore, it is an historical judgment and not polemics which prompts Mises (ibid., p. 176) to declare that "the exchange ratios between money and economic goods of completely similar constitution in all parts of a unitary market area . . . are at any time equal to one another." Wicksteed ([1932] 1967, 1, pp. 144), in fact, reaches a similar conclusion, stating that "this ideal state of equilibrium [i.e., the WSR] never exists; but a sense of mutual advantage is perpetually bringing about approximations to it."

However, as I argued above, the monetary adjustment process cannot be completely accounted for without reference to the FSR, because variations in the monetary data inevitably modify relative income and wealth positions and hence bring about an alteration in relative prices. These money-driven changes in the structure of relative prices account for the profits and losses realized in the transactions that establish the PSR at any point in the uncompleted adjustment process. The emergence of profits and losses impels entrepreneurs to immediately begin revising purchase, sale, and production decisions and so to drive the economy through a series of temporary states of rest toward a final position of full adjustment and zero profits. Unlike the geographically uniform value of money of the WSR, which is closely approximated in actually prevailing market conditions, at any point of historical time, the economy is always far from reaching the

FSR. The FSR only indicates the direction of movement of the historical market process at any moment. As Mises (1966, p. 245) writes: "the final state of rest will never be attained. New disturbing factors will emerge before it will be realized. . . . the market at every instant is moving toward a final state of rest. Every later new instant can create new facts altering this final state of rest."

In addition to this pathbreaking analysis of the international adjustment process and formulation of the law of one price under the conditions of a single money, Mises also pioneered in the early twentieth-century revival of the purchasing-power-parity (PPP) theory of exchange rates and in the formulation of what is now known as the "asset market" view of the influence of expectations on the formation of the exchange rate, two key elements of the MAIA when applied to the case of independent but co-existing moneys.

Edwards (1985, p. 73) points out that Mises rediscovered the PPP theorem four years before Cassel published the first of his many statements of it.[19] Edwards, unfortunately, does not perceive the fundamental difference between the Casselian and Misesian formulations of the theorem, which is crucial to explaining why Mises continued to rigorously maintain the "absolute" version of the theorem long after Cassel and almost all other economists abandoned it for the empirically testable "relative" version. Nor does he remark on the fact that Mises never vitiated the explanatory significance of the theorem by restricting it to a situation in which "real shocks" to the economy and therefore alterations in relative prices are assumed absent, as Cassel apparently did (Officer 1982, p. 254).

For Mises, the equilibrium exchange rate, or what he initially called the "static" and later the "final" exchange rate, between two currencies exactly equals the inverse of the ratio between the purchasing powers of the two currencies. In the Misesian version of the theorem, moreover, a given depreciation of the overall purchasing power of currency A relative to currency B effects an increase of the final price of B in terms of A in precisely the same proportion, despite the permanent revolution in relative prices that is invariably produced by the depreciation process.

[19]According to Officer (1982, p. 251 n. 1) Cassel devoted at least parts of twenty-five English-language publications to expounding the PPP theorem. Officer (ibid., p. 252) reports that Cassel claims to have perceived the main point of the theorem in 1904 and to have incorporated its main ideas into his classroom lectures as early as 1905.

The differences between Mises and Cassel ultimately stem from Mises's analytical coup in perceiving the artificiality of the distinction long maintained in classical monetary analysis between the case of a parallel standard, i.e., two different moneys circulating side by side in domestic use, and the case in which there is only one kind of money employed in domestic transactions while another kind is in use abroad. According to Mises ([1953] 1971, p. 179), although "prevailing opinion" treats the two cases separately, "there is no theoretical difference between them as far as the determination of the exchange-ratio between the two sorts of money is concerned." Where economic relations exist between a gold-standard country and a silver-standard country, "from the economic point of view, both metals must be regarded as money for each area" (ibid., p. 180). Furthermore, according to Mises (ibid.), whether traders utilize both moneys or the "foreign" money along in carrying out an international transaction, "the only important point is that the existence of international trade relations results in the consequence that the money of each of the single areas concerned is money also for all other areas."

One of the few economists who appreciated Mises's theoretical breakthrough in this area was Lord Robbins (1971, p. 22) who wrote: "As von Mises pointed out years ago, the theory of the foreign exchanges can be viewed simply as a special case of the theory of parallel currencies."[20]

As simple and compelling as Mises's insight is, it has revolutionary implications for the analysis of exchange-rate determination. Most importantly, the exchange rate between two different national currencies is no longer determined, as it was for Cassel (quoted in Officer 1982, p. 252), by the "quotient between the general levels of prices in the two countries." National price levels, each of which include purely domestic goods, e.g., houses and haircuts, whose spatial quality components render their prices interlocally, and *a fortiori*, internationally incommensurable, are wholly irrelevant to the issue, because there is no longer a reason to distinguish between internationally "tradable" goods and domestically produced and consumed "nontradable" goods. As in the case of domestically co-existing parallel currencies, each and every spatially-differentiated good finds expression in the purchasing-power array of each of the two national currencies.

[20]Rothbard ([1962] 1970, p. 725) also follows the Misesian approach in theorizing about exchange rates.

The Misesian exchange-rate theorist would thus reject out of hand the claim of modern macro theorists such as Jeffrey D. Sachs and Felipe B. Larrain (1993, pp. 657–58) that the presence of nontradable goods "affects every important feature of an economy, from price determination, to the structure of output, to the effects of macroeconomic policy [and] undermine[s] the case for purchasing power parity." In fact, all goods can be and are traded internationally, even though many are "immovable" or "nontransportable." Certainly, one of the lessons learned from the exchange-rate gyrations of the 1980s was that American real estate and consumer services, when rendered sufficiently cheap by a depreciated dollar, are purchasable by foreign speculators and tourists. For the Misesian, the apparent problem presented to the PPP theorem by the existence of goods whose position in space is fixed is easily soluble when the spatial dimension of quality is taken into account.

Thus, for example, if the final or PPP exchange rate between the U.S. dollar and the British pound is two-to-one, then the pound price of a house located in London must be exactly one-half the dollar price of this same house. Of course, due to consumer perceptions of the difference in quality between the two cities as residential locations, the final price in dollars (pounds) of an identically constructed house situated in Manhattan may be triple that of the London house also expressed in dollars (pounds). To maintain purchasing power parity, therefore, it is not necessary that technologically identical but immovable goods available in different locations maintain equal prices in the same currency, but only that the ratio of the prices in two different currencies of an immovable good in the same location equal the inverse of the exchange rate between these two currencies. If the ratio of currency prices for any given commodity diverges from the prevailing exchange rate, then the final state of rest has not yet been attained, and profit opportunities will exist for selling goods for the relatively overvalued currency, purchasing the undervalued currency, and using it to repurchase the original good. These arbitrage operations will drive the exchange rate and the ratio of currency purchasing powers toward a mutual and final adjustment.[21]

Another feature which significantly distinguishes Mises's formulation of the PPP theorem from Cassel's involves the question

[21]A good explanation of this arbitrage process is given by Rothbard ([1962] 1970, pp. 725–26).

of whether the exchange rate is exclusively a monetary phenomenon, or whether changes in the nonmonetary data are capable of bringing about a permanent departure of the equilibrium exchange rate from the rate which maintains strict PPP between the two currencies. As alluded to above, especially in his later writings, Cassel himself seems to have hinted at what might be termed an "inclusive" approach to exchange-rate determination, i.e., one which includes references to non-monetary factors as codeterminants of the exchange rate.[22]

More recently, proponents of the modern MAIA have been sharply criticized for writing out models of exchange-rate determination that embody an absolute version of the PPP theorem along Casselian lines and that exclude any reference to the influence of real factors on the formation of the exchange rate. Thus, for example, Thomas M. Humphrey ([1980] 1983, pp. 195, 200) has argued that "The main shortcoming of the monetary approach is that it ignores the effect of real relative price changes on the exchange rate. In particular, it ignores the influence of changes in the *real terms of trade* (i.e., the relative price of imports and exports) and *internal relative prices* (i.e., the relative price of exports and domestic nontradeable goods). . . . [R]eal structural changes in tastes, technology, and market structure . . . operating through real relative prices . . . necessitate real equilibrium changes in the exchange rate and thereby produce systematic divergences from purchasing power parity."

Whatever the validity of this criticism of the PPP theorem formulated in terms of relative national price levels, it has no bearing whatever on a theorem relating to the relative purchasing powers of independent currencies coexisting in a unitary market area. The Misesian version of the PPP theorem remains intact in its absolute and exclusively monetary formulation.

To illustrate, let us consider the case of a monopolistically-induced increase in the price of oil, the U.S. import, relative to the U.S. export, wheat. While the "terms of trade" turn against the U.S., *ceteris paribus*, i.e., in the (unlikely) absence of any induced changes in the monetary data, there will be no long-run depreciation of the U.S. dollar against the Saudi riyal, because both currencies experience an equal reduction of their purchasing powers in terms of oil and, assuming the demand for oil is inelastic along the relevant segment of the global demand curve,

[22]Officer (1976, p. 9) has argued this, while Paul Samuelson (1966) has denied it. For a brief description of this "milder approach," see Krueger (1983, p. 68).

equal increases of their purchasing powers in terms of wheat. Of course, this is not to deny that short-run and self-reversing fluctuations in the exchange rate may accompany the market's adjustment to the alteration in relative prices. Thus U.S. consumers may initially respond to the increased price of oil by increased expenditures on oil without a corresponding reduction in their spending on wheat, allowing their cash balances to temporarily run down.[23] This will cause an "overabsorption" of output relative to their shrunken real income by U.S. residents, creating an excess demand for riyals in the foreign-exchange market and necessitating a temporary rise in the exchange rate and a depreciation of the dollar. The movement in the exchange rate will thus assist in clearing excess demands in output markets and adjusting the terms of trade to prevent overabsorption and preserve balance of payments equilibrium, but only until U.S. residents' expenditures adjust, cash balances are reestablished at their former equilibrium levels, and the exchange rate floats back down to its unchanged PPP level.

Moreover, other things are not likely to remain equal; in particular, we can expect a change in the relative demands for the two currencies which results from the redistribution of income and wealth from U.S. entrepreneurs and laborers to their Saudi counterparts and leads to a long-run depreciation of the dollar. But it is the relative decline in the cash-balance demand for the dollar and therefore in its purchasing power *vis-à-vis* the riyal, and not the deterioration of the U.S. terms of trade, which is the direct cause of the change in the *final* exchange rate.

There remains to be noted Mises's status as a forerunner of the modern explanation of the effect of expectations on the exchange rate. The modern "asset market view," as it is called, treats foreign exchange markets as efficient asset markets in which current prices and exchange rates adjust promptly to changing expectations regarding the prospective development of the relative purchasing powers of the various currencies. Modern writers in the MAIA tradition, who have been responsible for reviving this view, generally give credit for its origination to such

[23]Hayek ([1937] 1971, p. 18) in his earlier incarnation as a Misesian monetary and business-cycle theorist discusses cash balances as cushions permitting market participants to soften and delay the adaptation of their real incomes to their altered money incomes. This function of cash balances has recently been rediscovered in the literature on the "buffer" or "shock-absorption" approach to the demand for money. See, for example, Kanniainen and Tarkka (1984), Knoester (n.d.), and Laidler (1984).

writers as Cassel, Keynes, and Dennis Robertson, and to German-speaking writers, including Walter Eucken, Fritz Machlup, and Melchior Palyi (Kreinin and Officer 1978, pp. 28–31; Humphrey [1980] 1983; Edwards, 1985, p. 79).

These economists writing in the 1920s arrived at this view while seeking to explain the significant discrepancy that they observed between the rates of price inflation and exchange-rate depreciation toward the end of the German hyperinflation. While Mises has been recognized as meriting inclusion in the group who pioneered the asset market view, and even as "perhaps its strongest proponent" (Humphrey [1980] 1983, p. 192), Edwards (1985, pp. 80–81) discovers a sophisticated statement of the view presented by Mises in the first German edition of the *Theory of Money and Credit* published in 1912, two years before the inception of the German war inflation. Amazingly, while Mises thus enjoyed a temporal advantage over the other expositors of the asset market view, he suffered the distinct disadvantage *vis-à-vis* those writing in the 1920s of not having had the direct and stark experience of the hyperinflation available to guide his inquiry.

In re-evaluating the main elements of Mises' monetary theory, one thing especially stands out. Mises took great pains to establish his theory of money on the bedrock of value and price theory. However, the value-theoretic concepts that Mises relied upon in pursuing his monetary analysis were not derived from Walras, Pareto, or Marshall but from Menger, Böhm-Bawerk, and Wicksteed. This fact goes a long way toward explaining the lack of comprehension that Mises' monetary theory has generally met with among mainstream monetary economists. While it represents an added burden to those who seek to present the Misesian approach to a wider audience, it also offers an opportunity to acquaint neoclassical economists with the fruitfulness of an alternative, but not unrelated, tradition in value and price theory.

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Justice and Redistributive Taxation: James Buchanan versus Ludwig von Mises

David Gordon*

The phrase "redistributive taxation" is in a sense misleading. The modifier "redistributive" suggests that some taxation is *not* redistributive. A moment's reflection will show that this is not the case. There would be no point in taking money from someone in taxation and returning to him precisely that amount. Unless taxation shifts resources, it achieves nothing. (It can of course work out that some people receive in benefits about what they pay in taxes; but this can hardly be the aim of the system.)

I address redistribution in a narrower sense here. It has sometimes been argued that the poor or those in other ways needy ought to receive compulsory benefits from those better off than they. Along the same lines but neither implying nor implied by the view just stated, some argue that too much difference among members of a society in wealth or income is usually undesirable and that the state ought to level income or wealth.

The arguments for these positions are many and various, but two limitations render the topic proposed for discussion here more manageable. First, only redistribution confined to a particular society (understood as equivalent to a modern nation-state) will be addressed here.[1] Claims that, e.g., citizens of the United States ought to give substantial amounts of their income to the impoverished in other parts of the world will be passed by. Also,

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[1]Gordon Tullock has noted that most people who are poor by U.S. standards are well off by comparison with Third World inhabitants. Why, then are the usual arguments in favor of redistribution restricted to a particular society? Gordon Tullock, *The Economics of Wealth and Poverty* (Sussex: Harvester, 1986), p. 19.

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our subject is redistributive taxation, within an economic system not centrally directed by the state. Some writers maintain that egalitarian (or other) reasons require the replacement of a market system with socialism or some other system, e.g., an economy controlled by workers' cooperatives. Others believe that a market system is not morally objectionable, provided that it is supplemented by measures deliberately aimed at redistributing income or wealth. It is the latter position that will be addressed here.

More specifically, I shall first discuss the arguments for redistribution advanced by James Buchanan, probably the leading free market defender of this policy. Then, more briefly and by way of contrast, an Austrian approach to the issue will be presented.

I

A standard libertarian contention is that everyone possesses the right to acquire and hold property. Once acquired, persons' property may not be taken from them even if, in the opinion of some, others need it more. To deny this seems at first sight to endorse robbery: What else can one term the forcible taking of property? That the takers assume the role of Robin Hood, taking from the rich and giving to the poor, hardly seems good moral justification for their activities.

One might expect James Buchanan, usually a strong supporter of the free market, to sympathize with this argument. In fact he does not. Redistributive taxation counts as robbery only if those who are taxed own the resources that are extracted from them. But suppose that they own their income only subject to the limit that part of what they own may be taken for purposes of redistribution. If so, no theft is involved; on the contrary, withholding one's money would violate the rights of those entitled to it.

The most direct argument in favor of this view is that justice demands such redistribution of property. Buchanan avoids completely this defense of redistribution. Although, as will soon become apparent, his defense of redistribution strikingly resembles the contractarianism of John Rawls, he makes no appeal whatever to the requirements of morality. In Buchanan's conception, all moral values are subjective preferences. The statement "it is wrong to kill for fun" tells us nothing about the world. It is neither true nor false; rather, those people who act in accord with it rank "not killing for fun" higher than "killing for fun" on their preference scales.[2]

[2]James Buchanan, *Liberty, Market and State* (Sussex: Harvester, 1986), p. 126.

Lest at the outset we misrepresent Buchanan, it does not follow at all that he thinks moral judgments do not matter. Preferences can be extremely strong; most people, e.g., will regard those who kill for fun with great horror. His point about subjectivity does not concern the importance of moral views. Whatever the importance of moral views are to those who hold them, there is no objective way to settle conflicting judgments about moral situations. No doubt most of us would regard someone who believed in killing for fun as a moral monster. This would not show that he was incorrect in his view, in the sense that someone would be incorrect who thought that increased demand reduces price.

If moral judgments merely state or express preferences, how can Buchanan's case for redistribution proceed? He can of course say that he favors redistributive taxation, but this gives no one who does not share Buchanan's preference a reason to alter his position. Buchanan, of course aware of this problem, seeks to evade the seeming implications of the moral subjectivism he professes by an ingenious stratagem.

Although there is no objective truth in morality, something does exist that for practical purposes is just as good. (In fact, as will be explained below, it is Buchanan's opinion better.) The substitute for truth is consensus. If everyone in a society agrees to something, this offers a good reason to establish the measure in question: "Good reason" not in the sense that it is objectively right that people ought to get what they want, but rather in the sense that if we wish to realize our own preferences, we will favor it.

At first sight this proposal appears to get us nowhere, since so far as redistributive taxation is concerned, there is no consensus. Some favor it, going so far as to think everyone should have an equal income; others oppose it altogether. On Buchanan's subjectivist doctrine, must we not fight it out on an arbitrary basis? How else can a redistributive policy be settled on, in the absence of either objective truth or agreement?

It is precisely in the midst of this apparently irresolvable warfare that Buchanan finds an escape. To establish a society's system of rights, we must start somewhere. To him, a proper beginning is a state of affairs in which people accept no moral constraints and must establish a constitutional order either by agreement or fighting.[3] To assume at the outset that certain

[3]James Buchanan, *Freedom in Constitutional Contract* (College Station, Texas: Texas A & M University Press, 1977), p. 84.

rights exist would give these a privileged position: In a subjectivist outlook, doing so is completely arbitrary.

Again it appears that Buchanan has backed himself into a corner. People in the Hobbesian state of nature he has invoked might come up with anything at all or nothing. Would not the outcome depend on which preferences people actually had in this situation, and how strong or persuasive the various persons happened to be?

Buchanan dissents. He thinks that almost all people in the state of nature would agree on a group of rights that secure to each individual a standard set of civil liberties including the freedom to own property. In the absence of continual bickering and warfare, each person can better endeavor to attain his goals. Almost no one wants to be in Hobbesian "war of all against all": hence the strong incentive to agree on minimum terms to exit from it.[4]

One might object that if some people liked the war of all against all, Buchanan cannot gainsay them; their preference is objectively on the same level as the wishes of their more pacific neighbors. No doubt; but so long as almost everyone disagrees with them, they can be compelled to conform. After all, there exist no objective moral restraints against the use of compulsion.

Buchanan may be right, but so far we have justified no redistributive measures. How do we know that people in the state of nature would favor them? Buchanan's response to an extent resembles that made famous by Rawls in *A Theory of Justice* (Cambridge, Mass.: Harvard University Press, 1971).[5] If vast inequalities of possessions exist in the state of nature, those with few possessions may not find it desirable to agree to a property rights system with no redistribution. Instead, they may find it to their advantage to refuse to cooperate and, relying on the force of superior numbers, gang up on the few wealthy. To counter this, the wealthy must buy them off.

Another consideration tells in favor of some degree of redistributive taxation. Although Buchanan's rational contractors do not operate behind a "veil of ignorance," many of them will have some doubt about their future prospects. If so, they will demand redistribution as an "insurance policy" against their failure.

[4]Ibid., p. 129.

[5]If some players of a game have superior capacities, then our "ordinary sense of fairness" seems to be violated when such players are put on equal terms with those who have relatively fewer advantages but who must, nonetheless, participate in the same game. Buchanan, *Liberty, Market and State*, p. 130.

Additionally, Buchanan believes that widespread agreement exists on certain procedural "rules of the game." Questions about euthanasia or abortion may well polarize people; but almost everyone thinks that people deserve a fair shake. Allowing too much inequality would be the equivalent of starting people off unequally in a race.[6]

Equality can, however, go too far. Once some measure of eredistribution has been instituted to start people off in a reasonably equal fashion, people are in Buchanan's view, free to use their varied incomes to their greatest advantage, even though, as a result of different abilities as well as accidental factors, inequalities are bound to rise.

How much is too much? Besides taxes for redistribution, Buchanan supports high inheritance taxes. Public education, financed by taxation, may also be justifiable on egalitarian grounds.[7]

There is an upper limit. In the presentation of the case for redistribution, many readers will probably have wished to interpose an objection. Even if the poor have to be bought off by redistribution in order to obtain their agreement to depart from the state of nature, why do the non-poor have to unite with them in a single society? What if the well-off form their own society and exclude those whom they regard as predators, i.e., the redistributionists?

To this there are two replies. First, as already mentioned, Buchanan thinks it false that only those who directly benefit from redistribution support it. Second, he entirely accepts the substance of the point just raised while denying that it has created any problems for his position. If wealthy people (or anyone else) do not like the conditions existing in their society, they are free to depart. Since everyone knows the wealthy can do this, redistribution must be below the lowest amount that will cause them to go. Higher rates of redistribution will be self-defeating.

There is one catch, however. If only a few people leave to form a society of their own, it will be very difficult for them to create an economy with any semblance of productivity. In almost all circumstances, the wealthy will find it to their advantage to remain within the larger society.

[6]Henry Jaffa, is another professed supporter of the market who uses this metaphor.

[7]Ibid., pp. 133–35.

Before turning to an evaluation of Buchanan's argument, one further point requires mention. He deems it of crucial importance that the agreement by which a society constructs a system of rights is not subject to the vagaries of day-to-day politics. It establishes a constitution for the society; although naturally some room for legislative discretion remains, persons' property rights are in place and difficult to alter.

Buchanan's provocative attempt to show that a free market order not only permits but virtually demands redistribution does not succeed. This essay has as its theme taxation, not the foundations of ethics. But it should at least be noted that Buchanan gives no convincing arguments for his fundamental assumption that all values are subjective.

This issue crucially affects the validity of his case for redistribution. Since preferences need not justify themselves before any external court of appeal, people in the state of nature are morally at liberty to agree to any arrangements they find to their mutual advantage. If, in contrast, the right and the good are not entirely matters of free choice, the situation altogether changes. If, e.g., everyone has certain rights by nature, people are morally required to acknowledge them rather than substitute something else as takes their fancy.

In support of his subjective view of morality, Buchanan claims that the position he opposes, i.e., that moral statements are true or false judgments about the world, leads to intolerance. If one believes that smoking is immoral and intends by this more than an expression of dislike, one will be apt to think it justifiable to suppress smoking. Smokers will not like this; but they are wrong and that is that. If one adopts Buchanan's view, one will live and let live; one will recognize that another person's preference is just as good as ones own.

Buchanan acknowledges an objection to his contention. What if someone thinks it objectively wrong to impose his views on others, even though the views are correct? (Of course, some things *should* be imposed on others; those who like assaulting others should not have this expression of preference tolerated. But this is not an area of dispute between Buchanan and his critics.) Libertarians, in point of fact, believe just this. Those libertarians who base their position on natural rights do not endorse forcible indoctrination of people with their views, even though they believe them true. Their very position forbids this.

Buchanan remains unshaken. While he does not deny that some moral realists are tolerant, he holds that *his* attitude leads

to more tolerance. Therefore, subjectivism remains preferable over this approach.

His argument strikes me as unconvincing, but a full discussion is not needed. Suppose that he is right: His subjectivism leads to more tolerance than competing interpretations of morality. So what? Why should this be the test by which a moral theory is judged? No doubt tolerance is a virtue; but this does not make true an analysis of morality whose general adoption would result in tolerance. Except to pragmatists, truth and good consequences are two very different things.

As to the argument itself, the mere fact that someone thinks that values are subjective hardly seems in itself sufficient to induce tolerance. Why should I not try to impose my tastes and desires on others, if I can? Tolerance, after all, is in Buchanan's view just a preference which I may or may not share.

When Buchanan says that moral values are preferences, in one sense he is clearly right. To the extent that one's moral principles guide action, they prescribe choices. But nothing about objectivity follows from this. Anything that one chooses is, by definition, part of one's preference scale. Where there exist principles that tell us what we ought to choose is another matter entirely.

The preceding few paragraphs may have seemed remote for our topic, but in fact they are not. Without his doctrine of value subjectivity, Buchanan would have no basis for his claim that whatever people agree to in the state of nature provides a fit basis for rights.[8] If values are objective, the possibility exists of moral criticism of the agreements emerging from the Hobbesian situation (unless objectivity mandates; but, as we shall soon see, it does not). Buchanan says, in effect, "Given the absence of agreement, we have to start somewhere; and the Hobbesian state of nature seems a natural starting point." Given true moral principles, we do not have to start from an amoral position.

An important question yet remains. Even if the criticisms given of the Hobbesian starting point are right, many economists and philosophers have found contractarianism of this sort illuminating. If so, it is of more than a little interest to see whether Buchanan's redistributive conclusion follows from his Hobbesian premises.

[8]A "'fair rule' is one that is agreed to by the players in advance of play itself . . . fairness is defined by agreement; agreement does not converge at some objectively determined fairness." Ibid., p. 126. Of course, one might maintain that morality objectively requires Hobbesian agreement, but Buchanan does not take this line.

The issue unfortunately cannot clearly be resolved, since Buchanan's case appeals to intuitive plausibility rather than rigorous logic. He nowhere offers a proof that his rational contractors will agree on redistribution. His strongest argument is that the less well off will not agree to leave the state of nature unless they are promised redistribution in their favor. No doubt it is correct that they will prefer this; but those from whom the taxes will be taken will not share this preference. (This abstracts from Buchanan's claim that *everyone* supports redistribution. This view will be discussed next; here we consider the matter just from the point of view of self-interested actors.) Why should either preference always win? The question appears incapable of decision at the *a priori* level.

But does this not to ignore Buchanan's argument that, in the absence of redistribution, the poor will refuse to enter society? In reply, a point Robert Nozick has raised against Rawls speaks precisely to this issue. Why do the poor need society less than the rich? Both groups benefit from leaving the state of nature; and threats and strategic behavior by one group are a monopoly of neither side.[9] Buchanan has failed to show an asymmetry between the rich and the poor which operates to the advantage of the latter in the bargaining.

A counter thesis is tempting here, but it too must be rejected. One might at first glance think that because the advantages of social cooperation over the state of nature make it imperative to reach agreement, everyone will arrive at terms likely to be universally satisfactory rather than hold out for their special interests. If so, will not the easiest point of agreement be on a system with property rights but no redistribution? Since we assume that people desire a regime with property rights, why increase the difficulty of agreement by requiring more than the minimum needed to exit the state of nature?

Exactly this argument has been recently advanced by the libertarian philosopher Jan Narveson.[10] But it fails because no clear criteria show what is the simplest system of property rights. An agreement that incorporates limits on the permissible degree of inequality seems offhand as simple as one without this feature.

[9]Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), pp. 192ff.

[10]Jan Narveson, *The Libertarian Idea* (Philadelphia: Temple University Press, 1988), p. 177. Of course, one might maintain that morality objectively requires Hobbesian agreement, but Buchanan does not take this line.

We have so far argued that Buchanan has failed to prove that the state of nature is the proper starting point for determination of rights; and that even if it were, he has not shown that people would agree to redistribution. But we can go one step further. The state of nature, far from being a good starting point, is morally unacceptable. In it, people are at perfect liberty to threaten or use force against one another. An agreement made under such terms has exactly the same moral force as any other agreement made under duress—little or none. To say that such agreements are the *fons et origo* of morality strikes one as wildly implausible.

Buchanan himself is aware of this objection. As he notes, slavery for some might be sanctioned by the agreement. If, in the state of nature, some people are too weak effectively to resist the force of others, a contract that allows slavery under fixed conditions may be to the advantage of both slave and master. Buchanan notes that many philosophers consider this morally outrageous. In reply, he again remarks that in the absence of agreement, there is no other natural starting point but the one he advocates.

His reply presupposes just the moral skepticism that we have already discussed. Unless one adopts Buchanan's view that morality rests on subjective preferences, nothing requires acceptance of his starting point; and, as we have just seen, a good deal calls for its rejection.

Buchanan's remaining arguments for redistribution of income seem detachable from his Hobbesian framework. In brief, he contends that almost everyone finds plausible certain fair rules of procedure that strongly tend in the direction of equality. To start some people far ahead of others in the race of life seems unfair.

Here one can appropriately cite Buchanan against himself. Some people no doubt feel the way he believes fitting about inequality. But others do not. Even if Buchanan is himself in the former group, this counts on his own theory as a mere preference. In the absence of general agreement on redistribution, why should Buchanan's preference be of more than biographical interest?

Paradoxically, it might be better for Buchanan if he is wrong in his subjectivist view of morality. We can then ask the question, has he given any sound arguments in support of redistributive taxation? On his own view of morality, this question cannot arise. There are no sound or unsound arguments about morality—just preferences. There can of course be arguments about the consequences of preferences or about how one can best put one's

preferences into effect. But remarks about fairness cannot be objectively true or false on Buchanan's doctrine. The issue of whether arguments are persuasive is another matter entirely. People may be persuaded by good arguments and fail to be persuaded by bad ones—if, contrary to Buchanan's position, one can speak of good and bad in this context.

Buchanan, however inconsistently, does advance some considerations in support of redistribution. As indicated already, these address the alleged unfairness of too much inequality. It is unclear whether he thinks that since most people actually hold these views, he can by calling attention to them induce support for redistribution or whether he thinks that the views are right regardless of whether others agree with him. Since, in my opinion, his view of morality as preference is wrong, his arguments will be taken in the latter way. The contention that it is unfair that people start too unequally relies uncritically on the metaphor of life as a race or competition. Of course, competition is basic to a free market economy, but this does not show that life itself is a race. People begin life with very different financial prospects; but there is no reason to assume that one has failed unless one finishes first. It might be replied here that the opportunity to become extremely wealthy is one many people desire, even granted the point that life as a whole is not a race. Initial inequality makes it much harder for some people to attain this goal.

This is certainly true; but it is not clear why people ought to be equal in the pursuit of every goal that many find desirable. People's physical appearances often make a great deal of difference to their attaining important goals, yet few find this reason to rectify matters along the lines of L.P. Hartley's *Facial Justice* (London: Hamish Hamilton, 1960).

If, further, people are concerned about inequality, Buchanan's redistributive measures will not allay their worries, since a great deal of arbitrary differences are left untouched by them. Well aware of this, Buchanan counters that even if practical obstacles and the value of liberty make complete equality incapable of achievement, at least redistribution will result in more equality than otherwise.

This is by no means certain. If differences in levels of income are reduced, other inequalities may become more important. Nothing rules out greater *in*equality as the net effect of Buchanan's proposals. Whether this outcome or some other more in line with Buchanan's wishes results is a matter on which we will not

here conjecture. It is enough for our purposes to note that Buchanan's claim that income redistribution moves a society toward equality of opportunity is unsupported.

Buchanan's case for redistribution thus fails. An additional problem for his fairness arguments enters the scene when these are combined with his contractarian framework. In the state of nature, people are not supposed to be influenced by preferences about justice, since the very point of the contract is to arrive at rules of justice. If moral views about fair procedure are allowed as an exception, why cannot people use other moral views to help determine their course of action in the state of nature? If they can, why not allow the preference of those who think redistribution unjust into the initial position? By not allowing this, Buchanan has skewed matters so that his contractors will arrive at the results he favors.

Buchanan's support for redistribution fits together poorly with his general stance of sympathy for the free market. He strongly supports individual liberty: one of his reasons for favoring moral subjectivism is that this will encourage people to mind their own business. In his view, people ought not to impose their personal preferences on others. However much one may disagree with Buchanan on the foundations of ethics, there is something both appealing and right in his wish to minimize the activities of moral busybodies. But is not the preference for equality just the sort of interference Buchanan elsewhere opposes? What is this preference but a wish to alter the incomes of other people—so that they do not from one another by more than a prescribed margin? Why does not the prescription mind your own business apply to proponents of redistribution?

II

The Austrian view of redistribution differs entirely from that of Buchanan. By "Austrian," I here intend the views of Ludwig von Mises and Murray Rothbard, in my opinion the most consistent representatives of the Austrian school. No claim is made here that all Austrian economists agree with these writers about redistribution.

One feature sharply and immediately characterizes the thought of both Mises and Rothbard. Each author distinguishes "without confusion, without separation" economics from ethics. Unlike Buchanan, who because of a subjectivist analysis of morality tries to use elementary economic theory to do the work of

ethics, Rothbard believe that ethics is a discipline with its own methods and criteria.

Thus, in "Toward a Reconstruction of Utility and Welfare Economics" Rothbard (in Mary Sennholz, ed. *On Freedom and Free Enterprise*, Princeton: D. Van Nostrand, 1956, pp. 250–52) hammers home the theme that since interpersonal comparisons of utility cannot be made, economics is in no position to claim that income transfers make anyone better off. If two people make an exchange, one can say that in their own view, each thinks himself better off than before. But if a transfer is not voluntary, the economist can say nothing. One person wishes the forced transfer, and the other does not. Assessment of this requires an ethical judgment.

It would not be a good reply to this to say that the economist cannot say that anyone is made worse off by the transfer, since this too involves an interpersonal utility comparison. (We abstract here from the cost of the transfer program and its effect on productivity.) This is exactly the point: the economist cannot say anything about the justice or injustice of the measure. This is not his business.

It of course does not follow from this that nothing can be said about the justice of redistribution, apart from facts about what people prefer and how they may realize their preferences. This is Buchanan's position: but, to reiterate a vital truth, this is not part of economic science. In particular, it is not a consequence of the subjective theory of value. Neither is it a consequence of economics that people ought to get what they prefer; this too brings in an assumption about ethics.

Mises was a utilitarian, and Rothbard is a defender of natural rights, two very different theories. However much they clash on ethics, both avoid the problem just mentioned. Mises, to be sure, in one respect resembles Buchanan. He asks the same fundamental question: how can people be enabled to realize their preferences? But Mises poses the question because he is a utilitarian: he does not, like Buchanan, abandon ethics but rather adopts the criterion of satisfaction as an ethical principle.[11] The case is even clearer with Rothbard, whose opinion of redistributive taxation stems from his analysis of the rights of self-ownership and property. Neither Mises nor Rothbard considers the question that

[11]I now think this view of Mises mistaken. See David Gordon, "The Philosophical Contributions of Ludwig von Mises," *Review of Austrian Economics* vol. 7, no. 1 (1994): 103–9.

principally interests Buchanan: what would people do in an amoral state of nature? In the absence of an argument showing that this topic has anything to do with ethics, it is the merest irrelevancy.

Rothbard carries out the separation of ethics from economics with even greater completeness than Mises. Although Mises never equates ethics and economics, he does at times rely on an argument for capitalism that in his view depends on no ethical premises. Intervention in the free market will not work, from the point of view of its advocates. Minimum wages, e.g., will produce unemployment, and prices controls, shortages. Thus, for Mises, it requires no ethical judgments to determine whether these measures should be put into effect. Assuming that people wish to realize their preferences (a principle of rational action rather than ethics),[12] they have no alternative but to reject these futile endeavors.

As Rothbard has rightly noted, not even this argument succeeds in avoiding a reference to ethics. First, it assumes that people ought to be concerned with their material welfare. No doubt most people *do* care about this, a fact Mises was not slow to note. But it does not follow from this that they ought to be, or that their preferences for material wealth ought to be overriding. Mises's use of this argument largely succeeds in bypassing this objection when it is taken within the context of his ethics. Given his utilitarian outlook, he can fairly readily supply the ethical premise we have just indicated he requires.

More controversially, Mises assumes that people ought to rank foremost the attainment of everyone's long-term material interests. But what if some people prefer their own interests to those of society? What if a group of workers prefer higher wages for themselves by the use of coercion, at the expense of unemployment for others? Perhaps they should not act on this preference, but an argument to this effect cannot appeal merely to premises which everyone accepts. Exactly the same point applies to the issue of whether long-term interests, *selfish* or not, are to be favored over short-term. Mises can again avoid much of the force of this objection, if his claim is taken as part of a utilitarian argument.

[12]Note the difference between "people wish to realize their preferences," apart from some "trick cases," a principle of rationality; and "it ought to be the case that, other things being equal, people be able to realize their preferences," a proposition of ethics.

Mises's utilitarian ethics led him firmly to reject redistribution of income by taxation. He stressed in this regard that the only permanent way to eradicate poverty lay in an increase in production. With greater total production, the poor, along with everyone else, would be better off than as the "beneficiaries" of costly programs which, by taxing income that might have been invested, lowered wealth.

It might be objected here that even if productivity rises, the poor need not share in the gains that result from this. Mises's thinking followed an utterly different line: in his opinion, capitalism was primarily a system of "mass production for the masses" and the unhampered operation of this system would be to nearly everyone's advantage. Because of their large numbers, the less well off when acting as consumers control much of the economy by indicating through their dollar votes what they want. In brief, Mises's argument against redistribution is that it is not the best means to aid the poor.

Rothbard's natural rights view of redistribution is consistent with Mises's position, though neither implied by it or implying it. In Rothbard's view, rights stem from self-ownership: each person has the exclusive right to control his or her own body. One of the activities people are at liberty to perform is to acquire unowned property: this can be done through a "Lockean" principle of labor mixture. Once acquired, property can be transmitted by gift, sale, or bequest.

The rights of people in this scheme of things preclude compulsory redistribution through taxation. To take away income from some on behalf of others is theft, just in the way suggested in the initial part of the discussion of Buchanan. In addition, income transfers in effect compel some to work on behalf of others, i.e., they involve forced labor. The fact that those who receive the transfers are handicapped or poor does not alter the case. It is not part of this position that people have no moral duty to be charitable.[13] But the condition of being *needy*, even if one sets aside the arbitrariness involved in determining who counts as needy, does not generate any rights to the person or property of others. Charity cannot violate the demands of justice.

Limits of space preclude a full discussion of this challenging position. It seems to me one of very substantial appeal and insight and deserves to be addressed by anyone who favors redistribution.

[13]Rothbard's political ethics makes no assumptions about moral duties that are not enforceable through coercion.

It is interesting to note that self-ownership has strong intuitive appeal even to those of quite other political persuasions than Rothbard's. G.A. Cohen ("Self-ownership, World-ownership, and Equality," Part 2, *Social Philosophy and Policy* vol. 3, no. 2 [Spring 1986]: 77–91)for example, a leading analytical Marxist, believes that socialists have failed to realize the full force of this principle. Few people think that someone who has two good eyes owes one of them to a blind person, even though in some sense the blind person needs it more. Nothing immediately follows about property; but granted the plausible additional premise that property is initially unowned (in the sense that until people acquire property through Lockean labor mixture, no one owns anything other than his or her own body), it seems difficult to avoid the Lockean position that self-owners can legitimately acquire and hold property. Cohen denies that property is initially unowned but as it seems to me gives no plausible arguments for this.

The point at which defenders of redistribution will be most apt to attack Rothbard's argument is the nature of initial acquisition. Like Buchanan, they will wish to limit property rights so that holders of wealth or income acquire a liability to taxation. If property is initially unowned, however, it is difficult to see how this limit can be supported. If the requirements of the poor can restrict the right to hold property, this suggests that they initially possess rights over the property which persons appropriate.[14] Otherwise, why do they have the right to part of the income from the property? Alternatively, defenders of this view might assume that someone else (the government? society?) has ownership rights to property before people begin to acquire it. Although in my opinion it is intuitively obvious that property is initially unowned, those who support redistribution will disagree. They are certainly not bound to accept a principle just because it is evident to libertarians; but they owe us explicit recognition of the fact that they *do* assume some form of collective initial ownership, and a justification for doing so. They will not have any easy time of this; and if there *are* any good arguments for redistributive taxation, James Buchanan for one has failed to present any.

[14]Or do these rights operate directly through limits on the activity of acquiring unowned property?

THE REVIEW OF AUSTRIAN ECONOMICS

Volume 8, Number 2

The Review of Austrian Economics

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The Review of Austrian Economics

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THE REVIEW OF AUSTRIAN ECONOMICS

Editorial
Walter Block, Hans-Hermann Hoppe, and Joseph T. Salerno ix

Articles

John B. Egger
Arthur Marget in the Austrian Tradition of the Theory of Money 3

Jesús Huerta de Soto
A Critical Analysis of Central Banks and Fractional-Reserve Free Banking from the Austrian Perspective 25

Murray N. Rothbard
Egalitarianism and the Elites 39

Notes and Replies

Walter Block
Ethics, Efficiency, Coasian Property Rights and Psychic Income: A Reply to Harold Demsetz 61

Nicolai Juul Foss
Information and the Market Economy: A Note on a Common Marxist Fallacy 127

Book Review

James M. Buchanan, *Ethics and Economic Progress*
Reviewed by David Gordon 137

VOLUME 8, NUMBER 2 **1995**

Editorial

Walter Block
Hans-Hermann Hoppe
Joseph T. Salerno

It is our sad duty to notify our readers that Murray N. Rothbard, editor-in-chief of the *Review of Austrian Economics* (1987–1995), has passed away. He died peacefully on January 7, 1995 in New York City.

This is not the place for an obituary. By the time this appears in print, *encomiums* to Murray will have appeared in many, many newspapers, magazines, and periodicals.

Nor is this the time yet for a full-scale appreciation of what he has meant to Austrian economics in general and to the *Review of Austrian Economics* in particular. A future volume of the *Review of Austrian Economics* will be devoted to a festschrift in honor of Murray Rothbard for that very purpose.

At present, our goal is more modest. To take stock of where the *Review of Austrian Economics* has come from since its birth in 1987 and to announce our editorial policy and indicate our hopes for the future.

Taking Stock

The Review of Austrian Economics was launched by Murray N. Rothbard in 1987 with two main objectives in mind. These were, in the words of the "Introductory Editorial" with which the *Review* began (p. xi), "to promote the development and extension of Austrian economics and to promote the analysis of contemporary issues in the mainstream of economics from an Austrian perspective."

It was important to launch a new journal for this purpose because it was exceedingly difficult, then, for Austrians to be published in the mainstream journals. If a manuscript ignored the Austrian underpinnings, and then discussed the topic at hand,

Co-editors of the *Review of Austrian Economics* are: Walter Block, associate professor of economics at The College of the Holy Cross, Hans-Hermann Hoppe, professor of economics at the University of Nevada, Las Vegas, and Joseph T. Salerno, associate professor of economics at the Lubin School of Business, Pace University.

the praxeological paradigm was different enough from the traditional one to render it unacceptable to the referees, and even unintelligible. If the manuscript depicted the Austrian philosophy as an introduction to its topic, it was almost always too lengthy for acceptance.

Has the situation changed in the intervening nine years? Unfortunately, with the exception of a handful of breakthrough Austrian publications in the neoclassical journals, the answer must be "NO." Although Austrianism is perhaps better known amongst the general profession than it was before—largely through the publication of the *Review of Austrian Economics* itself—the level of unfamiliarity that still remains continues to constitute a serious barrier to communication.

Editorial Policy

Typically, when a new editorial team takes over the reins, all sorts of new promises are made: "we'll add some bells and whistles"; "we'll produce a bigger and better product," and so on. In this case, nothing could be further from the truth. Rather than aiming to do "bigger and better," we shall be very happy indeed if we can even approach the meticulous standards set and maintained by Professor Rothbard.

We shall maintain policy precisely as it was before, to the best of our ability. Specifically, as stated in the "Introductory Editorial" (p. xiii), "the *Review of Austrian Economics* will publish manuscripts dealing with methodology, Austrian theory, business cycles, history of thought, monetary theory, microeconomics, public policy, and indeed with all traditional economic areas. We define our interests, concerns, and perspectives in the broadest possible manner. The *Review* is to be inclusive of all strands of Austrian economics, such as market process, subjectivism, emphasis on entrepreneurship, and praxeology. We most certainly welcome articles incorporating non-Austrian and even anti-Austrian viewpoints, provided only that they are of relevance to the Austrian perspective, broadly understood."

This was the policy at the outset; this will continue to be our policy for the foreseeable future. Indeed, we consider the controversies that have emerged within Austrian economics in recent years to be particularly welcome signs of its ongoing development as an intellectual movement that, we anticipate, will soon have to be reckoned with by the neoclassical mainstream. As a means of enhancing progress toward this end, we are pleased with the establishment of other Austrian-oriented

journals and hope they will join us in our continued commitment to providing a sympathetic forum for scholars seeking to strengthen the foundations or extend the frontiers of Austrian economics.

Conclusion

We keenly feel the loss of our friend, Murray N. Rothbard. We shall strive to follow the path he so ably blazed. Although none of us ever studied formally with Murray, he was our intellectual guide and mentor. He will be sorely missed.

Articles

Arthur Marget in the Austrian Tradition of the Theory of Money

John B. Egger

Arthur William Marget (1899–1962) was a respected American monetary theorist and scholar who received his doctorate from Harvard in 1926 and taught for the next fifteen years at the University of Minnesota. His best known work, *The Theory of Prices* (2 vols: 1938, 1942), had three goals. Marget sought to demonstrate that Keynes misrepresented the history of monetary theory, to reveal the shortcomings of Keynes's own approach, and to show that progress required an escape from the Keynesian "blind alley" and a return to the "high road" of earlier tradition.

The book was either behind its time, ahead of it, or (as I suspect) both. The doctrinal revolution that Marget opposed swept *The Theory of Prices* aside. Perhaps it was imprudent of him to pursue three ambitious goals at once, for even the book's supporters found it long and arduous.[1] Nicholas Kaldor, a non-supporter whose review managed to misstate the book's subtitle, called *Prices I* "mid-Victorian," with its "leisurely repetitiousness, elaborate style, pompous exactitude, and . . . exhaustive scholarship,"

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[1]Henry Hazlitt (1959, p. 437), clearly an enthusiast, wrote: "And not even the shortest 'anti-Keynesian' bibliography should omit Arthur W. Marget's monumental study, *The Theory of Prices* (2 vols., 1,426 pages). This work is distinguished both for its penetrating comment and for the immense range of its scholarship, but its relentless prolixity and disheartening length have caused it to miss the influence it might otherwise have had." Less understanding and charitable is Mark Skousen (1992, p. 34 n. 3) who informs us that his "search was in vain" for "something of value in this detailed work"—a work he also calls "ramshackle."

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reminding him "of the bourgeois solidity and spaciousness of that bygone age" (1939, pp. 495–6).[2]

For two reasons, this may be an appropriate time for a reconsideration of Marget's work. The first, which provides a backdrop, is that the interpretation and evaluation of Keynes's theory continues unabated. The second, on which this paper focuses, is the recent decades' renewal of interest in the Austrian School.

My principal argument is that most of the respects in which Marget asserted the superiority of pre-Keynesian orthodoxy over the revolution of Keynes are now primarily identified with the Austrian tradition in monetary theory.

This position calls for some explanation, because Marget had no special interest in the Austrians. He held an evolutionary theory of the growth of knowledge that he called "the Principle of Continuity," and identified Menger, Böhm-Bawerk, Mises, and Hayek as contributors (along with many others, especially Walras and Fisher) to the monetary edifice that more than two centuries of scholarship had established by the time of the *Treatise*. To Marget they were not a unique School that posed a challenge and offered an alternative to orthodoxy: they were a well integrated part of it.

At the time, though, that is how they viewed themselves. Kirzner (1989, p. 232) notes that: "About a half-century ago, Austrians such as Mises, Hayek, and Machlup all maintained that important Austrian insights had been successfully absorbed into the mainstream by the early 1930s." By 1969, however, Mises apparently believed "that the fundamental Austrian ideas, absorbed into general economics by the 1920s came, somehow, to be lost from general economics by about 1940" (the words are Kirzner's; ibid., n. 1).

The best single word that describes what intervened is Keynes. "[I]t is he," Marget wrote, "who is largely responsible for the feeling that the Principle of Continuity does not apply as a maxim of scientific procedure at the present stage in the development of monetary theory" (1938, p. 3). But Marget (and Hayek and a few others) lost the fight, so the orthodoxy after Keynes was not the orthodoxy that Marget defended. The characteristics of established pre-Keynesian thought that Keynes and

[2]Marget's response (1942, p. vii): "I, on the contrary, rest my case on the proposition that if the qualities of 'exactitude,' 'solidity,' and 'exhaustive scholarship' are indeed characteristic only of a 'bygone age,' that fact constitutes a condemnation of our own age and a commentary on our current needs."

the subsequent development of macroeconomics cast out, committing the grave error of which Marget warned, were reluctantly accepted back by the Austrians, like a glorious gift returned by an unappreciating recipient.

That is why I believe that Marget's staunch defense of "orthodoxy"—and his evolutionary belief that no valid advance remains for long the province of any unorthodox School—is in large measure a case for ideas that are now identified with the Austrians.[3]

My paper argues this position, but its scope is limited. It is far from a comprehensive study of either Marget's system, or Austrian economics, or pre-Keynesian monetary orthodoxy. Its case that Marget's work should be embraced by Austrians and identified as a contribution to their theory of money will rest on some observations about method, focusing on the methodologically individualistic analysis of temporal monetary processes and the role of aggregation.

"The ultimate goal of any Theory of Prices"—a phrase that Marget used interchangeably with "Theory of Money and Prices" to identify monetary theory—"is to explain why *realized* prices are what they are" (1942, p. 222).[4] The focus on explanation rather than prediction, and on "prices" rather than "price" (level) or rate of interest or other aggregate, establishes common ground with the Austrians at the most fundamental level.

Marget's "*realized* prices" refers to the money or nominal prices of all goods that are exchanged for money. Like many other economists, he found it analytically convenient to separate this pattern into a structure of relative prices and level. His "Theory of Prices" included the influence of money on both, however, since he understood that no market process could determine structure and level independently. A strict methodological individualist, he insisted that "explanation" link observable events to the choices of individuals.

[3]Another arguable Austrian link is a complementarity between *The Theory of Prices* and Hayek's *The Pure Theory of Capital* (1941). Convinced that the errors of the 1930s arose from capital theory, Hayek wrote of capital without money and planned a sequel to complete the story. Marget, on the other hand, attributed Keynes's popularity to a misunderstanding of monetary theory; his work is of money without capital, a deficiency he intended to correct (Marget 1942, pp. xvi–xvii) with *Money and Interest* and *Money and Production*. Neither returned to his ambitious plan after the War, so a comparison of *Money and Production* with Hayek's integration of money and capital must remain a fascinating exercise in double speculation.

[4]Since I have not found the phrase "Theory of Prices" in his earlier works, its origin is undoubtedly chapter 18 of Keynes's *General Theory*, of which it is the title.

The Individualistic Analysis of Process

Most economists would probably agree that the ideal analysis of monetary change is to trace its sequential effects on particular individuals. This ideal method was introduced by Cantillon in 1755; one of its virtues is the absence of any "dichotomy" between monetary and value theory, since the latter provides the analytical link between each individual's new alternatives and his new behavior. But our inability to identify particular individuals and to be certain of their actions prevents us from attaining this ideal. To some extent "schools" can be identified according to how they accommodate these problems of incomplete information.

One accommodation is to argue that consideration of the details of the process can be dismissed because they are unpredictable, random, and "average out," with no measurable effect on empirical relationships among aggregates. Since the analysis of those individual choices is the province of value theory, this avenue is risky: It makes possible a dichotomy in which value and monetary theory are at best isolated and at worst contradictory. Dichotomization is the most serious criticism of a monetary theorist, so it must be levelled with caution.[5]

Neither Keynes nor the Austrians took this route. They analyzed the process differently, but neither undervalued its significance. Indeed, Marget recognized this virtue in Keynes. Citing two writers who are praised by Austrians—e.g., by Hayek ([1935] 1967, pp. 8, 10) and Mises ([1952] 1971, p. 139)—for this very reason, Marget identified "the emphasis in the *Treatise*" as "a tribute. . . . to those writers, from Cantillon through Cairnes to writers of our own day, who . . . provided contributions to an understanding of the mechanism of price-change" (1938, p. 172). The fault that Marget found with Keynes's application of the method was chiefly his imprudent aggregation (different, but equally imprudent, in the *Treatise* and the *General Theory*). When Keynes attempted to differentiate his products[6]

[5]Patinkin (1965, p. 175, pp. 624–25) in fact accused Marget of dichotomizing. It would not be unreasonable to draw this conclusion from a few of Marget's comments if they are taken out of context, but the accusation is not valid and serves mostly to illustrate how difficult it is to avoid the appearance of dichotomization.

[6]In the *Treatise*, Keynes stated that "The forms of the Quantity Theory, however, on which we have all been brought up . . . are but ill adapted" for the analysis of a dynamic "causal process" because they are "identities or statical equations" (1930, p. 133). In the *General Theory*, he asserted that there is (in his predecessors) "a false division" between "the Theory of Value and Distribution on the one hand and the Theory of Money on the other hand," (1936, p. 293).

his products[6] by charging that his predecessors failed to recognize the importance of process, Marget sprang to their defense.

Marget's use of the method of the individualistic analysis of process is most clear in his extended rebuttal, in *Prices II*, of Keynes's charge that his predecessors dichotomized. In three chapters Marget (1942, pp. 221–403) examined the effects of money on ordinary Marshallian demand curves ("Particular Demand Curves and the Determination of Money Prices"), their role in mutually determining flows of money and flows of goods ("Stream Equations and the Price System"), and the significance of these flows in modern monetary dynamics ("Stream Equations and Process Analysis"). Later (ibid., pp. 521–624), he paralleled them with chapters on supply: "Elasticity of Supply and the Structure of Money Prices" and "Particular Supply Curves, Stream Equations, and the Determination of Money Prices." He endeavored to show not only that the "value theory" of dynamic monetary processes had dominated pre-Keynesian theory but that its application of the method was superior to those offered by Keynes himself.

It is impossible to discuss sequential processes without introducing time. Ever since Menger ([1871] 1981, pp. 67–71 *et passim*) an emphasis on the significance of time has been considered one attribute of the Austrian School, but few if any of their works equal the treatment of time in Marget's analysis of the monetary process. For a hint of the power and richness of Marget's method of sequences, consider his classification of different types of period. They can be (1) clock-time or analytical-time, (2) *ex ante* or *ex post*, or (3) *ceteris paribus* or non-*ceteris-paribus*. There are eight possible combinations; Marget listed them all (1942, pp. 402–3 n. 122), complete with page references to preceding discussions. He noted that because the goal of monetary theory is the explanation of realized money prices, "the 'periods' . . . to which all the other types of 'period' must be related, are . . . *ex post* non-*ceteris-paribus* clock-time periods" (ibid., p. 403 n. 122).

Expectations inevitably affect currently realized money prices, but these—in turn—*"help to determine expectations with respect to the future course of prices"* (ibid., p. 230 emphasis Marget's). Expectations must themselves be explained, Marget insisted:

> we must proceed upon the assumption that expectations are what they are largely as the result of experience of economic processes as they have been actually realized in the past and as they are being currently realized in the present. (1942, pp. 228–9)

The phrase "are what they are largely as the result of" accommodates a subjective perspective. It does not mean "are identical to," which would indicate a deterministic adaptive interpretation that some might find mathematically tempting. Marget's view is identical to that of Austrian writers who both preceded and succeeded him.[7]

Now that macrotheorists have discovered the electromagnetic property of hysteresis, it is interesting to note Marget's observation about the dependence of expectation upon knowledge acquired in the actual market process, and the resulting effects of those expectations on subsequent processes:

> When, therefore, it is said that "equilibrium" is "indeterminate" whenever "the final position is dependent upon the route followed," all that this can mean is that no account of the actual functioning of the economic process can be regarded as complete until it undertakes, *upon the basis of a study of the successive, actually realized steps in any economic process actually unfolding itself in time*, to establish the nature of the considerations likely to determine the nature of entrepreneurial responses to changes in the market situation, *including the possible changing nature of the goals whose attainment these responses are designed to aid.*[8]

Marget's analysis of the monetary process, with its sequential cause-and-effect relationship to expectations and—through them—to subsequent demands and supplies and, finally, to money prices and (if one wishes) to conventional monetary aggregates, is as sophisticated as any Austrian discussion of monetary processes of which I am aware. Combining this analysis with his

[7]See, in particular, Lachmann (1943), who approvingly quotes Lundberg: " 'It is sensible to link actions with expectations,' states Dr. Lundberg, 'only if the latter can be explained on the basis of past and present economic events. Total lack of correlation here would mean the complete liquidation of economics as a science'," (ibid., 1943, p. 66). Marget had quoted Lundberg's statement, too (Marget 1942, p. 228). (Lachmann later abandoned his 1943 view, asserting that because expectations arise from the subjective interpretation of "past and present economic events," they must be treated as "autonomous" [Lachmann 1976, p. 129]. [I thank a referee for reminding me of this.] Lachmann's later views are embraced by those who consider *hermeneutics* a promising Austrian research program, but to others they do indeed "mean the complete liquidation of economics as a science.")

[8]Marget's (1942, p. 233 n. 34) quotes are from Nicholas Kaldor, "A Classificatory Note on the Determinateness of Equilibrium," *Review of Economic Studies* 1 (1934), pp. 125ff, 132ff.

rich scheme for classifying periods produces a presentation that has yet to be equalled.

Underlying many analyses of process is the notion of a goal or target toward which the various actors are gradually moving the economic system. Modern Austrians continue to debate the usefulness of the concept of general equilibrium, and of Mises's evenly rotating economy in particular (see Fink and Cowen 1985). Their common ground, though, is sufficiently well known that Paque (1985) used it to differentiate an Austrian from a Chicago School approach. Marget's position on those interpretations of general equilibrium with which Austrians tend to agree, and the side that he would take in the debate, support my characterization of his theory of monetary processes.

Early in his career, Marget published two articles (1931, 1935) on the monetary economics of Leon Walras that are occasionally cited in today's literature, and he considered the mathematical formulation of general economic equilibrium immensely important among Walras's contributions. The concept of general equilibrium, Marget stated, "provides a description of one conceivable ('ideal') type of functioning economic system with which other types of functioning economic systems can be compared" (1942, p. 424), and in his analysis "full place is given to the possibility of using the *concept* of an equilibrium of the system as a standard of comparison" (ibid., p. 450). Mises accorded this role to his evenly rotating economy: "in order to analyze the problems of change in the data and of unevenly and irregularly varying movement, we must confront them with a fictitious state in which both are hypothetically eliminated" (1966, p. 247).

Although Mises identified "the tendency, prevailing in every action, toward the establishment of an evenly rotating economy" (ibid., p. 250), these actions take time during which knowledge and tastes must be presumed to change. He thus emphasized that the evenly rotating economy could never actually be approached. Marget shared this position:

> When, on the other hand, it is claimed that the concept of a state of general equilibrium is useful not only as a standard of *comparison*, but also as the specification of a goal which the economic system as a whole actually tends to approach, the cogency of the argument for the use of such a concept is very greatly diminished. (1942, p. 446)

But Marget shared with Lachmann a more fundamental objection to general equilibrium. He acknowledged and accepted the tendency for adjustment to bring about *partial* equilibria in particular markets, while noting that the specific entrepreneurial actions chosen to effect them do not necessarily succeed (1942, p. 448). Even when they do, though, he claimed that these very actions "might have the effect of driving the system still further away from 'equilibrium'" (ibid., p. 447). Lachmann expressed the same point like this: "we can never be sure that the spill-over effects which an equilibrating adjustment in one market has on other markets will always be in an equilibrating direction . . . Equilibrium in one market may be upset when the repercussions of the equilibrating adjustments in other markets reach it" ([1952] 1971, pp. 190–1).

The essential difference that Marget perceived, between the probable partial-equilibrating tendencies in particular markets, and an improbable approach to a general equilibrium, is that which Hayek (1976, pp. 107–32) drew between *economy* and *catallaxy*:

> It is of the utmost importance to observe, however, that in the case of the concept of an "equilibrium of the *system*," there is *no agency, under institutions such as ours, which can be assumed to be engaged in a type of calculation, or to cherish a type of intention, involving the conditions for "general" economic equilibrium* in a sense comparable to that in which the calculations and intentions of individual entrepreneurs can be said to involve a consideration of the conditions for "equilibrium" within their own firms. (Marget 1942, pp. 448–9, emphasis Hayek's)

These problems of process "strengthen the case for refusing to regard as identical the concept of 'general economic *interdependence*,' on the one hand, and 'general economic *equilibrium*,' on the other" (1942, p. 423). In a manner wholly consistent with modern Austrian technique, Marget recognized the linkages among actions and prices but insisted that the vagaries of subjective interpretation demand the "loose joint" of general interdependence rather than the hyper-refined precision of general equilibrium.[9] Indeed, despite

[9]Although Marget never used the phrase, others have used the "loose joint" metaphor to describe what money does to relationships among real variables. See Garrison (1982, p. 134; 1985, pp. 202–3), who identified it as significantly differentiating Austrian macroeconomics from its modern (tight-joint and no-joint) alternatives, and Hayek (1941, pp. 408–10). As Hayek (ibid., p. 408) put it, "money by its very nature constitutes a kind of loose joint in the self-equilibrating apparatus of the price mechanism."

Marget's nod to its usefulness as some kind of standard, the concept of general equilibrium seems to play no role in his system.[10]

Action in disequilibrium (general and partial) was important to Marget, so it seems unlikely that he would have accepted the "equilibrium always" interpretation of the new-Classicals. He objected, for example, to the "over-simplified propositions" that consumers' valuations are "reflected immediately and with unerring accuracy in the prices of producers' goods" (1938, p. 494). A few years later, Hayek (1945, p. 90) used the same example to demonstrate the profession's (specifically Schumpeter's) tendency to take for granted the market's solution of knowledge problems by unwarranted analogy to the actions of the individual, for whom a consistent set of knowledge and goals may be assumed. It was—as Hayek called it later—another failure to distinguish catallaxy from economy.

Although a thorough analysis of Marget's microeconomics must take place elsewhere, a part of it that is significant to our interpretation is his remarkable discussion of the role of "particular demand curves" in the determination of money prices (1942, pp. 241–63). His consideration of knowledge, time, and the microeconomic marketing process again illustrates an affinity with a method that is now associated with the Austrians.

In the third of his forty "Propositions" specifying the relationship of Value to Monetary Theory, he accepted that "any given realized price is what it is as the result of the conformation and position of the market demand curve and the market supply curve prevailing at the moment the price is realized" (ibid., p. 240). But he explained that these *market* demand and supply curves need not be the standard *ex ante* curves that we imagine to be formulated in the minds of the buyers and sellers prior to the start of the marketing process. If the knowledge of others' valuations that is acquired in the marketing process provokes a change in one's own valuations, these discoveries may change the supply and demand curves themselves, and a realized price and quantity (though necessarily characterizing the intersection of the curves that obtain at the moment of the exchange) need not lie on either the demand curve or the supply curve as these were conceived

[10]This is a strong contention, especially since Marget nodded to general equilibrium as "a standard of comparison." But I can recall in Marget's work no significant use of this standard. For example, his treatment of "the natural rate of interest" is sharply distinct from a real general-equilibrium conception relating saving to investment (1938, pp. 197–205).

prior to the marketing process (1942, p. 222). "[*R*]*ealized* prices are not necessarily 'equilibrium' prices," he noted (ibid., p. 231; emphasis his), "if the concept of 'equilibrium' is to be given most of the connotations which it carries in the 'general' Theory of Value." Conventional *ex ante* curves play an indispensible explanatory role, he quickly assured us, but that role is not as simple as elementary presentations of the Theory of Value make it appear (ibid., pp. 236–38).

Aggregation

It is easy to understand the appeal of macroeconomics, with its promise of simplicity and empirical manageability at the small cost of irrelevant detail. The Austrian criticism was never exclusively that the detail was interesting or important to a full understanding of economic processes: it was that the composition of the aggregates was important to the goals of the macroeconomists themselves. The effect of investment on current and future unemployment, for example, depends on both its amount (the aggregate of concern to macroeconomics) *and* composition—specifically, the likelihood that it conforms to the composition of future consumer demands.

What is the appropriate role for aggregates, one might wonder, to a writer as committed to the individualistic and temporal tracing of patterns of money flow as Marget obviously was? He issued many warnings against their incautious use. He insisted, for example, that "the *composition* of [the Fisherian] T . . . is particularly relevant for the role of *prices* in determining the absolute demand for cash balances" (1938, p. 210; emphases his). He understood, as do students of the Austrian theory of the business cycle, that "a process that deserves to be called 'inflationary' may take place under the cover of a 'stable' price level" (1937, p. 28; see also 1942, pp. 248–49 n. 43). And he warned that the use of Keynes's aggregate production function

> may prevent an adequate recognition of the importance of studying changes in the *structure* of output and employment which may be of the greatest importance for the explanation of movements in output "as a whole" or employment "as a whole" themselves. (1942, p. 537 n. 33)

In this advice Marget did not quarrel with the *goal* of explaining changes in aggregates, but argued that even for that goal it is not safe to rely on an analysis that largely restricts itself to aggregates.

It would be wrong to infer that Marget had no interest in aggregates. He himself cautioned against this misinterpretation:

> This does not mean, however, that a system such as that outlined in the present work implies a lack of interest in, or is incapable of dealing with, movements in *aggregates*. The possibility, stressed in earlier parts of this work, of *summing* the terms of the various "partial" stream equations into significant aggregates or sub-aggregates, proves the direct contrary. (1942, p. 437)

These are the two sides to Marget's view of aggregates, so it would clearly be too simplistic to identify him as either "for them or against them." To explore the relationship between his view and that of the Austrians, we must examine both judgments of aggregation in more detail.

One of the best-known warnings about the use of aggregates, and my own favorite, is Hayek's forceful statement in 1930:

> in the near future, monetary theory will not only reject the explanation in terms of a direct relation between money and the price level, but will even throw overboard the concept of a general price level and substitute for it investigations into the causes of the changes of relative prices and their effects on production. ([1935] 1967, p. 29)

By now it is apparent that Marget's evolutionary theory of the growth of knowledge produced an inherent conservatism in his theory of money. This alone would incline him against Hayek's revolutionary forecast; more importantly, though, he found that Hayek himself was unable to get along completely without the concept of the price level:

> [T]he most pertinacious critics of the concept of a "general" price level have been impelled to re-introduce, in one way or another, some analytical equivalent of the concept of a movement in the "general" level of prices. (1942, p. 332)

> [D]espite Professor Hayek's sharp attacks upon the usefulness of concepts, such as that of a "general" price level, which are alleged to imply an attempt "to establish causal relations between aggregates or general averages," he has found it necessary to speak, for example, of both the fact and the consequences of a "general fall of prices." (ibid., pp. 332–33)

Marget's point is likely to be admitted, reluctantly and with much sympathy for Hayek, by any Austrian who has attempted to discuss monetary matters without some concept of a "general" level of prices. Actually, though, an examination of the reasons that one might feel this reluctance finds Marget in substantial agreement with them.

The concept of a change in "the general level of prices" certainly *encourages* one to conceive, at least as an immediate impression, of equiproportionate changes in every individual money price. The Austrians are well known for insisting that such an impression is vacuous, and that even hypothetical means of monetary expansion that are designed to be uniform among individuals (whether Hume's, Mill's, or Friedman's) can never produce identical proportionate changes in each good's money price.

But an impression is not a logical implication, and a change in a "general level" does not *preclude* changes in the pattern. Marget had a couple of suggestions to guard against the unnecessary absurdity. First, he proposed the use of the term "*scale* of prices" or "*the scale of magnitude of money values*" (1942, p. 333; emphasis his) instead of a general price *level* (which, after all, suggests that individual prices are "level" or the same relative to each other). Second, Marget conceived of the general level of prices as a "swarm" of individual money prices. If one wished to gain an impression of general trends,

> [t]here is no logical reason why a picture of changes in the height of a given "swarm" could not be obtained by simply plotting the individual prices in such a "swarm," and then generalizing concerning the movements of the "swarm" on the basis of the picture of the movement of individual prices thus obtained. (1942, p. 333)

This "generalizing" is exactly the kind of casual, rough impression—something like looking at a scatter diagram from a distance or while squinting to deliberately blur the details—that is acceptable to Austrians.[11] It involves none of the methodological errors of which they warn, and the "precision" that it sacrifices is spurious and misleading anyway. "[I]t is possible to speak of a 'general' movement of prices," Marget assured us, "simply upon the basis of inspection of arrays of individual prices that remain uncombined into a single index figure" (ibid., p. 335).

[11]Both Menger and Mises used "general purchasing power of money" in precisely this way, as a referee observed.

Actually, the calculating of a precise numerical index through the assignment of specific weights was fully acceptable to Marget. Throughout his writings, he seemed unwilling to throw any analytical tool overboard. Time and time again, just when his sharp criticism had convinced the reader that an analytical device that had been misused and misconceived by predecessors was headed for the trash can, Marget backed off and suggested instead that the concept was acceptable if sufficiently "supplemented" by other analysis.[12]

He imposed two conditions on the use of a price index. First, most or many individual prices must in fact have changed by the average amount; he specifically rejected the use of a mean to measure price changes when the distribution was bimodal (with many prices changing more, many changing less, and perhaps not a single one changing by the average). The index must not, in other words, convey an inaccurate picture of the "swarm." Second, and more important, was his warning that "we carefully refrain from reading more into this single figure than is justified by an 'operational' view of the processes employed" (1942, p. 334). To explain the process by which an average changes, one must study the principles that determine its individual prices. "We are not warranted," Marget cautioned, "in assigning any 'reality' to the movements in this figure over and above the 'reality' which is represented by the individual price movements thus combined in the average" (ibid., p. 335).

This was Marget's advice against exactly the error that Hayek identified as establishing "causal relations between aggregates and averages" ([1935] 1967, p. 4). Even in those instances in which a precisely calculated numerical index accurately conveys the "general" movement of prices, an *explanation* of that move requires the explanation—according to the methodologically individualistic process described earlier in this paper—of the changes of the individual prices from which the average is computed. To Marget, and—in his judgment—to scores of preceding monetary theorists who recognized the significance of changes in relative prices, the disaggregated analysis of prices and production of which Hayek spoke constituted not (as Hayek implied) a *substitute* for an aggregate price level, but a *complement* to it.

[12]After encountering a number of such instances in Marget's work, one begins in frustration to wonder if he might have tolerated the hemline theory of stocks (prices vary inversely with the length of women's skirts), as long as it was "supplemented and analytically controlled" by some theory involving the discounted value of expected future dividends.

Marget was sensitive to an important limitation to the use of aggregates that was significant, also, in the Austrian theory of monetary processes. This analytical restriction is that only realized, *ex post*, quantities can be summed.

If the purpose of economic theory is to explain realized and observed events in terms of the choices of the individuals whose actions bring them about, the relation of the *ex ante* to the *ex post* is the essence of economics itself. Quantifiable, observed magnitudes—like the amount of money spent on certain goods in a time period—can clearly be aggregated. But what about the plans, the intentions, the *ex ante* demands or supplies? If the conception of "planned" aggregates is illegitimate, macroeconomics becomes, at best, an *ex post* exercise of quantitative economic history, filling certain economic categories (such as "the price level" or "national income") with numerical specifics.

The reason for Marget's unwillingness to aggregate everything that can be found in microeconomics is grounded in the point, raised earlier by Hayek (1937; also, see below) and later by Lachmann (1958, p. 222), that except in general equilibrium *ex ante* quantities are based on inconsistent plans, expectations of others' behavior that are logically incapable of realization. He noted:

> It should be observed that since the "summation" involved applies to the summation of *realized* magnitudes, it is not open to the objections that have been raised to a mechanical summation of "expected" magnitudes (Marget 1942, p. 437 n. 69),

and later that

> realized results do represent a net, quantitatively measurable social resultant of "expectations," after all allowance has been made for the loose quantitative aspects of the expectations themselves, their essentially contingent nature, and their possible mutual inconsistency. (ibid., p. 503)

Because he perceived this problem, two popular aggregates held little appeal for him. He referred sarcastically to "that blessed dichotomy, 'Savings and Investment' . . . , which some of us will continue to avoid as if it were the plague" (Marget 1936, p. 566). Marget's skepticism about the significance of general equilibrium may explain part of this position. But it is also consistent with Hayek's (1933, 1934, 1935) discussions of the

subjective and future-oriented nature of capital, saving, and investment.[13]

Marget knew that this criticism runs the risk of going too far, so it must be examined more closely. After all, in a sense every concept is an aggregate, in that it sweeps together individual elements with a particular common property and ignores their differences. He noted that "This is not to say, of course, that there are *no* circumstances under which it would be perfectly permissible to sum up *ex ante* values. The case of the 'total' demand schedule for a particular commodity proves an example to the contrary" (1942, pp. 503–4 n. 101). One wonders what principle differentiates this acceptable microeconomic *ex ante* aggregate from the dubious macroeconomic ones.

Even with the use of partial-equilibrium "particular demand curves" of microeconomics, he urged caution:

> Even here, however, the realistic validity of such a "total" demand schedule depends upon its being related in all cases to realized results; and since these results are in all cases "realized" through the actions of *individuals*, it would always be safer to approach the problem from the standpoint of the calculations and the probable reactions of these individuals, leaving for a next step an evaluation of the share contributed by the actions of individuals to the "total" realized result. (1942, p. 504 n. 101)

The only methodologically safe analysis, Marget advised, is that of the choices of individuals. With a wholly Austrian adherence to the principles of subjectivism and individualism, he warned that one forms even such aggregates as "the demand for widgets" only at some risk.

He was not very explicit about the relationship of his reluctance to accept macroeconomic *ex ante* aggregates with his acceptance of more modest microeconomic ones like the "market demand" for a particular good. I suspect that he may have accepted the latter as useful and coherent because the more narrowly a good is defined, the more likely it is that individual demanders can effect their demands for it without their very action exposing any contradictory expectations on which their individual demands

[13]Typically, though, Marget allowed that "Saving and Investment, the 'multiplier,' and even 'income velocity' . . . may be salvaged if their use is accompanied by more nearly microeconomic analysis" (1942, p. 504). Unfortunately, he noted, their sponsors seemed to believe that the concepts render this "microeconomic analysis" superfluous.

may have been based. If we were to conceive of an aggregate good consisting of widgets and a gradually increasing number of other goods, however, it becomes increasingly likely that individuals' demands for one component of the aggregate are inconsistent with their demands for other components of the same aggregate. The more narrowly a particular commodity is defined, or—perhaps more accurately—the fewer individuals who are included, the less likely it is that the problems of logical inconsistency lie interior to the concepts of its demand and supply.

This problem with multi-individual *ex ante* aggregates is that they constitute another application to the *catallaxy* of analytical devices truly appropriate only to *economy*. Although it surely may be identified with the works of Hayek (from the '30s to the '70s), it is perhaps again Lachmann who—among the Austrians—has expressed a position most like that of Marget. "We must not forget," Lachmann wrote in 1973,

> that whenever we pass from the sphere of action controlled by one mind, in household or firm, to the sphere of action in which diverse minds have to take their orientation from one another while each is pursuing its own interests, as in a market, we face a formidable array of problems of the existence of which all too many economists seem blissfully unaware, (Lachmann 1973, pp. 15–16),

and in 1977:

> Equilibrium of the individual, household, or firm, as an expression of consistent action, is indeed an indispensible tool of analysis. Equilibrium involving action planned by different minds involves altogether new problems. Equilibrium on a simple market, such as a Marshallian corn market, still has its uses. "Equilibrium of an industry" is already harder to handle. (Lachmann 1977, p. 37)

Lachmann's general perspective on aggregates, expressed over a span of many years, is also fully in keeping with Marget's. Referring in 1978 to "macroeconomic aggregates," he noted that "Austrian aversion does not pertain to these aggregates as such. . . . It pertains to the construction of an economic model in which these aggregates move, undergo change, and influence each other in accordance with laws which are devoid of any visible reference to individual choice" (1978, pp. 8–9). While the quest for "micro foundations" has not been, for at least several decades, the

exclusive property of Austrians, Lachmann insisted that such a micro foundation be properly subjectivist.[14]

Although Marget defended the use of aggregates in monetary analysis, and gently rapped Hayek's knuckles for suggesting that we could get along just fine without them, a careful examination of Marget's position uncovers a virtual identity with the Austrian viewpoint. "In fact, neither aggregates nor averages do act upon one another, and it will never be possible to establish necessary connections of cause and effect between them . . .," said Hayek ([1935] 1967, pp. 4–5) in 1930. Marget's insistence that aggregates be composed only of *ex post* data, changes in which must be explained according to methodologically individualistic analyses of effects on particular markets in temporal sequence, thoroughly precludes the simple kind of direct causal connection of which Hayek warned.

On the issue of doctrinal history, Marget might have challenged the Austrians. For he was convinced that, whatever shortcomings characterized the early stages of an evolving theory, there never had been a significant period (in the pre-Keynesian, pre-monetarist era, of course) in which monetary theorists had not sought individualistic, process, explanations of relationships between measurable aggregates.[15]

Conclusions

Exactly how Marget might have reacted to this interpretation of his work is a matter of some concern to me. Around 1940, he considered himself simply an expositor of (pre-Keynesian) orthodoxy, reminding those who had lost their way of its sophistication and urging that they return to its "highroad," and he would hardly have accepted a specific Austrian affiliation.[16] He probably would not have accepted it now, so I have tried not to thrust it upon him. But perhaps he would have agreed that—because of the very changes that he feared—some of the most important characteristics of the "orthodoxy" that he supported have come to be identified particularly with the Austrian School.

[14]For a fine statement, inspired by Hayek's *Prices and Production*, of an Austrian position on "averages and aggregates in economics," see Spadaro (1956).

[15]For an argument that Marget misinterpreted classical monetary theory, see Mason (1976). "In short, Marget's virtual denial of dichotomy in classical and neoclassical theory is really irrelevant to the issue because his 'resolution' was terminological, not substantive" (ibid., p. 194).

[16]Another writer who, while welcoming association with the Austrians, always insisted that his own work was exposition of pre-Keynesian orthodoxy, was W. H. Hutt. See Hutt 1963 (p. vii), Hutt 1974 (p. 1–2), and Egger (1994).

This paper has examined only two related characteristics of Marget's work: his advocacy of the method of the individualistic analysis of monetary processes, and his position on aggregation. Precisely because they are broad issues of method, however, the specific topics that I have chosen provide clues to Marget's position on a wide array of subjects not discussed here. As one might expect, an examination of his work on the theories of interest, capital, the business cycle, and economic policy usually—perhaps not always—illustrates the consistent application of a subjectivist methodological individualism.

Although some Austrians have taken notice of Marget (Hayek (1978, p. 75), Hutt (1963, p. 89), others may have been misled by the same "defender of orthodoxy" label that caused the Keynesian anti-orthodoxy to ignore *The Theory of Prices*. In particular, Marget identified pre-Keynesian theory with the "Quantity Equation" (the transactions form of the *ex post* identity). One consequence is that he is known today primarily as a "historian of the Quantity Theory,"[17] a label that—as my paper suggests—hardly does justice to his work.[18] But his association with the "Quantity Equation" may also explain the rather lukewarm welcome of his work by the Austrians. Despite Mises's comment that "one may call the modern theory of money an improved variety of the quantity theory" (1966, p. 405), there remains suspicion that the very adjective "quantity" denotes a belief in direct causal connections among averages and aggregates that is inconsistent with methodological individualism and subjectivism (Hayek ([1935] 1967, p. 3), Rothbard (1970, pp. 727–37).

Whether or not such a characterization is fair even to Fisher (to whom it was specifically directed), it clearly has nothing to do with Marget. After all, Marget's deep conviction in, and spirited argument for, the Quantity Equation's system of conceptual organization arose precisely because it was capable of the disaggregated, individualistic, and subjective analysis of temporal process that has always identified the Austrian method.

[17]A survey of the books that happened to be in my office as of this writing turned up eight with citations of Marget as historian of the "quantity theory." One of the most complimentary references is that of Humphrey (1973, p. 462): "it is ironic that the definitive history of the quantity theory was written by Marget at Minnesota rather than by someone at Chicago."

[18]*Prices* is considerably more than a history of the "Quantity Theory," but it is far from an exhaustive theory of money. As Gilbert (1953, p. 154) notes, "Marget, in his two lengthy volumes, fails to deal satisfactorily with the fundamental reasons for holding money . . . [He] merely gives special cases of the time factor with some references to uncertainty through anticipations. The uncertainty factor as an independent element is not analyzed."

Labels aside, Marget's work offers scholarship in the history of monetary doctrine that is unmatched, and an analysis of processes that is in some respects unmatched, in explicitly Austrian works. "Prolixity" or not, it deserves to be recognized as an exciting and significant contribution to the tradition of the methodologically individualistic analysis of monetary processes.

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A Critical Analysis of Central Banks and Fractional-Reserve Free Banking from the Austrian School Perspective

Jesús Huerta de Soto

The theory of money, bank credit, and financial markets constitutes the most important theoretical challenge for economic science on the threshold of the twenty-first century. In fact, it is no exaggeration to say that, now that the "theoretical gap" represented by the analysis of socialism has been covered, perhaps the least known and, moreover, most significant field is the monetary one. As Friedrich A. Hayek has rightly stated,[1] methodological errors, lack of theoretical knowledge and, as a result thereof, systematic coercion originating from the government prevail throughout this area. The fact is that social relations in which money is involved are by far the most abstract and difficult to understand, meaning that the social knowledge generated and implied thereby is the broadest, most complex and hardest to define. This explains why the systematic coercion practiced by governments and central banks in this field is by far the most damaging and prejudicial. Moreover, this intellectual lag in monetary and banking theory has had serious effects on the

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[1]F. A. Hayek, *The Fatal Conceit: The Errors of Socialism* (Chicago: University of Chicago Press, 1989), pp. 102–4.

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evolution of the world economy. At present, in spite of all the sacrifices made to reorganize the western economies after the crisis of the 1970s, the same errors of lack of financial and monetary control have unfailingly been committed, inexorably leading to the appearance of a new worldwide economic recession of considerable magnitude.

The fact that the recent monetary and financial abuses mainly originated in the second part of the decade of the 1980s in the policies applied by the supposedly conservative-libertarian administrations of the United States and United Kingdom, dramatizes even more the importance of making theoretical advances in order to avoid, even in the libertarian field, political leaders such as Ronald Reagan and Margaret Thatcher committing the same errors. It is important to make such leaders capable of clearly identifying the only monetary and banking system truly compatible with a free society. In short, it is necessary to develop an entire research program aimed at conceiving what the monetary and banking system of a non-interventionist society should be—a system which it is evident that many libertarians do not see at all clearly.

In the present article, we propose a new approach to the analysis of the problems of monetary and banking theory. We aim to provoke a renewal of the intellectual debate over some aspects of the doctrinal controversy between the advocates of free banking and those who defend central banking, particularly why the institution of central banking may not be a spontaneous and evolutionary result arising from the market. We also hope to throw some light on many specific problems of economic policy of great current importance, in particular the future evolution of the European monetary system.

The Debate Between the Theorists of Free Banking and Central Banking

Beginning with the doctrinal controversy between the supporters of central banking and those who favor free banking, it is first necessary to state that our analysis does not entirely coincide with the nineteenth century controversy between the theorists of the banking and currency schools. In fact, many of those who defended free banking based their reasons on the fallacious and defective inflationist arguments of the banking school, while the majority of the currency school theorists aimed to attain their objectives of financial solvency and economic stability by the creation of a central bank to put a stop to monetary abuses.

From the beginning, however, some reputable currency school theorists considered it impossible and utopian to think that a central bank would not make the problems even worse. They were aware that the best way of putting a stop to the creation of fiduciary media, and to achieve monetary stability was through a free banking system subject, like all other economic agents, to the traditional principles of civil and mercantile law. In addition, paradoxically, the majority of those who defended the tenets of the banking school were, in the end, pleased to accept the establishment of a central bank that, as last resort lender, guaranteed and perpetuated the expansionist privileges of private banking. The privileged bankers tried, in this way, to evade their commitments and devote themselves to the lucrative "business" of creating fiduciary money through the expansion of credit, without having to worry excessively about liquidity problems, thanks to the support implied by the establishment of a central bank.

It is important to emphasize the fact that most of the currency school theorists, even though the heart of their theoretical contributions was correct, were incapable of appreciating that the same defects they rightly attributed to the freedom of the banks to issue fiduciary money in the form of notes, were fully and identically reproduced, though in a more hidden, and therefore, dangerous way, in the "business" of expansively granting credits against the banks' demand deposits. And, moreover, these theorists erred in proposing, as a more appropriate policy, the establishment of legislation which would merely put an end to the freedom to issue notes without backing and create a central bank to defend the most solvent monetary principles.

Only Ludwig von Mises, following the tradition of Cernuschi, Hübner and Michaelis, was capable of realizing that the currency school theorists' recommendation for a central bank was erroneous and that the best and only way of achieving the credible monetary principles of the school was through a free banking system subject, without any privileges, to private law. This failure on the part of the majority of the currency school theorists was fatal. It not only led to the fact that Peel's Act of 1844, in spite of its good intentions and its elimination of the free issue of bank notes, did not eliminate the creation of fiduciary credit. Instead, Peel's Act in effect led to the creation of a central banking system which, subsequently and above all due to the influence of banking school theorists like Marshall and Keynes, was used to justify and promote policies containing a lack of monetary control and financial

abuses much worse than those it was originally intended to remedy.

The Evolution of the Banking System and the Central Bank

The central bank is not a natural product of the development of the banking system.[2] On the contrary, it is coercively imposed from outside the market as a result of governmental action. Such action, as a consequence of a series of historical accidents, gave rise to a monetary and financial system very different from that which would have emerged spontaneously under a free banking system subject, without privileges, to private law and not coerced by government through the central bank. It is impossible to know what knowledge and institutions the banking entrepreneurs would have created freely if they had been subject to the general principles of law and not to any kind of state coercion.[3] Yet we may imagine a generalized system of investment funds in which current "deposits" would be invested, and endowed with great liquidity, but without a guarantee of receiving the face value (which would be subject to evolution of the market value of the corresponding units); a network of entities providing payment and accounting services, etc., operating in free competition and charging fees for their services; and, separately, *without any connection with credit*, a series of private institutions devoted to the extraction, design and offer of different types of private money (also charging a small margin for their services).[4]

In fact, the current central banking system is merely the logical and inevitable result of the gradual and surreptitious introduction by private bankers, historically in complicity with the governments, of a banking system based on a fractional reserve. And it is here essential not to fall into the same intellectual trap as

[2]Vera C. Smith, *The Rationale of Central Banking and the Free Banking Alternative* (Indianapolis, Ind.: Liberty Press, 1990), chap. 12, p. 169.

[3]Israel M. Kirzner, *Discovery and the Capitalist Process* (Chicago: University of Chicago, 1985), p. 168.

[4]F. A. Hayek, *Denationalization of Money: The Argument Refined*, 2nd ed. (London: Institute of Economic Affairs, 1978), pp. 119–20. Hayek concludes, "I expect that it will soon be discovered that the business of creating money does not go along well with the control of large investment portfolios or even control of large parts of industry." I am afraid, however, that Hayek gives insufficient recognition of the fact—central to Mises's theory of money—that free market money must be a *commodity* money, and that competing kinds of money are dysfunctional of the very purpose of a medium of exchange, as the free market always generates a tendency of the convergence toward *one*, universally employed commodity money.

the majority of the theorists who have defended the free banking system. With the honorable exception of Mises and very few others,[5] they do not realize that the only way to achieve a truly free banking system is to reestablish the legal principle according to which it is necessary to keep a reserve of 100 percent of the sums of money received as demand deposits.

In the final analysis, the question is the application in the monetary and banking field of Hayek's seminal idea according to which, whenever a traditional rule of conduct is violated, either through institutional coercion on the part of the government or by the latter's granting special privileges to certain persons or entities, damaging and undesired consequences will, sooner or later, appear, seriously prejudicing the spontaneous social process of cooperation.

The traditional rule of conduct violated in the case of the banking business is the principle of law according to which, in the contract for the deposit of fungible money (also called *irregular deposit*), the traditional obligation of *custody*, which is the essential element of all non-fungible deposits, requires that, at all times, a reserve of one hundred percent of the amount of fungible money received in deposit be maintained. This means that all acts which make use of that money, specifically the granting of credits against it, are a violation of that principle and, in short, an illegitimate act of undue appropriation.

In the continental European juridical tradition, there is a long-established principle that dates back to the old Roman Law according to which *custody, in irregular deposits, consists precisely of the obligation to always have an amount equal to that received at the depositor's disposal.* The custodian of a deposit must "have always available a quantity and quality equal to that received of certain things," regardless of whether they are continually renewed or substituted. This requirement is the equivalent, for fungible goods like money, of the continued existence of the item *in individuo* for infungible goods.[6] This general legal

[5]Before Mises, the most distinguished author who defended the one hundred percent reserve requirement was David Hume in his essay "Of Money" (1752), where he states that "no bank could be more advantageous, than such a one as locked up all the money it received, and never augmented the circulating coin, as is usual, by returning part of its treasure into commerce." David Hume, *Essays: Moral Political and Literary* (Indianapolis, Ind.: Liberty*Classics*, 1985), pp. 284–85.

[6]On juridical considerations of the traditional legal principle in question, see not only all Title 3, Book 16 of the Digest, especially sections 7 and 8 on the bankcuptcy of bankers (*El Digesto de Justiniano* 1 [1968]: 606–17, esp. 112, [Spanish edition published by Aranzadi, Pamplona], but also the fine argument by

principle which requires one hundred percent reserve banking has been upheld, even in this century, by French and Spanish jurisprudence.

A ruling of the Court of Paris of June 12, 1927 condemned a banker for the offense of undue appropriation because he had used, in accordance with common banking practice, the funds which he had received in deposit from his clients. Another decision of the same Court dated January 4, 1934 made the same ruling, and even more curious was the ruling of the Court of First Level which heard the case of the bankruptcy of the Bank of Barcelona, according to which the depositor's power to draw checks implies for the depositee the obligation to *always* have funds at the disposal of the current account holder, making it unacceptable that a bank consider the funds deposited in a current account in cash as belonging exclusively to itself.[7] We should add that the "undue appropriation" arises when the undue act (lending the amount deposited) is committed, and not when it is discovered a long time afterwards (generally by the depositor at the counter of a bank which cannot return his money to him). Moreover, the trite argument that the "law of large numbers" allows the banks to act safely with a fractional reserve cannot be accepted, since the degree of probability of an untypical withdrawal of deposits is not, in view of its own nature, an insurable risk.

The Austrian theory of economic cycles has perfectly explained how the system of fractional reserve banking itself generates economic recessions *endogenously* and recurrently and, hence, the need to liquidate wrongly induced investment projects, to return bad loans and withdraw deposits on a massive scale. And, as all insurance theorists know, the consequences of an event (untypical withdrawal of deposits) which is not totally

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the Spanish Jesuit Luis de Molina, for whom the banker with a fractional reserve "*sins* by endangering his own capacity to meet his debts, even if in the long run he suffers no legal difficulties because his speculations with the clients' funds turned out well (quoted from *De Iustitia et Iure,* Maguntiae [1614], in Alejandro Chafuen, *Christians for Freedom: Late Scholastic Economics* [San Francisco: Ignatius Press, 1986], p. 146 n. 1–7). See also the refined conclusions of Pasquale Coppa-Zuccari included in his definitive work *Il Deposito Irregolare* (Modena 1901), quoted by, among others, Joaquín Garrigues in his *Contratos Bancarios,* 2nd ed. (Madrid, 1975), p. 365. All these considerations are also applicable to so-called financial operations with repurchase agreements at any moment and at face value (and not at a fluctuating secondary market price), since they disguise, by fraudulently using the law for a purpose for which it was not intended, what are really deposit contracts.

[7]Ibid., pp. 367–68.

independent of the "insurance" itself (fractional reserve) are not technically insurable, for reasons of *moral hazard*.[8]

In the course of history, bankers were soon tempted to violate the above-mentioned rule of conduct, using the money of their depositors to their own benefit.[9] This happened shamefacedly and secretly at first, since the bankers were still conscious of acting incorrectly. It occurred, for example, with the Bank of Amsterdam, when the activities of the bank were carried out, for the reasons mentioned, according to the words of Sir James Steuart, with the *maximum secrecy*.[10] It should be noted that the entire prestige of the Bank of Amsterdam was based on the belief that it held a reserve of one hundred percent, a principle which, only fifteen years previously, David Hume believed to be in force.[11] And in 1776, Adam Smith mentioned that, at that time, the Bank of Amsterdam *continued to say* that it held a cash ratio of one hundred percent.[12]

Only later did the bankers achieve the open and legal violation of the traditional legal principle, when they were fortunate enough to obtain from the government the *privilege* of using part of the money of their depositors to their own benefit (generally in the form of credits, often granted initially to the government itself). In this way the relationship of complicity and the coalition of interests which now traditionally exists between governments and banks commenced, explaining perfectly the relationship of intimate "comprehension" and "cooperation" which exist between both types of institutions and which, nowadays, may be observed, with slight differences of nuance, in all western countries at all

[8]With regard to the class probability (objective), which is insurable, and the single event probability, influenced and determined by human action (not insurable), see Ludwig von Mises, *Human Action: A Treatise on Economics*, 3rd rev. ed. (Chicago: Henry Regnery, 1966), pp. 106–15; and also Jesús Huerta de Soto, *Socialismo, Cálculo Económico y Función Empresarial* (Madrid: Unión Editorial, 1992), pp. 46–48.

[9]The temptation was enormous and almost irresistible, given how lucrative it was. We must remember that, in the final analysis, the system of fractional reserve banking consists of creating loans from nothing and requiring that the borrowers return them in real money and with interest, too!.

[10]Sir James Steuart, *An Inquiry into the Principles of Political Economy: Being an Essay on the Science of Domestic Policy in Free Nations* (London: A. Millar and T. Caddell in the Strand, 1767), vol. 2, p. 301.

[11]David Hume, "On Money," p. 284.

[12]"The Bank of Amsterdam professes to lend out no part of what is deposited with it, but for every gilder which it gives credit in its books, to keep in its repositories the value of a gilder, either in money or bullion" (Adam Smith, *The Wealth of Nations* [London: W. Strahan and T. Caddell in the Strand, 1776], vol. 2, bk. 4, chap. 3, p. 72).

levels. Furthermore, the bankers soon realized that the violation of the traditional legal principle mentioned above gave rise to financial activity which was highly lucrative for them, but which always required the existence of a last resort lender, or central bank, to provide the necessary liquidity at the difficult moments which, as experience demonstrated, always recurred.[13]

The Fractional Reserve Banking System: The Central Bank and the Theory of Economic Cycles

The inauspicious social consequences of this *privilege* granted to the bankers (but not to any other individual or entity) were not completely understood until the development, by Mises and Hayek, of the Austrian theory of economic cycles.[14] In short, what the Austrian School theorists have shown is that persistence in pursuing the theoretically impossible objective—from the legal-contractual and technical-economic viewpoints—of offering a contract that simultaneously tries to combine the best features of investment funds—especially the possibility of obtaining interest on the "deposits"—with the traditional deposit contract—which, by definition, must permit withdrawal of its face value at any moment—must inexorably, sooner or later, lead to uncontrolled expansion in the monetary supply, inflation, and the generalized incorrect allocation of productive resources at a microeconomic level. In the final analysis, the result will be recession, the rectification of errors induced in the productive structure by prior credit expansion and massive unemployment.

It is necessary to realize that the privilege granted to the banks permitting them to carry on activity with a fractional

[13]It is curious to observe how the bankers used all their influence and social power (enormous, in view of the large numbers of the public who received loans from them or were their shareholders) to impede and discourage the depositors from withdrawing their deposits, in the vain hope of avoiding the crisis. Thus, State Senator Condy Raguet of Pennsylvania, concluded that the pressure was almost irresistible and that "an independent man, who was neither a stockholder nor a debtor, who would have ventured to compel the banks to do justice, would have been persecuted as an enemy of society." Letter from Raguet to Ricardo dated April 18, 1821, published in David Ricardo, *Minor Papers on the Currency Question 1805–1823*, Jacob Hollander, ed. (Baltimore, Maryland: The Johns Hopkins University Press, 1932), pp. 199–201); quoted in Murray N. Rothbard, *The Panic of 1819: Reactions and Policies* (New York: Columbia University Press, 1962), pp. 10–11.

[14]A brief explanation of the Austrian theory of economic cycles, together with the most significant bibliography on the topic, may be found in my article "The Austrian Theory of Economic Cycles," originally published in *Moneda y Crédito*, no. 152 (Madrid, March 1980), and republished in volume 1 of my *Lecturas de Economía Política* (Madrid:Unión Editorial, 1986), pp. 241–56.

reserve, implies an evident attack against a correct definition and defense of the property rights of the depositors by the governmental authorities. This inevitably generates, as is always the case when property rights are not appropriately defined, the typical effect of "tragedy of the commons," by virtue of which the banks are inclined to try to get ahead and expand their corresponding credit base before, and more than, their competitors. Therefore, a banking system based on a fractional reserve will always tend towards a more or less uncontrolled expansion, even if it is controlled by a central bank which, in contrast to what has normally been the case, is seriously concerned about controlling it and establishing limits. In this respect, Anna J. Schwartz reaches the conclusion that many modern theorists of the free banking system do not completely understand: that the system of interbank clearing houses which they propose does not act as a brake on credit expansion if all the banks decide to expand their credit simultaneously, to a greater or lesser extent.[15] This phenomenon, which had already been set out by Ludwig von Mises in his brilliant explanation of the free banking system,[16] drove us to seek its explanation in the typical process of the "tragedy of the commons": the entire expansive process originates, as we have seen, from a *privilege* that contravenes property rights. Each bank internalizes all the profits obtained from expanding its credit, making the corresponding costs fall, dilutedly, upon the entire banking system. For this reason, it is easy to understand that a mechanism of inter-bank compensation or clearing houses may put a stop to individual, isolated expansion initiatives in a free banking system with fractional reserves, but is useless if all the banks, to a greater or lesser extent, are carried away by "optimism" in the granting of credits.

The proposal to establish a banking system with a one hundred percent reserve was already included in the first edition of *The Theory of Money and Credit* published by Mises in 1912, in which the author reached the conclusion that "it is obvious that the only way of eliminating human influence on the credit system is to suppress all further issue of fiduciary media. The basic conception of Peel's Act ought to be restated and more completely implemented than it was in the England of his time by including

[15]See her article "The Theory of Free Banking," presented at the regional meeting of the Mont Pèlerin Society in Rio de Janeiro from September 1993, especially page 5.

[16]Mises, *Human Action*, pp. 648–88.

the issue of credit in the form of bank balances within the legislative prohibition."[17] Subsequently, Mises again dealt with the matter even more explicitly in 1928[18] and especially in the appendix on *Monetary Reconstruction* which he incorporated into the English edition of *The Theory of Money and Credit* in 1953, where he expressly states that "the main thing is that the government should no longer be in a position to increase the quantity of money in circulation and the amount of checkbook money not fully—that is, one hundred percent—covered by deposits paid in by the public."[19] Hayek already referred to this proposal in 1937[20] and it is evident that Hayek, like Mises, proposes the free choice of currency and banking system as a means to achieve, in the final analysis, a banking system based on a one-hundred-percent-cash-ratio.[21] After Mises, the writer who has, in modern times, defended the elimination of the banking system as we know it today with the greatest determination and brilliance is, without doubt, Murray N. Rothbard.[22]

Also in modern times, Maurice Allais has defended the principle of the one hundred percent reserve, although it is true that he defends it as a means to facilitate the monetary policies of governments, preventing their elastic and distortive expansion through the fractional reserve banking system.[23] Maurice Allais, in this respect, merely follows the now abandoned Chicago School tradition in favor of the one-hundred-percent-cash-ratio in order to make the monetary policies of the governments more

[17]Ludwig von Mises, *The Theory of Money and Credit* (Indianapolis, Ind.: Liberty Press, 1980), p. 447.

[18]Ludwig von Mises, "Monetary Stabilization and Cyclical Policy," in *On the Manipulation of Money and Credit* (Irvington-on-Hudson, N.Y.: Free Market Books, 1978), pp. 167–68.

[19]Mises, *The Theory of Money and Credit*, p. 481.

[20]F. A. Hayek, *Monetary Nationalism and International Stability* (New York: Augustus M. Kelley, 1971), pp. 81–84.

[21]F. A. Hayek, *Denationalization of Money*, pp. 119–20.

[22]See particularly Murray N. Rothbard's books *The Case for a One Hundred Percent Gold Dollar*, 2nd ed. (Auburn, Ala.: Ludwig von Mises Institute, 1991) and *The Mystery of Banking* (New York: Richardson & Synder, 1983); and his articles "The Myth of Free Banking in Scotland," *Review of Austrian Economics* 2 (1988): 229–45 and "Aurophobia: or, Free Banking on What Standard?" *Review of Austrian Economics* 6, no. 1 (1992): 99–108.

[23]Maurice Allais, "Le retour à L'État du privilège exclusif de la creation monétaire" in *L'Impôt sur le capital et la réforme monétaire* (Paris: Hermann Editeurs, 1985), pp. 200–10, and also his most recent article "Les conditions monétaires d'une économie de marchés: des ensignements du passé aux réformes de demain," *Revue d'économie politique*, 3 (May/June 1993): 319–67.

effective and predictable.[24] Although monetary policy would be more predictable with a one-hundred-percent-cash-ratio, all the Chicago theorists are ingenuous if they think that the government can and will want to carry out a stable monetary policy. This ingenuousness is parallel and similar to that shown by the modern fractional reserve free banking theorists, when they trust that spontaneous clearing house mechanisms can put a brake on a simultaneous and agreed upon expansion by a majority of banks. *The only correct solution for a society free of privileges and economic cycles is, therefore, banking which is free but subject to the law, i.e., with a reserve ratio of one hundred percent.*

The Monetary and Banking System in a Free Society

In short, the main defect of the majority of the theorists who defend free banking is their failure to realize that the demand for a one hundred percent reserve requirement is theoretically inseparable from their proposal. Specifically, they have not appreciated that all the defects which advocates of the central bank see in the free banking system lose their potential and completely disappear if it is put into practice on the basis of traditional legal principles. Or, to put it another way, using Mises's words, the issue is to subject the banks to the traditional principles of civil and mercantile law, according to which each individual and each enterprise must meet its obligations in strict accordance with what is literally established in each contract.[25]

This error is very generalized and affects, in particular, the interesting and broad literature which has been developed as a result of the great echo arising from the publication of Hayek's book on the *Denationalization of Money*, together with the important economic and financial crisis which took place at the end of the 1970s. The most important comment I have on all this literature

[24]This tradition was initiated by an anonymous 26-page pamphlet on "Banking and Currency Reform," circulated in 1933 by Henry C. Simons, Aaron Director, Frank H. Knight, Henry Schultz, Paul H. Douglas, A. G. Hart and others and subsequently articulated by Henry C. Simons, "Rules *versus* Authorities in Monetary Policy," *Journal of Political Economy* XLIV, no. 1 (February 1936): 1–30; Albert G. Hart "The 'Chicago Plan' of Banking Reform," *Review of Economic Studies* 2 (1935): 104–16; and Irving Fisher *100 Percent Money* (New York: Aldelphi, 1936) culminating in 1959 with the publication of Milton Friedman's book *A Program for Monetary Stability* (New York: Fordham University Press, 1960).

[25]Mises, *Human Action*, p. 443. In short, according to Mises, it is a question of replacing the current tangle of administrative banking legislation by clear and simple articles in the commercial and criminal codes.

is that, apart from a few exceptions, it uses the defense of a free banking system to put forward whims typical of the old "banking school," the erroneous principles of which were demonstrated long ago. Moreover, all this literature, which is headed by the works of White, Selgin and Dowd,[26] among others, forgets that, as we have argued, the only way of getting rid of the central bank and its excesses is by eliminating the fractional reserve privilege which private bankers currently exploit.

If one wishes to defend a truly stable financial and monetary system for the next century, one which immunizes our economies against crises and recessions as much as is humanly possible, it will be necessary to establish three conditions: (1) complete freedom of choice of currency; (2) a free banking system; and (3) most importantly, all the agents involved in the free banking system are subject to and follow, in general, traditional legal rules and principles. In particular, the principle according to which nobody, not even the bankers, should enjoy the privilege of lending something which has been deposited with him as a demand deposit (i.e., to maintain a banking system with a reserve of one hundred percent).

The modern free banking theorists erroneously consider (due, among other things, to their lack of a juridical background), that the one hundred percent reserve requirement would be an inadmissible *administrative* interference with individual freedom. They do not realize that, far from implying systematic administrative coercion by the government, as we have seen, this precept is merely the application of the traditional principle of *property rights*. In other words, they do not realize that the famous anonymous phrase of an American quoted by Tooke, according to which "free banking is equivalent to free swindling"[27] is applicable to free banking not subject to law (and which, therefore has, fractional reserves). In the final analysis, the defense of free banking must be made, not as a means to exploit the lucrative possibilities of credit expansion, but as an *indirect* means to get closer to the

[26]Thus, for example, see the works of Lawrence H. White, *Free Banking in Britain: Theory, Experience and Debate, 1800–1845* (Cambridge: Cambridge Universiry Press, 1984) and *Competition and Currency: Essays on Free Banking and Money* (New York: New York University Press, 1989); those of George A. Selgin, *The Theory of Free Banking: Money Supply under Competitive Note Issue* (Totowa, N. J.: Rowman and Littlefield, 1988) and *The Experience of Free Banking*, George A. Selgin and Kevin Dowd, eds. (London: Routledge, 1992); and those of Kevin Dowd, *The State and the Monetary System* (New York: St. Martin's Press, 1989) and *Laissez Faire Banking* (London: Routledge, 1993).

[27]Quoted by Mises in *Human Action*, p. 446.

ideal model of free banking with a one hundred percent reserve requirement which, additionally, must be *directly* pursued by all the legal means available in each historical circumstance.[28]

Although the foregoing economic policy recommendations may appear *utopian* and very distant from the practical problems we have to deal with, especially with regard to the design and management of a European monetary system, they indicate, at all times, at least the appropriate direction which reform should take and dangers that must be avoided. Thus, it seems clear that we should reject both a system of monopolistic national currencies which compete among themselves in a chaotic environment of flexible exchange rates, as well as the move towards the creation of a central European bank.

This proposed central European bank would prevent the competition among currencies over a wide economic area, would not confront the challenges of banking reform, would not guarantee a monetary stability which is at least as great as that of the most stable national currency at each moment and would set up, in short, a definitive obstacle to making subsequent reforms in the right direction.

Perhaps the most practicable and appropriate model in the short and medium terms is, therefore, to introduce throughout Europe the complete freedom of choice of public and private currencies inside and outside the Community, linking the national currencies which, for reasons of historical tradition continue in use, to a system of fixed exchange rates. These rates would discipline the monetary policy of each country in accordance with the policy of that country which, at each historical moment, is carrying out the most solvent and stable monetary policy. In this way, at least the door would remain open for some nation-state of the EEC to have the possibility of advancing along the three lines of monetary and banking reform indicated above,[29] forcing its partners in the Community to follow its monetary leadership along the right lines. (This, and

[28]Only in the sense of indirectly getting closer to the ideal should we understand Cernuschi's position, mentioned by Mises (in *Human Action*, p. 446), when in 1865, he said, "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."

[29]The practical problems posed by the *transition* from the current monetary and banking system to a system in which, at last, the creation of money and the banking business were completely separated from the State have been theoretically analyzed and solved by, among others, Murray N. Rothbard in his *Mystery of Banking*, pp. 249–69.

nothing else, appears to have been the essence of the project defended by Margaret Thatcher and the incorrectly named group of "Eurosceptics" who follow her, among whom this author is included, for the monetary future of the EEC.)

It is evident that the definitive work on monetary and banking theory, in the light of the historic controversy taking place between those who favor free banking and those who support a central bank, has not yet been written. Therefore, we are afraid that it is not unrealistic to think that the world will continue to suffer recurrently, very dangerous economic recessions as long as the central banks maintain their monopoly on currency issue, while the privilege granted to the bankers by the governments is not abolished. And, in the same way as we began this article, we would dare to say that, after the historic, theoretical and actual fall of socialism, the main theoretical challenge faced by both professional economists and lovers of freedom well into the next century will consist of fighting with all their strength against both the institution of central banking and the maintenance of the privilege currently enjoyed by those who practice private banking activities.

Egalitarianism and the Elites

Murray N. Rothbard

The Alleged Self-Evidence of Equality

One of the great glories of mankind is that, in contrast to other species, each individual is unique, and hence irreplaceable; whatever the similarities and common attributes among men, it is their differences that lead us to honor, or celebrate, or deplore the qualities or actions of any particular person.[1] It is the diversity, the heterogeneity, of human beings that is one of the most striking attributes of mankind.

This fundamental heterogeneity makes all the more curious the pervasive modern ideal of "equality." For "equality" means "sameness"— two entities are "equal" if and only if they are the same thing. $X = y$ only if they are either identical, or they are two entities that are the same in some attribute. If x, y, and z are "equal in length," it means that each one of them is identical in length, say 3 feet. People, then, can only be "equal" to the extent that they are identical in some attribute: thus, if Smith, Jones and Robinson are each 5 feet, 11 inches in height, then they are "equal" in height. But except for these special cases, people are heterogeneous, and diverse, that is, they are "unequal." Diversity, and hence "inequality," is therefore a fundamental fact of the human race. So how do we account for the almost universal contemporary worship at the shrine of "equality," so much so that it has virtually blotted out other goals or principles of ethics? And taking the lead in this worship have been philosophers, academics, and other leaders and members of the intellectual elites, followed by the entire troop of opinion-molders in modern society,

Murray N. Rothbard (1926–1995) was S. J. Hall distinguished professor of economics at the University of Nevada, Las Vegas and editor of the *Review of Austrian Economics* (1987–1995).

[1]I realize that specialists on bees or ants will point out divisions of labor among various groups of their species, but I remain unconvinced that any individual ant or bee has a "personality" worthy of being honored, mourned, or denounced.

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including pundits, journalists, ministers, public school teachers, counselors, human relations consultants and "therapists." And yet, it should be almost evidently clear that a drive to pursue "equality" starkly violates the essential nature of mankind, and therefore can only be pursued, let alone attempt to succeed, by the use of extreme coercion.

The current veneration of equality is, indeed, a very recent notion in the history of human thought. Among philosophers or prominent thinkers the idea scarcely existed before the mid-eighteenth century; if mentioned, it was only as the object of horror or ridicule.[2] The profoundly anti-human and violently coercive nature of egalitarianism was made clear in the influential classical myth of Procrustes, who "forced passing travellers to lie down on a bed, and if they were too long for the bed he lopped off those parts of their bodies which protruded, while racking out the legs of the ones who were too short. This was why he was given the name of Procrustes [The Racker]."[3]

One of the rare modern philosophers critical of equality made the point that "we can ask whether one man is as tall as another, or we may, like Procrustes, seek to establish equality among all men in this respect."[4] But our fundamental answer to the question whether equality exists in the real world must be clearly that it does not, and any quest "to establish equality" can only result in the grotesque consequences of any Procrustean effort. How, then, can we not regard Procrustes's egalitarian "ideal" as anything but monstrous and unnatural? The next logical question is why Procrustes chooses to pursue such a clearly anti-human goal, and one that can only lead to catastrophic results?

In the context of the Greek myth, Procrustes is simply pursuing a lunatic "aesthetic" goal, presumably following his personal star of every person being precisely equal in height to the length of his bed. And yet, this sort of non-argument, this bland assumption that the ideal of equality needs no justification, is endemic among egalitarians. Thus, the argument of the distinguished Chicago economist Henry C. Simons for a progressive income tax

[2]Thus, the great late-eleventh-century Arab al-Ghazali denounced the idea of coerced equality and sternly warned that any sharing of wealth must be voluntary. See S. M. Ghazafar and A. A. Islahi, "The Economic Thought of an Arab Scholastic: Abu Hamid al-Ghazali (1058–1111)," *History of Political Economy* 22 (Summer 1990): 381–403.

[3]Antony Flew, *The Politics of Procrustes: Contradictions of Enforced Equality* (Buffalo, N. Y.: Prometheus Books, 1981), frontispiece.

[4]J. R. Lucas, "Against Equality Again," *Philosophy* 52 (July 1977): 255.

was that he found inequality of income "distinctly evil or unlovely."[5] Presumably, Procrustes might have used the same sort of "argument" in behalf of the "unlovely" nature of inequality of height had he bothered to write an essay advocating his particular egalitarian program. Indeed, most writers simply assume that equality is and must be the overriding goal of society, and that it scarcely needs any supporting argument at all, even a flimsy argument from personal esthetics. Robert Nisbet was and is still correct when he wrote, two decades ago, that

> It is evident that . . . the idea of equality will be sovereign for the rest of this century in just about all circles concerned with the philosophical bases of public policy. . . . In the past, unifying ideas tended to be religious in substance. There are certainly signs that equality is taking on a sacred aspect among many minds today, that it is rapidly acquiring dogmatic status, at least among a great many philosophers and social scientists.[6]

The Oxford sociologist A. H. Halsey, indeed, was "unable to divine any reason other than 'malevolence' why anyone should want to stand" in the way of his egalitarian program. Presumably that "malevolence" could only be diabolic.[7]

"Equality" in What?

Let us now examine the egalitarian program more carefully: *what*, exactly, is supposed to be rendered equal? The older, or "classic," answer was monetary incomes. Money incomes were supposed to be made equal.

On the surface, this seemed clear-cut, but grave difficulties arose quickly. Thus, should the equal income be per person, or per household? If wives don't work, should the family income rise proportionately? Should children be forced to work in order to come under the "equal" rubric, and if so at what age? Furthermore, is not *wealth* as important as annual income? If A and B each earn $50,000 a year, but A possesses accumulated wealth of $1,000,000 and B owns virtually nothing, their equal incomes

[5]Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), p. 19.

[6]Richard Nisbet, "The Pursuit of Equality," *The Public Interest* 35 (1974): 103, cited in Antony Flew, *Politics of Procrustes*, p. 20.

[7]Cited in ibid., pp. 22, 187.

scarcely reflect an equality of financial position.[8] But if A is taxed more heavily due to his accumulation, isn't this an extra penalty on thrift and savings? And how are these problems to be resolved?

But even setting aside the problem of wealth, and focussing on income, can incomes ever *really* be equalized? Surely, the item to be equalized cannot be simply *monetary* income. Money is, after all, only a paper ticket, a unit of account, so that the element to be equalized cannot be a mere abstract *number* but must be the goods and services that can be purchased with that money. The world-egalitarian (and surely the truly committed egalitarian can hardly stop at a national boundary) is concerned to equalize not currency totals but actual purchasing-power. Thus, if A receives an income of 10,000 drachmas a year and B earns 50,000 forints, the equalizer will have to figure out how many forints are actually equivalent to one drachma in purchasing power, before he can wield his equalizing axe correctly. In short, what the economist refers to as "real" and not mere monetary incomes must be equalized for all.

But once the egalitarian agrees to focus on real incomes, he is caught in a thicket of inescapable and insoluble problems. For a large number of goods and services are not homogeneous, and cannot be replicated for all. One of the goods that a Greek may consume with his drachmas is living in, or spending a great deal of time in, the Greek islands. This service (of continuously enjoying the Greek islands) is barred ineluctably to the Hungarian, to the American and to everyone else in the world. In the same way, dining regularly at an outdoor cafe on the Danube is an estimable service denied all the rest of us who do not live in Hungary.

How, then, is real income to be equalized throughout the world? How can the enjoyment of the Greek islands or dining on the Danube be measured, much less gauged by the egalitarian against other services of location? If I am a Nebraskan, and exchange rate manipulations have allegedly equated my income with a Hungarian, how is living in Nebraska to be compared with living in Hungary? The bog gets worse on contemplation. If the

[8]The progressive income tax, a favorite device of egalitarians to help equalize incomes, neglects the wealth differential. As a result it is scarcely outlandish for multi-millionaires with relatively low annual incomes to support a progressive tax that would cripple rising young, high-income but low wealth, competitors. Cf. Ludwig von Mises, *Human Action*, 3rd rev. ed. (Chicago: Henry Regnery, 1966), p. 809.

egalitarian considers that Danube-enjoyment is somehow superior to enjoying the sights and scenes of Omaha, or a Nebraska farm, on exactly what basis is the egalitarian going to tax the Hungarian and subsidize everyone else? How is he to measure, in monetary terms, the "value of dining on the Danube?" Obviously, the stern rigors of natural law prevent him, much as he would clearly like to do so, from taking the Danube physically and parcelling it out equally to every inhabitant throughout the world. And what of people who *prefer* the views of and life in a Nebraska farm community to the sins of Budapest? Who, then, is to be taxed and who subsidized and by how much?

Perhaps in desperation, the egalitarian might fall back on the view that everyone's location reflects his preferences, and that we can therefore simply assume that locations can be neglected in the great egalitarian re-ordering. But while it is true that virtually every spot on the globe is beloved by someone, it is also true that, by and large, some locations are greatly preferred to others. And the location problem occurs within as well as between countries. It is generally acknowledged, both by its residents and by envious outsiders, that the Bay Area of San Francisco is, by climate and topography, far closer to an earthly Paradise than, say West Virginia or Hoboken, New Jersey. Why then don't these benighted outlanders *move* to the Bay Area? In the first place, many of them have, but others are barred by the fact of its relatively small size, which (among other, man-made restrictions, such as zoning laws), severely limits migration opportunities. So, in the name of egalitarianism, should we levy a special tax on Bay Area residents and on other designated garden spots, to reduce their psychic income of enjoyment, and then subsidize the rest of us? And how about pouring subsidies into specially designated Dismal Areas, again in the pursuit of equal real incomes? And how is the equalizing government supposed to find out *how much* people in general, and *a fortiori* each individual resident, love the Bay Area and how much negative income they suffer from living in, say, West Virginia or Hoboken? Obviously, we can't *ask* the various residents how much they love or hate their residential areas, for the residents of every location from San Francisco to Hoboken, would have every incentive to lie—to rush to proclaim to the authorities how much they revile the place where they live.

And location is only one of the most obvious examples of non-homogeneous goods and services which cannot be possibly equalized across the nation or the world.

Moreover, even if wealth and real incomes are both equalized, how are *people*, their abilities, cultures, and traits, to be equalized? Even if the monetary position of each family is the same, will not children be born into families with very different natures, abilities, and qualities? Isn't that, to use a notorious egalitarian term, "unfair"? How then can families be made equal, that is, uniform? Doesn't a child in a cultured and intelligent and wise family enjoy an "unfair" advantage over a child in a broken, moronic, and "dysfunctional" home? The egalitarian must therefore press forward and advocate, as have many communist theorists, the nationalization of all kids from birth, and their rearing in legal and identical state nurseries. But even here the goal of equality and uniformity cannot be achieved. The pesky problem of location will remain, and a state nursery in the Bay Area, even if otherwise identical in every way with one in the wilds of central Pennsylvania, will still enjoy inestimable advantages—or, at the very least, ineradicable differences from the other nurseries. But apart from location, the people—the administrators, nurses, teachers, inside and outside of the various encampments—will all be different, thus giving each child an inescapably different experience, and wrecking the quest for equality for all.

Of course, suitable brainwashing, bureaucratization, and the general robotization and deadening of spirit in the state encampments may help reduce all the teachers and nurses, as well as the children, to a lower and more common denominator, but ineradicable differences and advantages will still remain.

And even if, for the sake of argument, we can assume general equality of income and wealth, other inequalities will not only remain, but, in a world of equal incomes, they will become still more glaring and more important in weighing people. Differences of position, differences of occupation, and inequalities in the job hierarchy and therefore in status and prestige will become even more important, since income and wealth will no longer be a gauge for judging or rating people. Differences in prestige between physicians and carpenters, or between top executives and laborers, will become still more accentuated. Of course, job prestige can be equalized by eliminating hierarchy altogether, abolishing all organizations, corporations, volunteer groups, etc. Everyone will then be equal in rank and decisionmaking power. Differences in prestige could only be eliminated by entering the Marxian heaven and abolishing all specialization and division of labor among occupations, so that everyone would do

everything. But in that sort of economy, the human race would die out with remarkable speed.[9]

The New Coercive Elite

When we confront the egalitarian movement, we begin to find the first practical, if not logical, contradiction within the program itself: that its outstanding advocates are not in any sense in the ranks of the poor and oppressed, but are Harvard, Yale, and Oxford professors, as well as other leaders of the privileged social and power elite. What kind of "egalitarianism" is *this*? If this phenomenon is supposed to embody a massive assumption of liberal guilt, then it is curious that we see very few of this breast-beating elite actually divesting themselves of their worldly goods, prestige, and status, and go live humbly and anonymously among the poor and destitute. Quite the contrary, they seem not to stumble a step on their climb to wealth, fame, and power. Instead, they invariably bask in the congratulations of themselves and their like-minded colleagues of the high-minded morality in which they have all cloaked themselves.

Perhaps the answer to this puzzle lies in our old friend Procrustes. Since no two people are uniform or "equal" in any sense in nature, or in the outcomes of a voluntary society, to bring about and maintain such equality necessarily requires the permanent imposition of a power elite armed with devastating coercive power. For an egalitarian program clearly requires a powerful ruling elite to wield the formidable weapons of coercion and even terror required to operate the Procrustean rack: to try to force everyone into an egalitarian mold. Hence, at least for the ruling elite, there is no "equality" here—only vast inequalities of power, decisionmaking, and undoubtedly, income and wealth as well.

Thus, the English philosopher Antony Flew points out that "the Procrustean ideal has, as it is bound to have, the most powerful attraction for those already playing or hoping in the future to play prominent or rewarding parts in the machinery of enforcement." Flew notes that this Procrustean ideal is "the uniting and justifying ideology of a rising class of policy advisors and public welfare professionals," adding significantly that "these

[9]On the Marxian ideal of abolishing the division of labor, see Murray N. Rothbard, *Freedom, Inequality, Primitivism, and the Division of Labor* (Menlo Park, Calif.: Institute for Humane Studies, 1971), pp. 10–15 (reprinted 1991 by the Ludwig von Mises Institute); and Paul Craig Roberts, *Alienation and the Soviet Economy*, 2nd ed (New York: Holmes and Meier, 1990).

are all people both professionally involved in, and owing to their past and future advancement to, the business of enforcing it."[10]

That the necessary consequence of an egalitarian program is the decidedly inegalitarian creation of a ruthless power elite was recognized and embraced by the English Marxist-Lenist sociologist Frank Parkin. Parkin concluded that "Egalitarianism seems to require a political system in which the state is able to hold in check those social and occupational groups which, by virtue of their skills or education or personal attributes, might otherwise attempt to stake claims to a disproportionate share of society's rewards. The most effective way of holding such groups in check is by denying the right to organize politically, or, in other ways, to undermine social equality. This presumably is the reasoning underlying the Marxist-Leninist case for a political order based upon the dictatorship of the proletariat."[11]

But how is it that Parkin and his egalitarian ilk never seem to realize that this explicit assault on "social equality" leads to tremendous inequalities of power, decisionmaking authority, and, inevitably, income and wealth? Indeed, why is this seemingly obvious question never so much as raised among them? Could there be hypocrisy or even deceit at work?

The Iron Law of Oligarchy

One reason that an egalitarian political program must lead to the installation of a new coercive political elite is that hierarchies and inequalities of decisionmaking are inevitable in any human organization that achieves any degree of success in attaining its goals.

Robert Michels first observed this Iron Law of Oligarchy, in seeing the Social Democratic parties of Europe in the late nineteenth century, officially committed to equality and abolition of the division of labor, in practice being run by a small ruling elite. And there is nothing, outside of egalitarian fantasies, wrong with this universal human fact, or law of nature. In any group or organization, there will arise a core leadership of those most able, energetic, and committed to the organization, I know, for example, of a small but increasingly successful volunteer, musical society in New York. Although there is a governing board elected annually by its members, the group has for years been governed

[10]Flew, *Politics of Procrustes*, pp. 11–12, 62.

[11]Frank Parkin, *Class Inequality and Political Order* (London: Paladin, 1972), p. 183; quoted in Flew, *Politics of Procrustes*, pp. 63–64.

by the benevolent but absolute autocratic rule of its president, a lady who is highly intelligent, innovative, and, though employed full-time elsewhere, able and willing to devote an incredible amount of time and energy to this organization. Several years ago some malcontent challenged this rule, but the challenge was easily beaten back, since every rational member knew full well that she was absolutely vital to the success of the organization.

Not only is there nothing wrong with this situation, but blessed be the group where such a person exists and can come to the fore! There is, in fact, everything right about a rise to power, in voluntary or market organizations, of the most able and efficient, of a "natural aristocracy," in Jeffersonian terms. Democratic voting, at its best when shareholders of a corporation vote the aliquot share of their ownership of a company's assets, is only secondarily useful as a method of displacing natural aristocrats or "monarchs" gone sour, or, in Aristotelian terms, who have deteriorated from "monarch" to "tyrants." Democratic voting, therefore, is even at its best scarcely even a primary good, let alone a good-in-itself to be glorified or even deified.

During a period in the mid-1960s, the New Left, before it hived off into Stalinism and bizarre violence, was trying to put into effect a new political theory: participatory democracy. Participatory democracy *sounded* libertarian, since the idea was that majority rule, even in a private and voluntary organization, is "coercive," and therefore that all decisions of that organization must be stripped of oligarchic rule. Every member would then participate equally, and furthermore, every member would have to give his or her consent to any decision. In a sense, this Unanimity Rule foreshadowed and paralleled the Unanimity Rule of James Buchanan and of Paretian "welfare economics."

A friend of mine was teaching about the history of Vietnam at the New Leftist Free University of New York, originally a scholarly organization founded by a young sociologist couple. The Free University set out to govern itself on participatory democratic principles. The governing body, the board of the Free University, therefore consisted of the "staff"—the sociologist couple—plus any students (who paid a modest tuition) or teachers (unpaid) who cared to attend the board's meetings. All were equal, the founding staff was no more powerful than any teacher or wandering student. All decisions of the school, from courses taught, room assignments, and on down to whether or not the school needed a paint job and what color the paint should be, were decided by the board, never by voting but always by unanimous consent.

Here was a fascinating sociological experiment. Not only, as one might expect, were very few decisions of any sort reached, but the "board meeting" stretched on endlessly, so that the board meeting expanded to become *life itself*—a kind of Sartrian *No Exit* situation. When my friend left the perpetual meeting each day at 5:00 pm to go home, he was accused of abandoning the meeting and thereby "betraying the collective" and the school by attempting to live some sort of private life outside the meeting. Perhaps this is what the current leftist political theorists who exalt the "public life" and "civic virtue" have in mind: private lives being forsaken on behalf of the permanent floating "civically virtuous" collective meeting of "the community!"

It should not come as any surprise to reveal that the Free University of New York did not last very long. In point of fact, it quickly deteriorated from a scholarly outfit to the "teaching" of New Left astrology, tarot cards, channeling, eurythmics, and whatnot as the scholars all fled before the mass man, or as a sociological Gresham's Law came into action. (As for the founding couple, the female wound up in jail for unsuccessfully trying to blow up a bank, while the male, getting increasingly glassy-eyed, in a feat of sociological legerdemain, talked himself into the notion that the only moral occupation for a revolutionary sociologist was that of radio repairman.)

New Left educational theory, during that period, also permeated more orthodox colleges throughout the country. In those days, the doctrine was not so much that teaching had to be "politically correct," but that the normal teacher-student relation was evil because inherently unequal and hierarchical. Since the teacher is assumed to know more than the student, therefore, the truly egalitarian and "democratic" form of education, the way to put teacher and student on an equal footing, is to scrap course content altogether and to sit around discussing the student's "feelings." Not only are all feelings in some sense equal, at least in the sense that one person's feelings cannot be considered "superior" to others, but those feelings are supposedly the only subjects "relevant" to students. One problem that this doctrine raised, of course, is why the students, or more correctly their long-suffering parents, should pay faculty who are qualified in knowledge of economics, sociology, or whatever but not in psychotherapy, to sit around gabbing about the students' feelings?

Institutionalizing Envy

As I have elaborated elsewhere, the egalitarian impulse, once granted legitimacy, cannot be appeased. If monetary or real incomes become equalized, or even if decisionmaking power should be equalized, *other* differences among persons become magnified and irritating to the egalitarian: inequalities in looks, intelligence, and so on.[12] One intriguing point however: there are some inequalities that never seem to outrage egalitarians, namely income inequalities among those who directly supply consumer services—notably athletes, movie and TV entertainers, artists, novelists, playwrights, and rock musicians. Perhaps this is the reason for the persuasive power of Robert Nozick's famous "Wilt Chamberlain" example in defense of market-determined incomes. There are two possible explanations: (1) that these consumer values are held by the egalitarians themselves and are therefore considered legitimate, or (2) that, with the exception of athletics, these are fields implicitly recognized as dominated nowadays by forms of entertainment and art that require no real talent. Differences in income, therefore, are equivalent to winning at a lottery, and lottery or sweepstake winners are universally lauded as purely "lucky," with no envy of superior attributes to be attached to them.[13]

The German sociologist Helmut Schoeck has pointed out that modern egalitarianism is essentially an institutionalization of envy. In contrast to successful or functional societies, where envy is always considered a shameful emotion, egalitarianism sets up a pervasive attitude that the *exciting* of envy by manifesting some form of superiority is considered the greatest evil. Or, as Schoeck put it, "the highest value is envy-avoidance."[14] Indeed, communist

[12]Murray N. Rothbard, *Freedom, Inequality, Primitivism, and the Division of Labor*, 2nd ed. (1971; Auburn, Ala.: Ludwig von Mises Institute, 1991); and Rothbard, "Egalitarianism as a Revolt Against Nature," in *Egalitarianism as a Revolt Against Nature and Other Essays* (Washington, D.C.: Libertarian Review Press, 1974), pp. 1–13.

[13]Helmut Schoeck refers to the "absolute equality of opportunity that prevails in a game of chance which, as all the players know from the start, can be won only by a very few." Schoeck points out that "the winner of a jackpot is very little envied. This is because of the real equality of opportunity and that absolute fortuitousness of the method of selecting the winner. A wife will not nag her husband for not having bought the right lottery ticket . . . no one could seriously suffer from an inferiority complex as a result of repeated failure." Helmut Schoeck, *Envy: A Theory of Social Behavior* (New York: Harcourt, Brace and World, 1970), p. 240

[14]Ibid., p. 151.

anarchists explicitly aim to stamp out private property because they believe that property gives rise to inequality, and therefore to feelings of envy, and hence "causes" crimes of violence against those with more property. But as Schoeck points out, economic egalitarianism would then not be sufficient: and compulsory uniformity of looks, intelligence, etc. would have to follow.[15]

But even if all possible inequalities and difference among individuals could somehow be eradicated, Helmut Schoeck adds, there still would remain an irreducible element: the mere existence of individual privacy. As Schoeck puts it, "if a man really makes use of his right to be alone, the annoyance, envy, and mistrust of his fellow citizens will be aroused. . . . Anyone who cuts himself off, who draws his curtains and spends any length of time outside the range of observation, is always seen as a potential heretic, a snob, a conspirator."[16] After some amusing comments about suspicion of the "sin of privacy" in American culture, particularly in the widespread open-door policy among academics, Schoeck turns to the Israeli kibbutz and to its widely and overly revered philosopher, Martin Buber. Buber maintained that to constitute a "real community," the absolutely equal members of the kibbutz must "have mutual access to one another and [be] ready for one another." As Schoeck interprets Buber: "a community of equals, where no one ought to envy anyone else, is not guaranteed by absence of possessions alone, but requires mutual possession, in purely human terms. . . . Everyone must always have time for everybody else, and anyone who hoards his time, his leisure hours, and his privacy excludes himself."[17]

The New Group Egalitarianism

So far we have been describing what may be called "classical," or the Old, egalitarianism, aimed to make all individuals in some sense equal, generally in income and wealth. But in recent years, we have all been subjected to a burgeoning and accelerating New Egalitarianism, which stresses not that every individual must be made equal, but that the income, prestige, and status of a seemingly endless proliferation of "groups" must be made equal to each other.

[15]For penetrating examples of this egalitarian dystopia in fiction, see L. P. Hartley, *Facial Justice* (London: Humish Hamilton, 1960) and Kurt Vonnegut, Jr., "Harrison Bergeron" (1961), in *Welcome to the Monkey House* (New York: Dell, 1970), pp. 7–13.

[16]Schoeck, *Envy*, p. 295.

[17]Martin Buber, *Paths in Utopia* (Boston: Beacon Press, 1958), pp. 144ff; Schoeck, *Envy*, pp. 298–99.

At first blush, it might seem that the new group egalitarianism is less extreme or unrealistic than the old individual creed. For if every individual is really totally equal to every other in income, wealth, or status, then it will follow logically that any subset of groups of such individuals will be equal as well. Shifting emphasis from individual to group egalitarianism must therefore imply settling for a less severe degree of equality. But this conclusion misconceives the whole point of egalitarianism, old or new. No egalitarian actually expects ever to be in a state of absolute equality, still less does he begin his analysis with that starting point.

Perhaps we can illuminate the true nature of the egalitarian drive, and the relationship between the Old and the New movements, by focussing not, as is usually done, on their patently absurd and self-contradictory ostensible goals of equality, but on the required means to attain such goals: namely the coming to power of the Procrustean State apparatus, the new coercive elite. Who are the Procrustean elite? That is, which groups are needed to constitute such an elite? By an odd coincidence, the makeup of such groups seems to correspond, almost one-to-one, to those people who have been most enthusiastic about egalitarianism over the years: intellectuals, academics, opinion-molders, journalists, writers, media elites, social workers, bureaucrats, counsellors, psychologists, personnel consultants, and especially for the ever-accelerating new group egalitarianism, a veritable army of "therapists" and sensitivity trainers. Plus, of course, ideologues and researchers to dream up and discover new groups that need egalitarianizing.

If these groups of what might very loosely be called the "intelligentsia" are the driving force of the Old and the New embodiments of egalitarianism, how does this minority hope to convince a majority of the public to turn over an apparatus of despotic power into its hands? In the first place, the intellectuals start with a huge advantage far beyond their relative smallness of number: they are dominant within the "opinion-molding class" that attempts to shape public opinion, and often succeeds in that task. As is always the case, the State rulers need the support of an opinion-molding class to engineer the consent of the public. In the Old Egalitarianism, the would-be rulers sought to bring into their camp, in the first place, the seeming economic beneficiaries of the egalitarian program—the lower-income groups who would be recipients of much of the transfer, or soaking of the wealthy (part of the transfer from the rich, of course, would go into the

coffers of the Procrustean elites themselves, the brokers of the egalitarian wealth-transfer). As for the plundered wealthy, *they* would be induced to support the system by being persuaded that they must expiate their "guilt" at being wealthier than their impoverished fellow-citizens. Infusion of guilt is a classic path of persuading the wealthy victim to surrender his wealth without a struggle.

Any success in the Old Egalitarian program led, of course, to expansion of the number, the wealth, and the power of the new Procrustean elite, resulting in an ever lower income definition of "the wealthy" to be plundered, and an ever higher definition of "the poor" to be subsidized. This process has been all too clearly at work in the United States and in the western world in the twentieth century. From being confined to the highest income brackets, for example, the payers of income tax have descended into the ranks of the far more numerous middle class. At the same time, the "poverty level" to be subsidized and cosseted has marched steadily upward, as the "poverty line" is continually revised upward, and the subsidized escalate from the very poor to the unemployed to the more affluent "working poor."

From the point of view of the egalitarians, however, the weakness of the Old Egalitarianism is that it has only one category of beneficiary—"the poor," however defined, and one category of the plundered, "the rich." (That they themselves are notable beneficiaries is always discreetly left hidden behind the veil of altruism and alleged expertise. For anyone else to bring up to the point would be considered ungentlemanly, or, even worse, to be engaging in the much-derided "conspiracy theory of history.")[18]

In the light of this analysis, then, let us examine the New Group Egalitarianism. As we all know, the new egalitarians search for "oppressed" groups who are lower in income, status, or prestigious jobs than others, who become the designated "oppressors." In classic leftism or Marxism, there was only one alleged "oppressed group," the proletariat. Then the floodgates were opened, and the ranks of the designated oppressed, or "accredited victims," have proliferated seemingly without end. It began with the oppressed blacks, and then in rapid succession, there were woman, Hispanics, American Indians, immigrants, "the disabled,"

[18]It seems to me that what is needed to perceive these relationships is no high-flown "theory," but only a willingness to part the curtains of obfuscation and see what is actually going on, and to acknowledge that the Emperor has no clothes.

the young, the old, the short, the very tall, the fat, the deaf, and so on *ad infinitum*. The point is that the proliferation *is*, in fact, endless. Every individual "belongs" to an almost infinite variety of groups or classes. Take, for example, a Mr. John Smith. He may belong to an enormous number of classes: e.g., people named "Smith," people named "John," people of height 5 feet 10 inches, people of height under 6 feet, people who live in Battle Creek, Michigan, people who live north of the Mason-Dixon line, people with an income of . . . etc. And among all these classes, there are an almost infinite number of permutations. It has gotten to the point where the only "theory" of "oppression" needed is if any such group has a lower income or wealth or status than other groups. The below-average group, whatever it is, is then *by definition*, "discriminated against" and therefore is designated as oppressed. Whereas any group above the average is, by definition, doing the discriminating, and hence a designated oppressor.

Every new discovery of an oppressed group can bring the egalitarian more supporters in his drive to power, and also creates more "oppressors" to be made to feel guilty. All that is needed to find ever-new sources of oppressors and oppressed is data and computers, and, of course, researchers into the phenomena—the researchers themselves constituting happy members of the Procrustean elite class.[19]

The charm of group egalitarianism for the intellectual-technocratic-therapeutic-bureaucratic class, then, is that it provides a nearly endless and accelerating supply of oppressed groups to coalesce around the egalitarians' political efforts. There are, then, far more potential supporters to rally around the cause than could be found if only "the poor" were being exhorted to seek and promote their "rights." And as the cause expands, of course, there is a multiplication of jobs and an acceleration of taxpayer funding flowing into the coffers of the Procrustean ruling elite, a not-accidental feature of the egalitarian drive. Joseph Sobran recently wrote that, in the current lexicon, "need" is the desire of people to loot the wealth of others; "greed" is the desire of those others to keep the money they have earned; and "compassion" is the function of those who negotiate the transfer. The ruling elite may be considered the "professional compassionate" class. It is easy, of course, to be conspicuously "compassionate" if others are being forced to pay the cost.

[19]On the new group egalitarianism, see Rothbard, *Freedom, Inequality, and Primitivism, and the Division of Labor*, pp. 8–15.

This acceleration of New Egalitarianism leads, relatively quickly, to inherent problems. First, there is what Mises called "the exhaustion of the reserve fund," that is, the resources available to be plundered and to pay for all this. As a corollary, along with this exhaustion may come the "backlash," when the genuinely oppressed—the looted, those whom William Graham Sumner once called the Forgotten Man—may get fed up, rise up and throw off the shackles which have bound this Gulliver and induced him to shoulder the expanding parasitic burdens.

The New Egalitarian Elite

We conclude with one of the great paradoxes of our time: that the powerful and generally unchallenged cry for "equality" is driven by the decidedly inegalitarian aim of climbing on its back to increasingly absolute political power, a triumph which will of course make the egalitarians themselves a ruling elite in income and wealth as well as power. Behind the honeyed but patently absurd pleas for equality is a ruthless drive for placing themselves at the top of a new hierarchy of power. The new intellectual and therapeutic elite impose their rule in the name of "equality." As Antony Flew tellingly puts it: equality "serves as the unifying and justifying ideology of certain social groups . . . the Procrustean ideal has, as it is bound to have, the most powerful attraction for those already playing or hoping in the future to play prominent or rewarding parts for the machinery of its enforcement."[20]

In a brilliant and mordant critique of the current ascendancy of left-liberal intellectuals, the great economist and sociologist Joseph Schumpeter, writing as early as World War II, pointed out that nineteenth-century free-market "bourgeois" capitalism, in sweeping away aristocratic and feudal political structures, and challenging the "irrational" role of religion and the heroic virtues in behalf of the utilitarianism of the counting-house, foolishly managed to destroy the necessary protections for their own free-market order. As Schumpeter vividly puts it: "The stock exchange is a poor substitute for the Holy Grail." Schumpeter continues:

> Capitalist rationality does not do away with sub- or super-rational impulses. It merely makes them get out of hand by removing the restraint of sacred or semi-sacred tradition. In a civilization that lacks the means and even the will to guide them, they will revolt. . . . Just as the call for utilitarian credentials has

[20]Flew, *Politics of Procrustes*, pp. 11–12.

> never been addressed to kings, lords, and popes in a judicial frame of mind that would accept the possibility of a satisfactory answer, so 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 victorious defense can possibly produce is a change in the indictment.

The capitalist process, Schumpeter adds, "tends to wear away protective strata, to break down its own defenses, to disperse the garrisons of its entrenchments." Moreover,

> capitalism creates a critical frame of mind which, after having destroyed the moral authority of so many other institutions, in the end turns against its own; the bourgeois finds to his amazement that the rationalist attitude does not stop at the credentials of kings and popes but goes on to attack private property and the whole scheme of bourgeois values.

As a result, Schumpeter points out, "the bourgeois fortress becomes politically defenseless." But,

> defenseless fortresses invite aggression especially if there is rich booty in them. . . . No doubt it is possible, for a time, to buy them off. But this resource fails as soon as they discover that they can have all.

Schumpeter notes that his explanation for rising hostility to free market capitalism at a time when it had brought to the world unprecedented freedom and prosperity, is confirmed by the striking fact that,

> there was very little hostility [to free-market capitalism] on principle as long as the bourgeois position was safe, although there was then much more reason for it; it [the hostility] spread *pari passu* with the crumbling of the protective walls.[21]

At the head and the nerve center of the driving force to take advantage of this bourgeois weakness have been the left-liberal intellectuals, a class multiplied vastly in number by the prosperity of capitalism and particularly by continuing and vast government subsidies to public schools, to formal literacy, and to modern communications. These subsidies not only helped create a huge class of intellectuals, but also have provided them—as well as the

[21]Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Bros., 1942), pp. 137, 143–44.

state apparatus—for the first time in history with the tools necessary to indoctrinate the mass of the public at large.[22] Moreover, since the bourgeois free-market order is deeply committed to the rights of private property, and hence to freedom of speech and the press, by the very principles at the heart of their system, they find it impossible to "discipline" the intellectuals, in Schumpeter's phrase "to bring the intellectuals to heel." Thus, the intellectuals, nurtured in the bosom of free-market capitalist society, take the earliest opportunity to turn savagely on their benefactors, "to nibble at the foundations of capitalist society," and finally to organize a drive for power using their virtual monopoly of the opinion-molding process by perverting the original meaning of such words as "freedom," "rights," and "equality."[23]

Perhaps the most hopeful aspect of this process is that, as the late sociologist Christopher Lasch points out in his new work, the values, attitudes, principles and programs of the increasingly arrogant liberal intellectual elite is so out of sync, so much in conflict, with those of the mass of the American public, that a powerful counter-revolutionary backlash is apt to occur, and indeed at this very moment seems in the process of spreading rapidly throughout the country.[24]

In his sparkling essay, "Equality as a Political Weapon," Samuel Francis gently chides conservative opponents of egalitarianism for expending a large amount of energy in philosophical, historical, and anthropological critiques of the concept and the doctrine of equality. This entire "formal critique," however rewarding and illuminating, declares Francis, is really wide of the mark:

> In a sense, I believe that it has been beating a dead horse—or more strictly, a dead unicorn, a beast that exists only in legend. The flaw, I believe, is that the formal doctrine of equality is itself nonexistent or at least unimportant.[25]

[22]For an illuminating discussion of the use of such subsidies and technology by the political and media elites to manipulate mass support, see Benjamin Ginsberg, *The Captive Public: How Mass Opinion Promotes State Power* (New York: Basic Books, 1986), pp. 86–98.

[23]Schumpeter, *Capitalism*, p. 150.

[24]See Christopher Lasch, "The Revolt of the Elites," *Harper's* 289 (November 1994): 39–49.

[25]Samuel Francis, "Equality as a Political Weapon," *Essays in Political Economy* 10 (July 1991): 2. The essay was originally delivered as a lecture at the Ludwig von Mises Institute's conference on "Equality and the Free Society" in April 1991. Also published in *Beautiful Losers: Essays on the Failure of American Conservatism* (Columbia, Mo.: University of Missouri Press, 1993).

How so? The doctrine of equality is "unimportant," Francis explains, "because no one, save perhaps Pol Pot or Ben Wattenberg, really believes in it, and no one, least of all those who profess it most loudly, is seriously motivated by it." Here Francis quotes the great Pareto:

> a sentiment of equality . . . is related to the direct interests of individuals who are bent in escaping certain inequalities not in their favor, and setting up new inequalities that will be in their favor, the latter being their chief concern.[26]

Francis then points out that "the real meaning" of the "doctrine of equality," as well as its "real power as a social and ideological force," cannot be countered by merely formal critiques. For:

> the real meaning of the doctrine of equality is that it serves as a political weapon, to be unsheathed whenever it is useful for cutting down barriers, human or institutional, to the power of those groups that wear it on their belts.[27]

To mount an effective response to the reigning egalitarianism of our age, therefore, it is necessary but scarcely sufficient to demonstrate the absurdity, the anti-scientific nature, the self-contradictory nature, of the egalitarian doctrine, as well as the disastrous consequences of the egalitarian program. All this is well and good. But it misses the essential nature of, as well as the most effective rebuttal to, the egalitarian program: to expose it as a mask for the drive to power of the now ruling left-liberal intellectual and media elites. Since these elites are also the hitherto unchallenged opinion-molding class in society, their rule cannot be dislodged until the oppressed public, instinctively but inchoately opposed to these elites, are shown the true nature of the increasingly hated forces who are ruling over them. To use the phrases of the New Left of the late 1960s, the ruling elite must be "demystified," "delegitimated," and "desanctified." Nothing can advance their desanctification more than the public realization of the true nature of their egalitarian slogans.

[26]Samuel Francis, *Beautiful Losers: Essays on the Failure of American Conservatism*, pp. 208–9. The Pareto quote comes from Pareto's *The Mind and Society* (New York: Harcourt, Brace, 1935), vol. 2, pp. 735–36.

[27]Francis, *Beautiful Losers*, p. 209.

Notes and Replies

Ethics, Efficiency, Coasian Property Rights, and Psychic Income: A Reply to Demsetz

Walter Block

The Debate over Property Rights

The purpose of the present article is to continue my part in the debate over property rights in which I have become enmeshed with Harold Demsetz. It all began with the publication of my piece (Block 1977a), which was critical of Coase (1960) and of Demsetz (1966, 1967). The second round consisted of Demsetz (1979), in which he replied to my critique (Block 1977a).

Ronald Coase

In his seminal article, Coase (1960) turned the world of economics upside down. It might even be said that with one (longish) stroke of the pen, he created the entirely new sub-discipline of Law and Economics; and that he did so out of the ashes of at least one part of the traditional field as it stood before his onslaught: that occupied by Pigou (1932).

Previously, the view of the profession regarding invasions against another person or his property was the classical liberal one of cause and effect. A was the perpetrator, B the victim. To be sure, there was some equivocation amongst the Pigovians as to whether the proper public policy response to this was to tax A in an effort to force him to stop his depredations, or to give him a subsidy so as to entice him toward this end (ibid., p. 184). But the

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idea of property rights was maintained intact: there was always a clear cut distinction maintained between the violators of that institution and those who suffered thereby.

As well, in the more traditional perspective, wealth maximization was the byproduct of private property rights, rather than the progenitor. In other words, economic considerations was the tail, and property rights was the dog. Locke (1955, 1960), for example, did not ask whether the homesteader was the most efficient utilizer of virgin territory. For this philosopher, it was enough that a person was the first to "mix his labor with the land"; this, and this alone, would suffice to make him the legitimate owner. Following in the footsteps of Locke, libertarian philosophers (Rothbard 1962, 1970, 1982a; Hoppe 1989, 1993; Nozick 1974; Epstein 1985) did not attempt to determine who was the Coasian "most efficient user" of a good, or "least cost avoider" of an accident as a means of assigning rights, blame or punishment. Instead, resort to property rights and strict liability was made.

But all this changed with Coase and his adherents. In this new view, property rights became the handmaiden of so called economic efficiency. The very determination of private property became dependent on cost considerations. Another way to put this is that in the pre-Coasian days, property rights were exogenous to economics. Thanks to Coase and his followers (Demsetz 1966, 1967; Posner 1986; Landes 1971, 1973, 1979),[1] this is no longer true. Now, if anything, economics is the independent variable; property rights have become indigenous on it.

Further, reciprocity was nominated to take the place of previously sacrosanct causal relationships. It was no longer true that the factory that emitted sparks which set ablaze the farmer's crops was at fault.[2] The latter became equally blameworthy, or rather, since it became no longer appropriate to relegate blame to anyone, responsible. Had the farmer not planted in that spot, no harm would have befallen him. Says Coase (1960, p. 37), "[it] is not that the man who harbors rabbits is solely responsible [for damage to neighboring farms]; the man whose crops are eaten is equally responsible."

[1]This is only the tip of the veritable iceberg. These four are perhaps the most prominent of the Coasians. But most economists have now accepted the methodology and tools of analysis pioneered by Coase. Indeed, it is probably no exaggeration to say of virtually the entire profession that we "are all Coasians now." See Samuelson (1976, p. 193) who quotes Milton Friedman to the effect that we are "all Keynesians now."

[2]Indeed, the very concept of "fault" began to sound archaic.

And what was the advice to the judiciary which emanated from this new outlook? Judges were to rule in such a way as to maximize the value of economic activity. Under a zero transactions cost regime, it really wouldn't matter—as far as the allocation of resources was concerned—which of two disputatious parties received the rights in question. If they were given to the person who valued them more, well and good. If not, the loser would be able to pay off the winner so as to enjoy their use. But in the real world of significant transactions costs, in contrast, the juridical determination was absolutely crucial. Whatever the judge decided would endure; there could be no opportunity for mutually beneficial exchange, *ex post*.

From these deliberations emerged, especially in the writings of his followers, the "Coasian" public policy recommendation. The jurist must ignore tradition, property rights, ownership, and the niceties of Lockean homesteading theory upon which all were based, and instead make his award solely in order to maximize wealth. That is, he should find in favor of the disputant who values the rights in question more strongly; the one who, had he lost the court battle in the zero transactions cost world, would have successfully bribed the winner.[3]

Demsetz (1967), for example, went so far as to apply this to matters of freedom. In his view, it doesn't matter—for purposes of resource allocation—whether the army hires the recruit (the volunteer military) or commandeers him (the draft), but then allows him to buy his way out of this predicament.

There is an alternative way of characterizing Coase's very interesting contribution to economics. He maintained, contrary to the prevalent (Pigovian) belief at the time,[4] that under certain circumstances a judicial decision concerning property rights would not affect the allocation of resources.

Take the case of the sparks from the factory which set afire the farmer's flowers. The farmer sues, demanding among other things that the factory add a smoke prevention device, so as to protect his private property rights. Coase argues that under zero

[3]Posner (1986, p. 45) makes this point most succinctly. He states: "It does not follow, however, that the initial assignment of rights is completely immaterial from an efficiency standpoint. Since transactions are not costless, efficiency is promoted by asssigning the legal right to the party who would buy it—the railroad in our first hypothetical situation and the farmer in the second—if it were assigned initially to the other party."

[4]Pigou, of course, also dealt with "positive externalities," not just with property rights invasions.

transactions costs assumptions, resource allocation—whether or not the smoke prevention device is used—will not depend upon the court's finding. If the factory values the right more, it will use that right if its suit finds favor with the judge. That is to say, it will not install the smoke prevention device. Under a negative ruling to it, the factory will purchase these rights from the farmer.

To be sure, the decision from the bench would have *some* effect. States Coase (1960, p. 488), it "would not affect the allocation of resources, but would merely alter the distribution of income as between the two parties, plaintiff and defendant." (Henceforth, I shall refer to this as statement "A.") In other words, the property rights finding of the court may be irrelevant to resource allocation, but it would be of great importance to the wealth positions of the two legal opponents.

Walter Block

The next installment in this brief history of the debate concerns my criticism of Coase and Demsetz (Block 1977a). In that article I attempted to distance myself from Coase on several points. I took the position that not only was Coase required to assume zero transaction costs in order to reach his conclusion, he also needed to make a supposition about the form in which the wealth was held. I maintained that as long as the values of both sides in the legal dispute were real, or general,[5] that Coase's Theorem was correct. However, if these values were psychic or not general across at least a few people, it was incorrect. Alternatively, I took the position that yet another assumption was required by Coase in order to defend his Theorem; namely, that the values could not be psychic or specific to one particular person.[6]

The question to be emphasized is this. How does the farmer bribe the factory, in the case where the farmer values the crop more than the factory, and the court decides against the farmer? With collateral, real, objective, general wealth at stake, there is no problem. That is, if the crop is *worth something* to the factory, or to someone else, the bribe is easy to finance. The farmer can give part of this crop to the factory. But if this is not true, the bribe cannot occur.[7]

My response (Block 1977a) to Coase and Demsetz made the following points:

[5]That is, of value to other people as well as to the owner.

[6]Becker (1964) makes this distinction between general and specific with regard to on-the-job training.

[7]I also assume that the human capital of the farmer can not serve as collateral, or that if it can, it is worth less than the damages in this made up case.

(1) It does matter for resource allocation purposes who wins a property rights lawsuit—even under zero transaction costs conditions, even ignoring the wealth effects of the judicial decision. This is because there is no guarantee that the loser will have the requisite funds with which to bribe the victor, even if he indeed values the bundle of rights under contention to a degree greater than his opponent. Coase had supposed that the payment could be financed out of the greater value; but if this took the form of mere psychic income, it would be unable to do any such thing.

(2) The Coasian advice to the judge is arbitrary, and counterproductive. Due to the subjectivity of costs and evaluations (Buchanan 1969; Mises 1963; Rothbard 1977) and to the impossibility of interpersonal utility comparisons (Rothbard 1977), it is inconceivable for anyone, even a magistrate, to know who is the most efficient user, or the least cost accident avoider. It is extremely difficult to foretell, under the zero transaction costs assumption, who would end up bribing whom. To place such a burden on our court system moreover would be to saddle it with the same task so dismally acquitted by the communist central planning boards in the former U.S.S.R., Eastern Europe, and all throughout the third world.

(3) It is morally problematic to overturn property rights, surely a bedrock of western civilization, even if the purpose is benevolent—to promote utility. It is morally questionable to make legal findings not on the basis of justice but rather wealth maximization.

(4) Yes, a tort is reciprocal, or mutually determined, in the narrow sense that if the victim were not present, it could not have occurred. But by that token, there could never be any real crime. It takes "two to tango," so to speak, and without one of the participants, the dance cannot occur. Where is the murderer, rapist or thief who could not make use of this unique legal defense? All he has to do is plead that but for the presence of the victim, the crime could not have taken place; therefore, the victim is actually a contributor to the villainy. Cause and effect, then, not mutual determination or reciprocity, is the only proper basis for settling disputes over personal or property rights.

Harold Demsetz

The third chapter in this tale was written by Demsetz (1979).[8] In it, he accused me of failing to take into account one of Coase's explicitly made assumptions. Were I to have done so, Demsetz

[8]All otherwise unidentified page number citations refer to this one article.

challenges, I would not have been able to write my critique of Coase, or at least a large part of it.

In Demsetz's own words (p. 98), "The substantive issue has to do with whether or not the assignment of right ownership will alter the mix of output when 'bargaining transactions . . . are costless [and] changes in the distribution of wealth . . . can be ignored.' Coase and I [with a proviso about 'free riders'] say no; Block says yes. Block then presents some examples that appear to refute our analysis, but which really only violate our explicitly made assumption" Henceforth, I shall refer to this statement as "B."

The first thing to notice about B is that it appears without benefit of citation.[9] This makes it difficult to evaluate, because there is no context available in which it can be embedded.

Secondly, A and B are by no means equivalent, although Demsetz appears to treat them as such. The fact that they are not may have led him astray. It is important to realize that Block (1977a) was written in response to a paper which contained A (Coase 1960) not B (Demsetz 1979). Therefore, if A and B are different, while it is of course legitimate and permissable to criticize Block (1977a) for attacking Coase (1960) while violating an explicitly made assumption A, it is by no means permissible to do so with regard to Demsetz (1979), e.g., B.

So we arrive at the issue of whether A and B are equivalent or not. On the face of it, B seemingly undermines the validity of the criticism I launched against Coase (1960), while A does not. This is because B assumes away the possibility of wealth or income effects while A makes no such stipulation.[10] On the contrary, A specifically mentions that the distribution of wealth *will* change.

Thus Block (1977a) does not violate an assumption made by Coase (1960)—the only article it was criticizing on these grounds.[11] My 1977a article is entirely innocent of Demsetz's charge that it attacked Coase on a ground from which he had explicitly absolved himself. In 1977a I claimed merely that under certain circumstances (the farmer has only psychic assets which are specific to him and are thus not attractive to the factory, or anyone else, as would be general assets which are of value to all or many persons) the

[9]Despite numerous efforts, I have been unable to uncover the source of this quotation.

[10]This is a charitable interpretation. One might say, alternatively, that Demsetz didn't really "assume away" wealth or income effects; he just *ignored* them.

[11]In this context, that is. Block (1977a) did indeed go on to take Demsetz (1966) to task, but not for a confusion over specific vs. general wealth. It did so on entirely different grounds.

farmer will not be able to bribe the factory into using the smoke prevention device in the zero transactions cost world, even though he (subjectively, specifically, psychically) values his flowers or crops more than the cost of the smoke prevention device.

In A, Coase merely states that while different court decisions will imply different states of wealth distribution between the farmer and the factory, the use of the smoke prevention device (resource allocation) is invariant with regard to the juridical finding, again, assuming zero transaction costs. Coase is wrong in this contention, as I claimed in 1977 and still maintain; and my utilization of the distinction between general and specific wealth in no way violates any strictures set up by this author, certainly not in statement A.

Let us put this in other words. In A and B there are two different articulations of what may be roughly called "wealth effects." In A, it involves "the distribution of income as between the two parties." In B it concerns the claim that "there are no wealth effects on the demands for the commodities being discussed. . . . and that changes in the distribution of wealth can be ignored." Although these expressions are interchangeable for Demsetz, they are actually quite different.

Wealth distribution

The first case carries a clear implication. It is that Coase and Demsetz are conceding, for the sake of argument, that there may well be changes in the distribution of wealth depending upon whether the judge rules in favor of plaintiff or defendant. However, since they have made no claim one way or another on this matter, no allegation, or even proof—that a change in the distribution of wealth from this source actually occurs—can be counted against their hypothesis.

Coase actually does make such a concession. He does so several times in the course of his 1960 article. Clearly, were any critic, such as the present writer, to have upbraided Coase with the fact that changes in the distribution of wealth would result from different court decisions, Demsetz would be correct in asserting that "Block then presents some examples that appear to refute our analysis, but which really only violate our explicitly made assumption" (p. 98).

Now consider the second case referred to by Demsetz: that "there are no wealth effects on the demands for the commodities being discussed" (p. 98). The meaning of this, in contrast to the first case, would appear to be that both plaintiff and defendant

will spend whatever additional monies awarded to them by the Coasian judge in exactly the same manner. Therefore, no matter which one wins, the same goods and services will be purchased. Thus, there will be no wealth effects on the demands for the commodities being discussed. Here we find the elements of a completely different charge against Block (1977a). In this case I am not guilty of violating the explicit assumption of Coase and Demsetz that changes in the distribution of wealth would result from different court decisions. Rather, I violate their very different explicitly made assumption that both plaintiff and defendant will spend whatever additional monies are awarded to them by the Coasian judge in exactly the same manner.

Let us now turn to Block (1977a) to see which one (or both) of these violations can be found therein.

In my view, neither error is committed. Paradoxically, the best source of this claim is none other than Demsetz himself. Let us quote him in full on this matter:

> [Block] considers a case involving "psychic income" wherein a smoke prevention device can be installed for $75,000 by a factory which, in the absence of such a device, will ruin a neighbor's flower bed because of smoke pollution. The flower bed is worth nothing to anyone else, but to the neighbor it is worth $100,000 because of sentimental value. The factory would not be willing to pay its neighbor more than $75,000, the cost of the smoke cleaning device, for his permission to pollute the air, so, if the neighbor has a right to a soot-free garden, the factory owner would elect to install the smoke cleaning device rather than pay the $100,000 demanded by its neighbor. But if the factory owner has the right to use smoke-producing fuel, the neighbor, being so poor, would be unable (unwilling) to pay the factory owner the $75,000 required to install the smoke cleaning device. With the first assignment of rights, there is a flower garden and no smoke (and there also is less factory output). With the second, there is smoke (more factory output) and no flower garden. The mix of output is contingent on the assignment of rights. True, but only because of the income effect, as can be seen with the aid of figure [1]). (pp. 98, 99)

But Demsetz has misdescribed the case. The flower bed owner is not "unwilling" to pay the $75,000 required to install the smoke cleaning device. Why should he be unwilling? By stipulation, the garden is worth fully $100,000 to him. Surely—in the case under

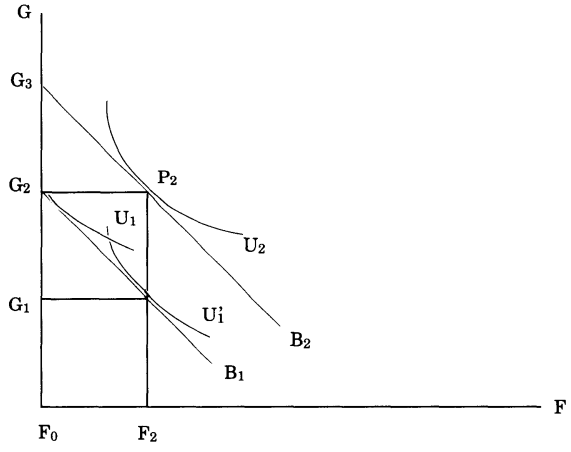

Figure 1
Rights Assignments and Income Effects

Source: Harold Demsetz, "Ethics and Efficiency of Property Rights Systems," in *Time, Uncertainty and Disequilibrium: Explorations of Austrian Themes*, Mario Rizzo, ed. (Lexington, Mass.: D. C. Heath, 1979), p. 99.

discussion where the court assigns the right to pollute to the factory owner—if the farmer had such an amount of funds available to him, he would gladly pay the $75,000 in order to forestall damage to his property valued at $100,000. In this way he could earn a profit for himself of $25,000, the difference between what he must pay to protect his flower bed, and its value to him.

Income effect

Let us now discuss the income effect. A careful reading of Block (1977a) indicates not that there *is* an income effect (which might conceivably violate the Coase–Demsetz explicitly made assumption), but that there is *not*. After all, the flower bed owner starts out with *no income*, and never gets any, at least in the situation where the court awards pollution rights to the factory owner. It is difficult to see how an income effect can be constructed out of such paltry raw material.

Nevertheless, we can try. What of the "income effect" that can be construed to take place between the situation where the court awards pollution rights to the factory owner, and the one where these rights are awarded to the owner of the flower bed? In the former case, the florist has absolutely nothing. He loses his $100,000 flower bed, because he lacks the $75,000 with which to

bribe the proprietor of the factory. In the latter case, he retains the use of this $100,000 flower bed.

One could conceivably call this an "income effect." There are reasons for and against. On the pro side is the fact that the flower lover gains a value, to himself, of $100,000, as between the cases where he is not, and is, awarded the requisite rights. On the con side is the fact that there is no real income or money or wealth involved. It is all a psychic value.

But it is not really important whether one chooses to call this an income effect or not. The issue between Demsetz and myself is whether or not Coase anticipated this sort of "income effect," in which case Block (1977a) has indeed violated explicitly made assumptions. And, as we have seen, this charge cannot be substantiated.

Coase stipulated only that wealth effects as a result of court decisions be ruled out of consideration. I didn't consider them. Instead, I focussed on something entirely different: that one of the parties not have sufficient funds with which to make the requisite bribe. Demsetz conflates the two. *That* is the substantive issue between us.

Obstacles

Now for an even greater challenge. We have seen that Block (1977a) can pass muster with regard to A. Can it do so even for B?

At first glance, this is an impossible task. We have seen that B demands that we ignore wealth distribution changes, while my 1977a article depends intimately upon certain states of the distribution of wealth. These are dependent on court decisions which, in turn, are intimately associated with wealth effects. Nevertheless, from this rather unpromising beginning, it is still possible to reconcile B with Block (1977a).

It can be done by realizing that B is not a statement about comparative statics, as Demsetz seems to think. For him, the problem with Block is that it compares two states of the world: one where the farmer has the right to impose a smoke prevention device on the factory, and one where he does not. Since there is indubitably a change in the wealth position of the farmer when he goes from one of those states of the world to the other, Demsetz sees a violation of B (changes in the distribution of wealth can*not* be ignored) and cries "foul!"

But Demsetz misinterprets Block. This article does not require any dependency on changes in wealth. All it says is that—by use of psychic or specific wealth—a scenario can be concocted in which the Coasian Theorem no longer holds true. No *change* in

wealth is required for this scenario to obtain. All that is necessary is that there be an otherwise penniless farmer who derives more value from his flower bed than the cost of installing a smoke prevention device, and cannot bribe the factory to install it, even though he inhabits a zero transaction costs world. He cannot do so, to repeat, because even though his psychic income is $100,000, and the smoke prevention device costs a mere $75,000, this psychic income is specific to him and him alone. It does not translate into a value recognized by anyone else, particularly including the factory owner. He cannot sell this flower bed to a third party, and use the proceeds to bribe the factory owner. This is because the flower bed, his only possession, is not valued by *anyone* else besides himself.

It is impossible for him to "give up $75,000 of the other goods" (as claimed by Demsetz in his indifference curve analysis) because he simply does not have such funds available to him. We conclude that property rights determinations are relevant to resource allocation. That property rights are *ir*relevant depends upon the loser being able to bribe the winner of the lawsuit; if he is unable to do so, the entire scenario does not arise.

The geometry

This is why Demsetz in figure 1 (p. 99) is misdirected. It depends, crucially, on a nonexistent income or wealth effect. How else can one explain the move in budget lines from G2B1 to G3B2? But there are additional problems with this diagram, and with the analysis that accompanies it.[12] It clearly indicates

[12]It is possible to criticize *all* uses of indifference curves. The main problem is that there is no way to reconcile them with human commercial interaction. In the real world, markets consist of people ranking goods, preferring and setting aside, ordering (Mises 1963; Rothbard 1962). If I buy a newspaper for $.50 it is because I value the paper *more* than $.50. If the vendor sells it to me, it is because he values it *less* than my coins. Technically speaking, there can be no indifference in such a world.

On the other hand, "indifference" is a perfectly good English word, and it must refer to *something* in order to be used coherently. In ordinary language, it refers to cases where we just don't care very much which of two alternatives we choose. But once we act, we demonstrate, by that very fact, that we preferred the option we took to the one we renounced. In common parlance, Buridan's Ass was indifferent to the two bales of hay. However, once he headed off in one direction, as a technical matter of economics we are entitled to say that he preferred the bale toward which he moved to the one he spurned; that there is no way that he, or anyone else for that matter, can *demonstrate* indifference. Even standing equi-distant between the two haystacks, and starving to death, does not demonstrate indifference. It shows only that the stupid animal preferred death to picking one of the bales, either of them.

that Demsetz has not applied the difference between general and specific wealth. Consider his statement:

> If the neighbor has the right to soot-free air, he consumes P2 containing F2 of flowers and G2 of other goods. But since he can sell the right to pollute the air for $75,000, he also can consume no flowers, F0, and G3 of other goods, where G3 - G2 equals $75,000 worth of other goods. He therefore confronts a budget line, B2, that passes through P2 and G3.
>
> The second rights assignment alters the budget line on which he can operate. Given his income and no right to soot-free air, he can consider G2 of other goods and enjoy no flowers or he can give up $75,000 of the other goods, consuming only G1 of these but increase his garden to F2. The second rights assignment, therefore, has reduced his budget line to B1. (p. 99)

The first rights assignment G3B2 is straightforward. As we have seen, I do not criticize Coase only with regard to his case where the farmer is given the right to clean air. He need not do any bribing, here, so no problem arises. The second rights assignment, G2B1, however, is highly problematic. The difficulty is that my assumption (Block 1977a) is that the farmer has no other income, wealth or goods. It is impossible, then, for him to "give up $75,000 of the other goods," because he simply does not have *any* amount of goods available to him (apart from his flower bed), let alone an exalted amount such as $75,000. I therefore continue to maintain that property rights determinations are *relevant* to resource allocation, at least under present assumptions. The Coasian claim to the contrary depends, once again, upon the loser of the judicial decision being able to bribe the winner of the lawsuit; since he is unable to do so, the situation described by Demsetz does not occur.

On the assumption, just for argument's sake, that indifference curves have a legitimate role to play in economics, how can Demsetz's figure 1 be altered so as to be consonant with the analysis of the situation? It is very straightforward. G2P2 should be converted into the x axis. All else on the diagram would simply disappear. My assumption is that the farmer has no money at all and only one flower bed, for which no one else will give anything at all in trade. Therefore, there *is* no budget line. There *are* no terms of trade offered to the farmer. U2 remains, only the part of it above G2 (now the x axis) depicting a "corner" solution at P2: flowers, but no money.

Twist and turn as one may, it cannot be denied that property rights are relevant to resource allocation. Even with zero transaction costs, the entire bribery scenario can never take place, and it is this upon which the Coasians rely in order to maintain the contrary position.

Let us summarize to this point. We have claimed that Demsetz makes two mistakes. First, he falsely ascribes to me the obligation of overcoming objection B against Block (1977a). But I meant this article as a criticism of the Coasian A, not the Demsetzian B. Second, more radically, he fails to show that even B can be used, successfully, to disparage that article. He seems unwilling to apply the distinction between general and specific wealth, and between comparative statics and an unchanging static situation, to this case.

Contrary to fact conditional

This is a rather complex issue. In order to further clarify, let me attempt yet another way of explicating my side of this debate. What *would* I have had to have said were Demsetz to be correct in his criticism that I was attacking Coase on a point of which he was fully aware, and indeed had specifically assumed away in his analysis? To reiterate, Coase said that assuming zero transactions costs, resource allocation would be invariant with regard to the way in which the judge decided nuisance cases (statement A).

Demsetz would have been correct had I attributed to Coase the following: that it doesn't matter, as far as matters of *equity* are concerned, which conclusion the judge reaches; that the economic welfare of each litigant is the same whether the judge finds in his favor or not; that litigants are indifferent to judicial decisions. But for Coase's specific assumption, that Chicago economist *would* have left himself open to such an interpretation. However, because of the fact that this Nobel prize winner did indeed make this assumption, he is guiltless of this charge.

I would have had to have said something along these lines in order to be guilty of the charges leveled against me by Demsetz. In actual point of fact, however, I said no such thing. Instead, I claimed that Coase's mental experiment couldn't work because it depends upon the farmer or the factory *having* an income or wealth with which to bribe its opponent, should it find itself on the losing side of the courtroom battle. If it is only psychic income that the loser can rely upon, no bribe can be financed. But as the Coasian insight depends crucially upon this bribe, the whole scenario falls apart in the absence of the necessary funding.

Even though mistaken, one can readily discern why Demsetz should have confused these two very different concepts. After all, both employ wealth, or income. But we must not lose sight of the fact that they are, at the end of the day, very different. One, Coase's, deals with questions of equity. The other, mine, deals with Coase's major and paradoxical finding, that under the assumption of zero transaction costs, court decisions do not affect resource allocation. Coase, unfortunately, needs one more assumption in order to make good on his discovery: that the benefits to both parties in the dispute must be real; they cannot consist of psychic income alone. But this was precisely my point in Block (1977a).

Background

It is now time to consider several aspects of Demsetz's article apart from those relating to the flower bed-psychic income example. But before we begin, a little bit of context might be in order.

There are several issues separating Demsetz and myself (more broadly, these distinguish from one another the Chicago positivist School of Coase, Posner, Demsetz, et al., and the Austrian-Libertarian School led by Murray Rothbard).

A crucial one is how property rights *should* be defined, in general and in particular in the (real world) situation where transaction costs make post definitional bargaining difficult or impossible. Demsetz's suggestion is that they be defined in such a way as to maximize total wealth. My contention is that the rules of homesteading and voluntary trade be employed instead.

But this is merely my own way of characterizing the dispute. Demsetz sees the matter quite differently. In his view, my discussion rests on "emotionalism," and "strong ethical feelings as to how property rights *should* be defined" (p. 100). Instead of using reason, my views are supported by little or nothing more that the "definiteness with which they are held" (p. 100). In contrast, he is not "emotional," nor given to normative "should" statements. He has far more in his intellectual arsenal than mere definiteness. Further, and perhaps even worse, I employ easy examples to buttress my views, particularly the right to be free of the draft.[13] The remainder of

[13]He allows that this has a certain intuitive appeal, although "the ownership by the gardener of the right to control the soot content of the air does not" (p. 100). As stated, this is something of a straw man, since I never called for *total* control of the air's soot content by the gardener. Rather, following Rothbard (1982b), I took the view that the gardener has the right to be free of invasive interferences with his physical and human property (lungs). As to whether this is intuitively appealing, there is little doubt that in this rabidly ecological oriented age, it certainly is.

Demsetz's (1979) essay is devoted to correcting my many errors and oversights. Let us consider his objections in some detail.

Competition and sports

He starts off by approvingly quoting Frank Knight. According to Knight, there is a strong similarity between "competitive business" on the one hand, and "the sporting view of life" on the other. Both have "a detectable impact on our basic psychological drives" in that in a society earmarked by them, people go out and emulate, or copy others, goal of getting ahead, or succeeding.

But the Knightian analogy between business competition and sports is mistaken. Business competition is a positive sum game, while sports are a zero sum game. Business consists of the concatenation of trades (purchases, sales, hirings, etc.) in a given society. As such, both participants who engage in any particular business arrangement gain, at least in the *ex ante* sense. That is, neither would have agreed to commercially interact with the other did he not expect to improve his condition thereby. In the sporting arena, in contrast, benefits for one do not necessarily benefit the other.[14] On the contrary, when one team scores a goal, for example, far from the other team also gaining an advantage, it actually loses out.[15]

There is a second error as well. Citing sociobiological findings, Demsetz is led to assert that basic inner drives cannot "be modified significantly by the choice of institutional environment" (p. 97). However, unless "significantly" is used tautologically to deny that different economic arrangements can ever alter people's psychological states, it would appear that there is ample evidence to the contrary. After 70 years of communist rule, for example, the tendency of people in the former U.S.S.R. to "barter and truck," in Adam Smith's felicitous terminology, has been vastly attenuated. At the

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However, to be fair to Demsetz, we must realize that he wrote in the late 1970s, long before the advent of modern "greenism."

[14]They might well, however. Both the winning and losing teams may obtain a psychic advantage from playing the game. This is so, for the losers, if their love for the sport outweighs their frustration at being second best.

[15]Let it not be objected that both teams gain revenue from the fact that they can sell large numbers of expensive tickets to an audience if their game is expected to be a competitive one. This is true, and in this regard sports are indeed also mutually beneficial. But this is the sense in which athletic events are actually a competitive business. Both teams, that is, gain not from the game they play with *each other*, but rather from the transaction they are both able to effect with their *customers*. In the pure sense of sport, unrelated to commercial endeavors, one team's gain is still the other's loss.

very least, it has been perverted into something very different than what once it was, or, better yet, what it might otherwise have been. Consider also the different psychological states regarding commercial risk and endeavor that now—in 1995—exist in East and West Germany. Before 1945, the inhabitants of these two areas were one virtually homogeneous people. After experiencing the Sovietization of their economy, there are few in the east of this country who retained the entrepreneurial spirit that characterized the original population, but this still prevails to a great degree in the West.

There is yet another difficulty in Demsetz's introduction: he pays insufficient attention to the distinction between the normative and the positive. It might be too harsh to charge that he totally conflates the two; on the other hand, he seems to think that "ethical judgments about economic organization" are inextricably connected to the "Austrian economics [which] centers on the praxeology of human action" (p. 97). The truth of the matter, however, is that "the simplistic faith of a few libertarians" (p. 98) is totally a normative concern, while, in contrast, the economics of the Austrian school is totally positive (Egger 1979, p. 119; Rothbard 1973a; Block 1975). Also, Demsetz uses his introduction to take a gratuitous swipe at religion (p. 98); but the less said about this the better.

Austrian Pure Snow Trees

Demsetz offers the case of the Austrian Pure Snow Trees, which are owned by a religious sect. This resource is the only cure for cancer, but these islanders will not allow it to be used for that purpose, reserving it instead for religious worship.[16]

Demsetz then asks what I consider to be a very misleading rhetorical question. His challenge: Is it really "'evil and vicious' to believe it would be preferable for someone else to own the right to this ingredient?" (p. 100).

But it is not at all my contention that this state of the world would not be preferable. On the contrary, given his highly emotional example, it is indeed hard to resist the notion that it would be preferable if the trees were used as a cancer cure.

[16]Here is Hamowy's (1978, p. 289) trenchant criticism of Hayek's (1960) version of Demsetz's example: "Is the owner of the spring acting coercively if he refuses to sell his water at *any* price? Suppose, for example, he looks upon his spring as sacred and to offer its holy water to non-believers a sacrilege. Here is a situation which would not fall under Hayek's definition of coercion since the owner forces *no* action on the settlers."

Emotionalism can be a double edged sword, however. As long as our intuitive imagination has been unleashed by Demsetz in this creative way, why not push the envelope a bit? Consider, then, the case where the views of this religious sect are absolutely correct! That is, if the trees are torn down for so idolatrous and unimportant a purpose as curing cancer, then we'll all be consigned to Hell forever. Wouldn't it *then* be "intuitively appealing" to allow the islanders to continue their ownership of these trees?[17]

But this is all somewhat beside the point. For my contention had nothing to do with preferability. Rather, it focussed on what the law should be.[18] It held, specifically, that private property rights are sacrosanct, and should not be overturned, even for "good" purposes. Even though he does not state the issue in this manner, it will be interesting to interpret Demsetz as if he were making the claim not merely that it would be preferable to divert the Pure Austrian Snow trees from prayer to curing cancer, but that the law *should* be employed in this manner; or, at the very least, that seizing the trees is permissible, and should not be interfered with.

It is "interesting" to interpret Demsetz in this way, even though he might resist, for the alternative renders his position totally unintelligible. If all he wishes to assert is that it would be preferable that the Austrian Pure Snow Trees be allocated to curing cancer, then we can perhaps agree with him if the religious fanatics have a mistaken theology, and disagree if they are correct. But all the preferring in the world will not change reality in Demsetz's health oriented direction.[19] For this, the forces of law and order must swoop down on the recalcitrant

[17]Demsetz, in taking the opposite position, is acting as if the cult is erroneous in its religious beliefs. But assume for the moment the "cultists" to be correct in their world view. It would then be justified—according to Demsetz—not only to protect them from the onslaught of the cancer victims, but to seize the assets of the latter if this would in any way help the former. Suppose, that is, that there *was* a cancer cure, owned, now, by the victims of this dread disease, but that for some reason the worshippers determined that this material would help them in their efforts to contact the Deity. Then, according to the logic established by Demsetz, it would be appropriate public policy to forcibly transfer the cure to the control of the religious "fanatics." Surely Demsetz knows nothing—for certain—that would render such a conclusion invalid.

[18]There is all the difference in the world between these two concepts. For example, I might prefer that all ice cream come in one flavor, the one favored most by me. But I would hardly urge the passage of a law which banned all other alternatives.

[19]That is, *physically* health oriented direction. If the worshippers are correct, then it is only their remedy which will achieve *spiritual* health.

zealots,[20] and compel them to yield their Austrian Pure Snow Trees to the medical profession. That is to say, Demsetz must claim that the law *should* be written so as to attain this result, if that is his actual goal.

But if he does so, he is just as un-value-free, and "emotional," as he accuses me of being. *Demsetz* would then be revealing himself as a person with "strong ethical feelings as to how property rights *should* be defined in such cases" (p. 100).

Even mere preferability, let alone legal justice, runs into problems of interpersonal comparisons of utility. As we have seen, there is no warrant, anywhere within the corpus of value-free economics, for us to compare the utilities of one group of people—e.g., "worshippers" with another, "cancer patients"—and to claim that one outweighs the other. Demsetz as a private citizen may engage in all the preferring he wants; but it is impermissible for him to do so *qua* economist.

In his view, "the instrumental nature of property rights is made clear in this Austrian Pure Snow Trees example" (ibid.). Perhaps. A better description for property rights in his philosophy would be "provisional." That is to say, when a "better" use for someone's property is found—curing cancer instead of worshipping—there is at least a *prima facie* case for re-ordering the relevant property rights. He states, "A question of the ownership of this ingredient, unavailable elsewhere, arises" (ibid.). Interesting word, "arises." How is this to be distinguished from advocacy of theft? Can we in this vein say that during the Los Angeles riots of 1992 the question of the legitimate ownership of all of those looted television sets "arose?"

Ethical superiority?

Consider now my claim that "It is the gardener who should have the right to soot free air, and the potential [military] recruit who should have the right to his freedom" (p. 100). Demsetz is highly critical. He states: "One is entitled to an explanation of why these assignments of property rights are ethically superior to their alternatives" (ibid.). We already know of the ethical

[20]"Preferable" is one thing; taking the cancer cure away from the worshippers by force is entirely a different matter. Suppose the religious sect fought back to defend its legitimate ownership of the Austrian Pure Snow Trees, based on "being the first to mix their sweat and blood with the island's soil, thus satisfying Rothbard's principle of 'original ownership'" (p. 100). Would the forces of law and order be justified in doing to them what was done to the Branch Davidian sect in Waco, Texas? No less than that seems to be implied by the Demsetzian analysis.

perspective from which Demsetz chooses between these options: pick that which maximizes wealth or utility, or income. And as we have seen the Achilles heel of his vision—it founders on the rock of interpersonal comparisons of utility—we do well to follow Demsetz's advice and to offer an explanation of our own.

At one level, the most unsophisticated and commonsensical, we have the right to our freedom, and to not have our lungs invaded by soot particles, because of Adam Smith's "Obvious and natural and simple system of liberty" ([1776] 1965). If a woman "owns her own body," as most people would concede, then so, too, do men. If this is true, then slavery, or the draft, is illegitimate. For it means that outside forces can dictate to the supposed owner of the body in question.[21] At another level, people should be free and secure in their persons, at least in the U.S., because our constitution guarantees this.

But perhaps the most powerful basis on which this claim to freedom can be defended is the philosophical. The freedom philosophy is ethically superior to all alternatives because is it necessitated by the laws of logic. Demsetz's position, in contrast, is untenable because it commits a logical contradiction.

This UCLA economist considers himself to be a rational man. He is willing to *argue* his differences with me. Were this not so, instead of writing an article critical of my own, he would have sought to physically abuse me. But in taking this eminently sensible, legal and moral tack, he has necessarily associated himself with certain positions. When the implications of these are elaborated upon, it will be seen that the arguments he uses to refute me are rendered invalid by his very decision to employ argumentative methods against me in the first place.

By engaging in only verbal fisticuffs, and eschewing physical ones, he has conceded my right to my own body; to be secure in my person; to be free of physical invasion. In a word, by the choices Demsetz has made, he has left himself open to the interpretation that he *respects* the freedom of others. Since "actions speak louder than words," we are entitled to discount his anti-freedom verbiage, and to focus on his pro-liberty behavior.

Hoppe explains:

[21]It is also logically inconsistent, since the argument of the draft board is that this system of raising an army is necessary in order to "promote freedom," by protecting the domestic nation from the external aggressor. The problem is, the country which relies on compulsion to attract soldiers for this purpose *starts* off by violating the very rights of the citizenry the war was supposedly engaged in to overcome.

First, it must be noted that the question of what is just or unjust—or, for that matter, the even more general one of what is a valid proposition and what is not—only arises insofar as I am, and others are, capable of propositional exchanges, i.e., of argumentation. The question does not arise vis-à-vis a stone or fish, because they are incapable of engaging in such exchanges and of producing validity claiming propositions. Yet if this is so—and one cannot deny that it is without contradicting oneself, as one cannot argue the case that one cannot argue—then any ethical proposal, as well as any other proposition, must be assumed to claim that it is capable of being validated by propositional or argumentative means. . . . In fact, in producing any proposition, overtly or as an internal thought, one demonstrates one's preference for the willingness to rely on argumentative means in convincing oneself or others of something; and there is then, trivially enough, no way of justifying anything, unless it is a justification by means of propositional exchanges and arguments. But then it must be considered the ultimate defeat for an ethical proposal if one can demonstrate that its content is logically incompatible with the proponent's claim that its validity be ascertainable by argumentative means. To demonstrate any such incompatibility would amount to an impossibility proof; and such proof would constitute the most deadly smash possible in the realm of intellectual inquiry.

Secondly, it must be noted that argumentation does not consist of free-floating propositions, but is a form of action requiring the employment of scarce means; and furthermore that the means, then, which a person demonstrates as preferring by engaging in propositional exchanges are those of private property. For one thing, obviously, no one could possibly propose anything, and no one could become convinced of any proposition by argumentative means, if a person's right to make exclusive use of his physical body were not already presupposed. It is this recognition of each other's mutually exclusive control over one's own body which explains the distinctive character of propositional exchanges that, while one may disagree about what has been said, it is still possible to agree at least on the fact that there is disagreement. And obvious, too: Such property right in one's own body must be said to be justified *a priori*. For anyone who would try to justify any norm whatsoever would already have to presuppose an exclusive right to control over his body as a valid norm simply in order to say "I propose such and such." And anyone

disputing such right, then, would become caught up in a practical contradiction, since arguing so would already implicitly have to accept the very norm which he was disputing.

Furthermore, it would be equally impossible to sustain argumentation for any length of time and rely on the propositional force of one's arguments, if one were not allowed to appropriate next to one's body other scarce means through homesteading action, i.e., by putting them to use before somebody else does, and if such means, and the rights of exclusive control regarding them, were not defined in objective physical terms. For if no one had the right to control anything at all except his own body, then we would all cease to exist and the problem of justifying norms—as well as all other human problems—simply would not exist. Thus by virtue of the fact of being alive, then, property rights to other things must be presupposed to be valid, too. No one who is alive could argue otherwise.

And if a person did not acquire the right of exclusive control over such goods by homesteading action, i.e., by establishing some objective link between a particular person and a particular scarce resource before anybody else had done so, but if, instead, late-comers were assumed to have ownership claims to things, then literally no one would be allowed to do anything with anything as one would have to have all of the late-comers' consent prior to ever doing what one wanted to do. Neither we, our forefathers, nor our progeny could, do or will survive if one were to follow this rule. Yet in order for any person—past, present or future—to argue anything it must evidently be possible to survive then and now. And in order to do just this property rights cannot be conceived of as being "timeless" and non-specific regarding the number of people concerned. Rather, they must necessarily be thought of as originating through acting at definite points in time for specific acting individuals. Otherwise, it would be impossible for anyone to first say anything at a definite point in time and for someone else to be able to reply. Simply saying, then, that the first-user-first-owner rule of libertarianism can be ignored or is unjustified, implies a contradiction, as one's being able to say so must presuppose one's existence as an independent decisionmaking unit at a given point in time.

And lastly, acting and proposition-making would also be impossible, if the things acquired through homesteading were not defined in objective, physical terms (and if, correspondingly,

> aggression were not defined as an invasion of the physical integrity of another person's property), but, instead, in terms of subjective values and evaluations . . .
>
> By being alive and formulating any proposition, then, one demonstrates that any ethic except the libertarian private property ethic is invalid. Because if this were not so and late-comers were supposed to have legitimate claims to things or things owned were defined in subjective terms, no one could possibly survive as a physically independent decisionmaking unit at any given point in time, and hence no one could ever raise any validity claiming proposition whatsoever . . .
>
> As regards the utilitarian position, the proof contains its ultimate refutation. It demonstrates that simply in order to propose the utilitarian position, exclusive rights of control over one's body and one's homesteaded goods already must be presupposed as valid. And, more specifically, as regards the consequentialist aspect of libertarianism, the proof shows its praxeological impossibility: the assignment of rights of exclusive control cannot be dependent on the—"beneficial" or whatever else—outcome of certain things; one could never act and propose anything, unless private property rights existed already prior to any later outcome. A consequentialist ethic is a praxeological absurdity. Any ethic must, instead, be "a prioristic" or "instantaneous," in order to make it possible that one can act here and now proposing this or that, rather than having to suspend acting and wait until later. Nobody advocating a wait-for-the-outcome ethic could be around anymore to say anything if he were to take his own advice seriously. And to the extent that utilitarian proponents are still around, then, they demonstrate through their actions that their consequentialist doctrine is, and must be, regarded as false. Acting and proposition-making requires private property rights now, and cannot wait for them to be assigned only later. (Hoppe 1993, pp. 204–7)

What Demsetz does in speaking out against freedom and property rights, but *acting* in a manner compatible with them, is to engage in a performative contradiction. This is logically identical to a person stating "I am unconscious." Here, behavior belies a mere verbal claim. Demsetz's view of property rights, is, of course, a utilitarian one. As he sees things, one cannot define matters in this regard "a prioristically." Rather, they must be defined in terms of beneficial consequences; in his case, wealth maximization.

You got to have heart

Let us extend the Demsetzian argument in yet another dimension. Suppose that it was not the islanders's trees that could cure cancer, but rather their hearts. That is, the only way to save the sufferers from this disease would be to kill, not the Austrian Pure Snow Trees, but their owners, the members of this religious sect, and then to take their hearts, chop them up, and feed them to cancer victims. Would Demsetz ("emotionally") support this "modest proposal" to do just that? It is hard to say. From his perspective, he would have to ascertain the answer to a series of empirical questions before he could vouchsafe us an answer: What is the rate of transformation between dead cultists and live cancer patients; e.g., how many islanders would have to be murdered (killed? final solutioned? homesteaded? harvested?) in order to save how many cancer victims? Which group has higher incomes? Which has more members? Would this act set up anti-wealth precedents for the future? Who are more productive—wealth maximization is the criterion—the heart "donors" or recipients? The only constant in the world of Demsetz (the writer, that is, who ideologically contemplates the justification of theft, enslavement, murder; not the man whose actions show he refrains from engaging in initiatory violence) is the overwhelming need to increase wealth.[22]

Ultimately, there are only two ways of settling such problems. All others are merely combinations and permutations of these two. On the one hand, there is a provisional or instrumental property rights system. Here, holdings are secure only as long as no one can come up with a plausible reason for taking them away by force. Under this system, either dictators or majorities (or dictatorial majorities) hold the key to property rights. The difficulty is that there are no moral principles which can be adduced to derive any decisions. Presumably, utility or wealth or income maximization is the goal; but due to the utter impossibility of interpersonal comparisons of utility, this criterion reduces to arbitrariness.

On the other hand is a thoroughgoing and secure property rights system. Here, one owns one's possessions "for keeps." The only problem here is the temptation to overthrow the system in order to achieve some vast gain, such as the cure for cancer.[23] But

[22]How is *that* justified as "ethically superior to alternatives?" (p. 100).

[23]Demsetz's example is so forceful by virtue of the fact that he expects his readers will consider a cure for cancer to be more valuable than a pagan rite—he knows it is likely they will engage in interpersonal comparisons of utility.

these temptations are easily resisted as they are inevitably imaginary and artificially constructed. We have yet to be presented with a real world example where there is a clear cut case for massive property rights violations.[24]

Note how far from reality Demsetz must remove himself in order to manufacture an example that is intuitively consonant with his support[25] for what in any other context would be considered murder (hearts) or theft (trees) or slavery-kidnapping (draft).[26] It is perhaps possible—in the sense that it would not be logically contradictory—to cite an actual case where a great boon to millions of people is denied by a recalcitrant minority, on seemingly frivolous grounds.[27] In very sharp contrast indeed, resort need not be made of fanciful examples to defend the libertarian vision.

Here is another problem. It is Demsetz's view that in the world of zero transaction costs, it doesn't matter (for resource allocation purposes, not for the distribution of wealth) who gets the cancer cure trees. Surely in this case transaction costs are very low. There are very few worshippers. It is just a small cult. They are all located on one small island. (If nothing else, the world wide publicity attendant upon the discovery of the magic trees would undoubtedly reduce transactions cost to near zero.)

If we wish, we may even suppose that there is only *one* worshipper (to get closer to the case of the single farmer with the flowerbed). Under these conditions, Demsetz is logically obliged to maintain that if the Deity is more important than physical health, the Pure Austrian Snow trees will (and *should*) continue to be utilized for prayer; on the other hand, if the cure is worth more than the worship, the trees will (and *should*) be used for

[24]I am not objecting to the technique of artificial constructions *per se*. Hypothetical arguments have their undoubted philosophical use. The point being made here, in contrast, is that libertarian rules are only inconsistent with broad based utilitarian concerns in the imagination, not in reality.

[25]I must say "possible support" in this case, since he hasn't consented to this proposition.

[26]However, the draft during World War II furnishes what for many people would be a counter example.

[27]The tree worship is frivolous only to us; to the members of Demsetz's fictitious religious sect, this practice is anything but. Otherwise, they would hardly withhold a cancer cure from a suffering humanity. In any even remotely real world situation, possibly, some of their own number might have cancer. Alternatively, the money that would be forthcoming from highly motivated purchasers would likely sway them to go off and worship some other kinds of entities.

medicinal purposes. In any case, there is no case for forcibly transferring these trees from the cultists to those afflicted with cancer. The "market" will tend to ensure that the Austrian Pure Snow Trees will come to be owned by those who value them most.

By use of this example we have furnished ourselves with yet another refutation of the Coase Theorem. If under zero cost conditions the sale from islanders to doctors does not take place on its own, this is *prima facie* evidence for the claim that the trees are worth more to the worshippers than to the victims of cancer. A cancer cure, after all, can only improve the body. Worship aims higher, at the soul.

To be sure, Demsetz asserts that "the religious sect will in no way, for any compensation, allow that ingredient to be extracted" (p. 100). So what? On his own premise, this just shows that the worshippers value the Austrian Pure Snow Trees more than alternative users. If true, this cuts against his own claim that resource allocation is invariant with respect to decisions as to property rights, given zero transaction costs.

In contrast, the libertarian need ask none of these questions. For this philosophy it is sufficient that the religious fanatics, not the cancer victims or their agents, own the curative hearts, or the Austrian Pure Snow Trees. And it really doesn't matter whether it is body parts, trees, or anything else that is the property in question.

There is yet another problem with Demsetz's analysis of the Austrian Pure Snow Trees. And this difficulty is pinpointed by no less an authority on property rights theory than Richard Posner (1986). According to him as long as there are zero transaction costs, there is no warrant for seizing the property of another. On the contrary, this is the purpose of markets: to transfer goods from those who value it less to those who value it more.

He states:

> The landowner's right to repel a physical intrusion in the form of engine sparks is only a qualified right. The intruder can defeat it by showing that his land use, which is incompatible with the injured landowner's, is more valuable. But if your neighbor parks his car in your garage, you have a right to eject him as a trespasser no matter how convincingly he can demonstrate to a court that the use of your garage to park his car is more valuable than your use of it.
>
> The difference between the cases is, at least on a first pass at the problem, the difference between conflicting claims and conflicting uses. In general, the proper [because cheaper and more

> accurate] method of resolving conflicting claims is the market. If your neighbor thinks your garage is worth more to him than to you, he can pay you to rent it to him. But if he merely *claims* that he can use your garage more productively, he thrusts on the courts a difficult evidentiary question: Which of you would really be willing to pay more for the use of the garage? In the spark case, negotiation in advance may be infeasible because of the number of landowners potentially affected, so if courts want to encourage the most productive use of land they cannot avoid comparing the values of the competing uses. (Posner 1986, pp. 48–49)

So there we have it. If Posner, another Coasian traditionalist, is correct, Demsetz's critique of my article cannot be sustained. For the garage and the snow trees examples are directly analogous. One must, according to Posner, *convince* the garage owner to rent it to the would be user. If one cannot do so, one must do without the services of the garage. The clear implication is that this applies as well to the cancer victims. If they can convince the religious sect to sell them the Austrian Pure Snow Trees for medicinal purposes, well and good. If not, and Demsetz posits this, then, at least according to Posner, the religious group has the "right to eject [the cancer victims] as a trespasser no matter how convincingly [they] can demonstrate to a court that the use of the [snow trees to cure cancer] is more valuable than your use of it" for purposes of prayer. Demsetz's argument, then, is not only with me. It is also with Posner.

Tennis, Anyone?

Next, consider Demsetz's analysis of the tennis game. Here, he attempts to show that my philosophy cannot reconcile the demand for noise on the part of tennis players with that for peace and quiet on the part of would be sleepers, while his Chicago Law and Economics perspective can accomplish this task.

As he sees this matter, there really is no debate at all. The *only* way to settle the dispute between tennis players and sleepers is through the use of the Coase–Demsetz insights. All that needs to be done is to determine the value to each side of daytime and evening accommodation, and (on the assumption of high transaction costs which preclude rearranging property rights) have the judge rule in such a way that the group which benefits more attains the property rights in question. In that way wealth will be maximized, and resources used "efficiently."

Since, in Demsetz's opinion,

> the dollar value of benefits of assigning rights over noise levels during nighttime hours to would-be sleepers *plausibly* exceeds the dollar value of costs thereby imposed on would-be nighttime tennis players (p. 101, emphasis in original),

the decision is easy and straightforward. Only an Austrian Pure Snow Tree cultist could fail to see this: grant the after dark noise rights to the sleepers.

> Similarly, the assignment to tennis players during daytime hours of the right to control noise levels yields a dollar value of benefits that exceeds the dollar value of costs imposed on neighbors. (ibid.)

So, give the nod to the netmen during the day.

But there are problems with this. First is the issue of information. How is the judge supposed to know who values which asset more highly?[28] We have stipulated that there are no possible markets, given out of reach transaction costs. In their absence, such a determination is impossible.

Yes, it seems reasonable to suppose that people would rather sleep at night and play tennis during the day. But is this always so? Might there not be "night people" who prefer the exact opposite? If so, wouldn't Demsetz's advice to the court lead to wealth reduction, and *in*efficiency?

Note that when discussing the night situation, Demsetz only goes so far as to say that it is *plausible* that the sleepers value the midnight hours more than the jocks. However, when it comes to the hours of sunlight, there is no modifier at all. Demsetz in this case contents himself with the claim that during these hours the right to control noise "yields" more to the racket wielders than to the pillow wielders. Why the difference? Is it that Demsetz mentions the evening case first, and is tentative about this somewhat dubious position, as well he should be, but then gets into the "rhythm" of the thing, and by the time he reaches the daylight hours, has picked up some momentum, and is therefore now more sure about who values what to a greater degree? If so, this seems rather a weak foundation on which to base the edifice of property law. Sure, it is "plausible" to make the Demsetzian supposition; but the very opposite is "plausible" as well. Out of

[28]See Cordato (1989, 1992); North (1992); Krecke (1992).

such raw material it is rather difficult to construct an edifice that will withstand the rigors of everyday events.[29]

Not content to criticize my tennis game, Demsetz throws his racket at Rothbard as well. He castigates his views about homesteading and original ownership as "hopelessly superficial and vague." He claims that "such a criterion (could not) be applied to the conflict over decibel levels between would-be tennis players and sleepers" (p. 107).

How would Rothbard's philosophy work in the present case? Simple. Whoever "got there" first would decide whether tennis could be played at night or not.

For example, consider town A, which was first settled by night owls. They sleep all day long. But when the sun sets, the inhabitants come sailing out of their homes, ready to do battle across the tennis net. Sleep? Not in town A—at least not at night. There must be a vampire gene in there somewhere.

The point is, from the Lockian–Rothbardian perspective, the after dark athletes have *homesteaded* the rights to make noise during the evening. But not any old noise. Only the decibel levels appropriate to tennis. If a normal person moves into town A and complains about nighttime tennis playing, he will have no recourse at law, nor should he. This is because the right to play ball at all hours of the evening is *owned* by the tennis buffs. However, if these people suddenly escalate, and begin playing steel drums at night, or turn their "ghetto blasters" onto high gear at 3:00 a.m., it is *they* who will be guilty of a rights violation, since the night sleepers in town A are entitled to the limited peace and quiet afforded them by tennis, but no less than that.

As well, tennis playing would be strictly prohibited during the day, when the inhabitants of A take to their beds. This is because, by assumption, it is the sleepers who have homesteaded the rights to peace and quiet during daylight hours.

[29]True, far more people hold day jobs than night jobs. Therefore there are far more "day people" than "night people." If we can infer interpersonal comparisons of utility from so light a straw (not likely!), we can then indeed agree with Demsetz that in the general case wealth will be maximized by allowing noise to emanate from the tennis court during the hours of light, not darkness. But even here we cannot be sure that this will hold true in any specific case.

On the other hand, the situation in very hot climates would seem to cut against Demsetz's supposition. There, the only practical time to play tennis is at night, since it is somewhat cooler then. One might as well sleep (take a siesta) during the day, for this reason. (I owe this point to Karen Selick.) Are we then to have one set of property rights for the nothern climes, and a different one for the southern? Suppose that the temperature changes, due to global warming, or cooling. Should we then change the previous set of property rights?

Town B, in contrast, is more "normal." They sleep at night, and work and play while the sun still shines. Anyone engaging in an act of tennis there at night would and should be forced to cease and desist, because he would be trespassing on the property rights of the sleepers who had homesteaded quiet evening hours.

We can now return to the Demsetz critique of my analysis. In his view,

> *Both* rights assignments are equally private and both seem equally productive of individual freedom. Neither exhibits any obvious ethical superiority over the other even when one's preferences are highly weighted in favor of individual freedom. (p. 101)

But it is clear that under the homesteading assumptions we have made, Demsetz is in error. It is not true that *both* rights assignments are compatible with the libertarian code. On the contrary, only one is appropriate for town A, and a very different one is appropriate for town B.

Demsetz claims that "Neither exhibits any obvious ethical superiority over the other even when one's preferences are highly weighted in favor of individual freedom" (p. 101). But in this he is again mistaken. The Lockean system is far more heavily weighted in favor of individual freedom than is that which emanates from the Chicago Law and Economics tradition. In the former case, property rights are "for keeps," as we have seen. Once they are established, through homesteading, no court can trifle with them. All justification of property titles is traceable to this original ownership, plus a legitimate process of transfer (Nozick 1974). In contrast, in the latter case the courts can always break into the voluntary chain of market transactions, and render them asunder. Harking back to the Posner insight, freedom consists of keeping your own garage if you wish, despite the claims of others, no matter *how* plausible. In my philosophy, this is guaranteed. In Demsetz's there is at best a presumption in this direction. But the door is always open. The judge must decide cases on their "merits," with, presumably, little "favoritism" in the direction of extant owners.

Property Rights Definitions

Another of Demsetz's parries reads as follows:

> Once a private property rights system is defined . . . it can be expected that subsequent negotiations will *tend* to tolerate only efficient uses of scarce resources. (p. 101)

This, it must be allowed, makes perfect sense. Once property rights limitations are clearly made, the market is perfectly capable of "bartering and trucking" them around in a way that pleases all parties to any agreements. But the key, here, is that property rights be clearly delimited, and reliably be expected to endure. If not, it is extremely unlikely that any deals will be made on the basis of them.

But this is something that Demsetz, at least during his Austrian Pure Snow Trees example, steadfastly refuses to do. There, he eschews "for keeps" property rights systems. If he did so in that context, however, he cannot logically utilize them in the tennis example.

Demsetz dismisses as "hopelessly superficial and vague" Rothbard's eminently sensible view that

> every man has the absolute right of property in his own self and the previously unowned natural resources which he finds, transforms by his own labor, and then gives or exchanges with others. (p. 107)

In particular, Demsetz casts aspersions on the contention that this dictum could be applied to the tennis at night conflict.

However, the libertarian theory of private property rights most certainly can be applied to this case, as to every other. Of course this does not

> mean that everyone has the right to use his person as he pleases, for the very question of defining private property rights is that of determining what can and what cannot be done by one's self. (ibid.)

But Rothbard in the above quoted statement certainly does answer "the very question of defining private property rights." He agrees, moreover, "that [it consists] of determining what can and what cannot be done by one's self." Demsetz in contrast is simply not open to even consider the common sense notion that homesteading, trade, exchange, etc., can serve as a rule by which boundaries can be placed between one person's fist and another's chin.

Now it is one thing to assert that the libertarian property rights rule is inferior to his own. Demsetz, however, is not merely claiming this. In this section of his paper, he attempts to maintain that the homesteading rule is incoherent; incapable, even, of unambiguously—albeit wrong headedly—settling boundary disputes. But surely this is erroneous. The Lockean–Rothbardian

method, whatever its flaws,[30] is after all buttressed by hoary tradition. It, not the Coasian vision, is the established order, at least outside of the economics profession.

Interpersonal Comparisons of Utility

In this section of his paper Demsetz launches a blistering attack on Murray Rothbard. Specifically, Demsetz[31] takes issue with Rothbard's claim that "the free market always benefits every participant, and it maximizes social utility *ex ante*" (p. 105). His criticism is that Rothbard relies on interpersonal comparisons of utility, "a notion fraught with pitfalls and arbitrariness" (ibid.). This is rather remarkable, emanating as it does from a person, Demsetz that is, who advocates allocating property rights on the basis of their divergent values to different people. This, it would appear, is a paradigm case of the pot castigating the kettle for being black.

But even if Demsetz himself relies on interpersonal comparisons of utility, that does not mean that Rothbard is guiltless of this serious charge. Is he? At first glance, the case against Rothbard seems strong. He does resort to the problematic phrase "social utility," and Demsetz, reasonably enough, maintains that "The maximization of 'social' utility implies interpersonal comparisons of utility" (ibid.).

The problem, here, is that Demsetz has not carefully read this quote. He fails to take cognizance of the import of the phrase "every participant." Strictly speaking, there are only *two* participants in every trade. (The free market is no more than the concatenation of all such trades.) And surely, at least in the *ex ante* sense, *both* parties to the commercial interaction benefit. That is, "the free market always benefits every participant" or *all* participants. It is in this sense, and this sense alone, that the market maximizes "social utility." Interpersonal comparisons of utility simply do not enter the picture. If I buy a newspaper for $1.00, then *both* the vendor and I benefit. We (the two of us, that is) *all* gain. *Every* one of the two of us is better off. Social utility increases. That is, the total utility of myself and the vendor rises.

[30]Such as that furnished by the Austrian Pure Snow tree cancer cure example. The fact that he offered this criticism is evidence of the fact that he *does* consider homesteading to be logically coherent, even if wrong. His analysis in that section of the paper is thus incompatible with that which appears in this section.

[31]It is somewhat difficult to discern whether or not Demsetz is quoting Rothbard accurately, and in context. This is because Demsetz, again, fails to cite his source. Efforts on the part of the present author to trace down this citation again proved to be of no avail.

This is not due to a comparison of his utility and my own, but rather to the fact that the utility of *each* of us, in the *ex ante* sense, is enhanced by the trade. In this sense, also, there is unanimity: *all* of the trading partners, me and the newsdealer, the totality of the two participants, unanimously agree to interact in this manner in the expectation of gain.

Demsetz sees matters very differently. For him, the market yields both "beneficial *and* harmful effects" (p. 105). The beneficial effects are easy enough to discern, but from whence spring the harmful ones? For Demsetz, it is not true that there are only two participants in each market engagement. Rather, there are, at least potentially, thousands of third parties: competitors, buyers and sellers of complements and substitutes. As well there are the external[32] diseconomic effects, which give rise to people for whom the traders' utility enters their utility functions in a negative direction.[33] Demsetz correctly sees that if the views of all of these people have to be considered before any trade could take place, that is, if the market prohibited such "harmful effects," commercial activity would quickly grind to a halt, an abrupt one. In his view, a system that did prohibit such harmful effects, "such as one based on the unanimity principle, would be . . . intolerably impractical" (ibid.).

So there we have it. For Rothbard, unanimity is the guarantee that trade will maximize the social utility of the market. For Demsetz, unanimity is the hangman's noose of the business; once give it credence, and there can *be* no market.

How can we decide between these two starkly contrasting views? I propose that we do so based upon the one principle that both these economists claim to hold firm: the impermissibility of interpersonal comparisons of utility. One of their views is compatible with this stricture, and one is not. We will reject the one that is inconsistent with this agreed upon doctrine.

On this basis, it is clear that Demsetz is in logical hot water. On the face of it, his views cannot be reconciled with the impermissibility of interpersonal comparisons of utility. Remember that for him the market is the source of both "beneficial *and* harmful" (p. 105) effects. If we are to be able to sustain the claim that the market, on net balance, is utility enhancing (let alone maximizing) we must claim that the beneficial effects *outweigh*

[32]For a critique of the literature supporting this perspective, see Block (1983); and Hummel (1990).

[33]We need not mention positive external economies, since these would be listed under beneficial, not harmful, effects.

the harmful ones. But to do any such thing would surely be an instance of interpersonal comparison of utility. Remember also that it is impossible to apply this criticism to Rothbard. For in his view it is not true that there are beneficial and harmful effects which must be weighed, one against the other, thus giving rise to interpersonal comparisons of utility difficulties. On the contrary, the market for him is the unambiguous locus of utility enhancing activity (always in the *ex ante* sense.)[34]

Demsetz tries an end run around this objection. Although valiant, and even brilliant, it unfortunately fails. He argues that his perspective doesn't need to rely on interpersonal comparisons of utility because the market itself will determine whether or not the harm outweighs the benefit. As an example he mentions the introduction of a new product which benefits customers, but hurts their previous suppliers:

> The open market will allow the innovation to succeed only if customers and new product producers . . . are benefitted more than competitive sellers are harmed. If the customers experience a gain worth $100 by shifting their trade to the innovator while the sellers they leave suffer a loss of only $80 as a result, then these sellers will be unwilling to cut prices sufficiently to hold their customers. Whereas, if these sellers suffer a loss of $150 if customers switch, they would be willing to cut prices sufficiently to retain patronage. The innovation succeeds only if the gains it confers, measured in dollars, exceed the cost it imposes. (pp. 105–6)

The problems with this are manifest. The first is based on my original criticism of Coase in terms of psychic income. Consider the situation of the seller who suffers a loss of $150. According to Demsetz, this person would in effect bribe the fleeing customers to return to the fold. But suppose that their loss takes the form of psychic income, and that they do not have the wherewithal to make the bribe. Under these conditions, the scenario falls apart. Second, we must assume perfect competition,[35] in that Demsetz mentions "competitive sellers." But under perfect competition,

[34]Praxeologically, the claim of utility enhancement must be limited to the *ex ante* sense. But as a matter of practicality, the presumption is that trades, particularly if they are ongoing, promote utility gains for both parties in the *ex post* sense as well. One could, conceivably, purchase a one shot item (a meal while on the road, a toy bought on impulse) and not achieve a utility gain *ex post.* But this can hardly often apply to repeat purchases.

[35]The Austrians, of course, need do no such thing. For a critique of this notion, see Rothbard (1962); Armentano (1972, 1982); Armstrong (1982); Block (1977b).

profits are assumed to be zero, and full employment of all land, labor and capital is a given. Why, then, under these wierd and exotic conditions, would anyone even notice the departure of customers, much less offer to *do* anything about it? Third is the problem that Demsetz here covers only pecuniary externalities. But what about real externalities? What about soot pollution, for example? How is the market going to determine whether the benefits are greater than the costs, without engaging in the odd sport of interpersonal comparisons of utility? Demsetz tosses about figures such as $80, $100, $150; this is all well and good as a hypothetical example. But when push comes to shove, interpersonal comparisons of utility are required if we are to determine real world values. In contrast, the Lockean–Rothbardian position[36] clearly need not rely on interpersonal comparisons of utility. The first settler is entitled to either clean or dirty air, whichever he established before the advent of the second settler. The latter must accept the situation as he finds it.[37] The issue of interpersonal comparisons of utility does not arise.

Fourth, Demsetz is in effect arguing that we don't really need extraneous doctrines such as the homesteading principle to determine property rights. Instead, the market can do this for itself without resort to interpersonal comparisons of utility via the principles adumbrated to us in the case of the introduction of the new product. But this is a serious mistake. The market is merely the totality of all trades. Before any commercial interaction can properly take place, the issue of legitimacy must be faced. I may give you $1 for a newspaper, but if this arrangement is to be part of the *free market*, it must be assumed that each of us has valid title to that which we are giving up. For example, if I stole the $1, or you the newspaper, this contract,

[36]See Block (1990), and Rothbard (1982a).

[37]Does this mean that a person who moves into a dangerous neighborhood, e.g., Harlem in New York City, must not protest at the epidemic of crime he finds there? Not a bit of it. The cleanliness of the air, and noise pollution at different times of day or night, *define* the property rights in operation there. They determine what the newcomer can homestead, and what is owned by others. (I owe this example to Ben Klein.)

Crime, in contrast, is an attack on the person or property of the new settler. These are objects over which he has clear title before he came to inhabit the new area. For example, his own body. As a self owner, he has a right not to be murdered. If this happens to him, he (his estate) has the right to the fullest compensation allowed by law, even if the "reasonable man" would not have ventured there in the first place. If he brings property such as a car with him, and people trespass upon it, they have no right to do so even if this is the practice common in Harlem. Presumably, Posner would rise to the defense of anyone victimized in such a manner.

however described, cannot be considered part of the free enterprise system. To deny this is to argue in a circle. It is to say that market activity can be based, ultimately, upon market activity.

This circularity is too much for even Demsetz to incorporate into his philosophy. Indeed, he states:

> The definition of rights by the legal system, which precedes market negotiations, of course, does not have the benefit of market-revealed information when ownership decisions are made. (p. 106)

But if this is so, how can he logically maintain that the market is sufficient unto itself to define property rights?

Stability of Property Rights

In the libertarian philosophy, rights are stable. Indeed, totally so. This holds true in the sense that theft is strictly forbidden, and so is the law of eminent domain. The only way that property can change hands is through voluntary, e.g., market activity: trade, barter, purchase, gift, gambling, inheritance, etc. Nozick (1974) called this the theory of legitimate entitlements. In this way, all legitimate property titles, at least in principle, can be traced back to the homesteading stage.

The Law and Economics perspective is very much the opposite. Here, stability of property titles is instrumental at best, certainly not intrinsic. Demsetz specifically does not:

> endorse frequent involuntary reassignment of such [private property] rights . . . Frequent involuntary reassignment would destroy confidence in the longevity of property rights and all long-run consequences of resource use will tend to be neglected, at least in a world of uncertainty and positive transaction cost. Efficiency calls for a high degree of stability in property rights definitions, but it does not necessarily forbid all involuntary reassignment, especially when high exchange cost or free-rider type problems reduce the efficacy of allocations through the market. (p. 106)

No Marxist, he, but this is hardly a ringing endorsement of property rights. Happily, one supposes, we live in an era of "uncertainty and positive transaction cost." If not, one would shudder at the prospect of leaving the determination of property rights to the Chicagoans. On the other hand, this is scant comfort, for we most certainly *do* live in a "high exchange cost" world, and in which, moreover, people like Demsetz see "free-rider type problems" under every bed.

The Panglossian Demsetz arises again when he asserts:

> The producer of a new product receives the right to offer it for sale to all potential buyers; producers of rival old products are denied the right to the trade of their customers, and these producers therefore suffer an uncontemplated loss. [There is good reason for this rights assignment. It would be too costly to ascertain who is harmed by how much, or who would be harmed by how much, when a new product is to be introduced.] (p. 106)

But this account is problematic for several reasons. First of all, whenever one hears of government having solved a problem, no matter how simple, one should check one's wallet; extreme suspicion is the only appropriate response to such claims. Imagine: the very same government which brings us the U.S. Post Office, minimum wage, rent control, tariffs, and thousands of other wealth destroying institutions, has finally "got it right." It has somehow thrust itself forward into the breach, and come up with a rational property rights determination. If so, it is probably *despite* its best efforts.

Second, while Demsetz's account of present law is indubitably correct in some particulars, this state of affairs did not always exist. During medieval times, for example, it was by no means true that people with new products were free to offer them for sale. On the contrary, the guild system was then in place, and monopoly powers were often enjoyed by these government sanctioned cartels. Even nowadays some vestiges of this system still endure. Medical and other occupational licensure laws (Friedman 1962; Williams 1982) prohibit people who wish to, from offering services to customers. In effect "producers of rival old products are *not* denied the right to the trade of their customers," at least vis-à-vis doctors and taxi cab drivers who would *like* to offer their wares, but are prohibited by law from doing so. If the government is so gloriously efficient, how does Demsetz explain these counterexamples?

Third, why "uncontemplated?" Surely every person who ever conducted a business fears the possibility that one day his customers will desert him in favor of a better offer. Indeed, the nightmares of businessmen probably consist of little else. Not that this is relevant to legitimate property rights determination, a normative question. Whether loss is or is not contemplated determines on the positive issue of whether these considerations are capitalized into prices.

Rear End Collision

Demsetz next seeks to buttress his "law is wonderful" thesis by use of the rear end collision case. "The driver of the second car is liable," he tells us, "'because' in the general case the driver of the second car can avoid such accidents more *cheaply* than the driver of the first car" (p. 108). According to Demsetz, the system works this way for slow speed congested traffic. But for "high speed expressways" where "the driver of a second car has a more difficult time avoiding rear end collisions, . . . we often observe minimum speed limits" (ibid.).[38]

The implication, here, is that some modicum of efficiency has been attained as far as road and highway operation, legislation, and institutions are concerned. The judiciary is flexible enough to be able to function in two very different kinds of situations: slow and fast speeds. Not only does state law call down penalties on the correct party in rear end collisions at slow speeds (the second car), it even focuses on the correct party at higher speeds (the first car, by forcing it to travel above a minimum speed level.) Its functioning has nothing to do with so philosophical a notion as causation, responsibility, guilt. On the contrary, it is tightly calibrated enough to be able to maximize wealth under, seemingly, all conceivable conditions. Just let it loose, let "the law be the law," and watch it avoid accidents as "cheaply" as possible.

But there are serious reservations which must be registered about this optimistic scenario. If it is true, why, then, are people being slaughtered like flies on the nation's highways? Surely, unnecessary deaths cannot be completely irrelevant to wealth maximization. On the contrary, life is the very basis of wealth. Without people to enjoy them, goods and services are just so many wasted molecules and actions.

If the law is so efficient, why does it allow for road socialism, that is, government ownership and management of highways? *This* is the cause of 40,000 plus traffic fatalities per year, more than two million serious injuries, and untold loss of property values (Block 1979; Woolridge 1970; Rothbard 1973b). If leaving auto travel to the tender mercies of the state is such a good idea, why do commuters in large cities face congestion that virtually strangles movement? We all know that socialism is inefficient.[39] What

[38]One wonders whether Demsetz would accept as a refutation of his theory those cases where there are *no* minimum highway speed limits?

[39]Chicago economists, as well as Austrians, have been preaching this message for years. On the former, see M. Friedman (1980); D. Friedman (1989); on the latter, Mises ([1969] 1981); Hayek (1989); Hoppe (1989).

Demsetz does not seem to realize is that this applies not only to steel mills, trains and foodstuffs, but also to motor vehicle transportation arteries. It pertains to both slow speed city traffic and high speed expressways. Judges, in interpreting the law[40] so as to allow road socialism, are thus inefficient, contrary to Demsetz. For every penny possibly saved by holding the second driver responsible for accidents on city streets, and placing minimum speed limits on freeways, much more is lost by prohibiting roads from being run on market based private property right principles.

There is a second argument against the position staked out by Demsetz. Take slow speed crashes. How does he know that "the driver of the second car can avoid such accidents more *cheaply* than the driver of the first car?" Where is his proof? The problem is that in order to adduce any evidence, Demsetz would have to violate the strictures of interpersonal comparisons of utility, something we have seen him on record as opposing.

Third, there is an asymmetry in Demsetz's analysis. He maintains that in slow traffic the second car must be held liable because he can avoid the accident more cheaply. He states that things are different in fast traffic. Here, logically, we are entitled to deduce that the first driver can more cheaply avoid the accident, and hence must be hold liable. But Demsetz never reaches this point. Instead, he contents himself with the comment that "we often observe minimum speed limits on expressways." But why only "often?" Why not "always," or at least "almost always?" Could it be that the government sector is not the cheapest conceivable option, as is mandated by the system of socialist law which undergirds it? Why not carry through on the logic of this claim and call for holding liable the first car in a rear end collision on the highway? Alternatively, he could have inverted things; adopted the speed limit policy he uses in high speed cases for local traffic. That is, he could have claimed as efficient a maximum speed limit under congested traffic conditions—rather than a finding of liability.

[40]There is a bit of an equivocation as to the institution for which Demsetz is claiming such great efficiency. On the one hand, he on numerous occasions states that this is the judicial bench. On the other hand, the officials in charge of imposing minimum highway speed limits are not judges, but rather highway bureaucrats, or legislators. In Demsetz, then, we have a writer who deems the state, the political process, the bureaucracy, government courts, to be highly efficient. That he is despite this widely seen as an advocate of markets is a phenomenon in need of explanation.

There is yet another difficulty: the alternative hypothesis has by no means been refuted by Demsetz. The commonsensical notions of cause, blame, fault, come into play here. The reason the second motor vehicle operator is found liable is not that he could have more cheaply avoided the accident, but rather that he *caused* it. He crashed into the first automobile, not the other way around. He is at fault. This is shown by the fact that if the party of the first part suddenly jammed on his brakes for no reason at all, or, worse, put his gear into reverse and rammed into the party of the second part, no one in his right mind would find the latter liable, despite their relative positions.

Demsetz, himself, of course, would have to agree with this latter point. After all, he states only that "there is a *prima facie* case that the driver of the second car is liable" (p. 108), not that he always is, or necessarily is. But if so, we arrive at a *reductio*. How does a Demsetzian determine, in a particular rear end collision, who is liable? He cannot rely merely on the positions of the two vehicles. He has to look beneath this superficiality, to the underlying causal relationship. Namely, he must look to cause, to negligence, to choice, in short, to all the common sense notions he is so anxious to throw out in favor of cost calculations and mutual determination.

Factory vs. Laundry

By his comments on this subject, Demsetz shows himself not so much in disagreement with Rothbard, as unable to comprehend the latter. In Demsetz's view,

> If the owner of a factory considers locating next to an existing laundry, and the owner of that laundry protests in court that soot from the factory will raise the cost of laundering, the factory owner is more likely to be held liable for damages than if it is the laundry that contemplates locating next to an existing factory. (p. 108)

And why is this? It is due

> to the generally correct judgment that he who has not yet located his business can move his business to another location at less cost than he who has already fixed his assets into a particular location. (p. 108)

Demsetz castigates Rothbard for eschewing this wealth maximization based analysis, and instead determining the property

rights in this case on the ground "that every man has the absolute right of property in the previously unowned natural resources which he finds" (p. 108).

If this is the best Demsetz can find in Rothbard as an answer to this question, he is dealing with a straw man. To be sure, Demsetz's is an accurate protrayal of a view Rothbard has expressed. But Rothbard did so in another context. In *this* context, Rothbard would say nothing of absolute property rights. Instead, he would utilize the homesteading principle. If the factory was located there first,[41] it would have homesteaded the right to spew forth soot into the area under contention, in Rothbard's view. *That* is why the Johnny-come-lately laundry would have to take the air as it found it, not because of absolute property rights in virgin territory. Alternatively, if the laundry were the original homesteader, it would be deemed by Rothbard to have established rights to enjoy the same air quality it found upon arrival, namely, pure.[42] This firm would be granted an injunction against the late arriving factory polluter not because of the costs of moving people before they establish themselves, not because of the notion of absolute property rights in hitherto unowned resources, but because of the homesteading maxim: first come, first served. The first arrival gets the right to interact with nature as he sees fit.[43] Demsetz, in other words, has not succeeded in achieving "real disagreement" with Rothbard. He does not even understand the view of the latter, a necessary precondition.

Nor is his own perspective in this regard above reproach. Based on his statements, one would expect symmetry from Demsetz. It shouldn't matter who locates in the given area first; the newcomers should always have lower relocation costs than the established firm—before, that is, he has put down roots. Therefore, the property rights nod should always be given to the business concern with assets fixed into the geographical space.

In the event, however, we are disappointed. This works just fine when the soot creating factory owner is the new kid on the block. However, when it is the laundry's turn to play newcomer, this no longer holds. Nor are we vouchsafed any explanation as to why not.

[41]I now assume that there are only the two firms to be considered, the factory and the laundry.

[42]Assuming, again, that the only way this air quality could be altered would be by intervention of the factory.

[43]That is, after he becomes the owner of it. And this he can do by "mixing his labor with the land" in a productive manner.

Boat Dock

Nothing daunted, Demsetz next illustrates his philosophical perspective with a case in which a boat and a moving dock collide, leaving the latter damaged. In his view, it is nonsense to think that the former caused the harm and is thus liable, while the latter was the recipient of the harm and is thus the victim. Why? Because "all motion is relative" (p. 108). One could with equal reasonableness say that the boat bashed the dock, or *vice versa*. And attempt to discern blame or fault would be foolish.

Demsetz's alternative scenario fairly leaps off the page at us. Whoever "could have prevented the damaging interaction at least cost . . . is viewed as 'causing' the accident" (ibid.). He does not explicitly state that this party should be held legally responsible for the accident, but this is the clear implication.

We have already seen that the impossibility of interpersonal comparisons of utility could bar the court from making a non-arbitrary determination of least cost. In the economic sense cost is the next best opportunity foregone by taking any action. This, by its very nature, can only be known by the economic actor himself, and not by anyone else, such as a Coasian–Demsetzian judge.

Let us however explore not the economic notion of cost, but rather Demsetz's stipulative definition. One possible tack he could have taken would have been to maintain that if a boat and a dock crash together, and this causes damage to either, the owner of the one who failed to put in place protective barriers (e.g., rubber tires) should be found liable.[44] This appears to be the logical conclusion, since "an ounce of prevention is worth a pound of cure," and Demsetz is, if nothing else, an avid proponent of wealth maximization. The problem, here, though, is that it all depends upon one's level of time and risk preference. The old adage applies, clearly, if the boat/dock owners are risk avoiders or even risk neutral, and have a low time preference. But if their preference for risk is intense enough, and their time preference rates are high enough, it may, paradoxically, be cheaper to "go full speed ahead and damn the possible, later, interactive damage consequences." That is, the rational course of action is to gamble: to use no protection at all.

Let us now abstract from objections based on time or risk preference and consider the case in which, for some reason,

[44]We here assume that rubber tires of one level of thickness is sufficient to prevent damage.

neither the boat or dock owner uses such protective devices. One could maintain that cost[45] is proportional to the length of the side of the edifice, and that since the dock is larger than the boat, the latter is the least cost avoider, and should hence be penalized for any crash. However, even though this is true, the precise area where the two may come into contact with each other is precisely the same. That is, a 100 foot boat may only hit 100 feet of a 1,000 foot dock, no more, no less.[46] So this is no solution to the problem, since the cost of installing rubber tires is identical.[47]

Now let us assume that the costs of tire installation (for any given perimeter) is cheaper for the dock than for the boat because the former is more stationary, is located closer to the land (where used tires may more cheaply be found), is closer to sources of cheap labor, etc. Here, at last, we would have a relatively clear cut non-arbitrary judicial decision[48]: theowner of the dock, not the boat, is the least cost accident avoider, and hence should be legally liable.

There are still problems, though, even in this "clear cut" case. It is always possible to ask the following questions: The dock owner is the least cost avoider of the accident, but is he responsible for it? Is it *just* to penalize someone, given that he didn't cause an accident, merely because he could have avoided it more cheaply than someone else? The answer that springs to mind is No, it is *not* just to penalize a person who has not caused an accident,[49] even though he could have more cheaply avoided it.

Demsetz's thinking, however, does not lie in this direction. Instead of speculating about different cost scenarios, he focusses on one: "the dock was rotten for want of maintenance" (p. 108). But why would this make it cheaper for the dock owner to invest in taking ameliorative action? To be sure, it would presumably be easier for the dock owner to repair his own dock than for the boat owner to do this for him (at the very least, the latter would have

[45]We are now discussing cost in the superficial out-of-pocket sense of this term, not the proper alternative cost doctrine.

[46]I abstract from the possibility of multiple collisions, at different points of the dock.

[47]If the boat is made of wood, and the dock of metal, the former may be easier to destroy, and hence deserving of more protection, under the vision we are now considering.

[48]Due, of course, to our many assumptions which violate economic axioms. But the decision would still be arbitrary, unless we also jettison our analysis of interpersonal comparisons of utility.

[49]This does not apply to a firm or a condominium which announces beforehand that this is precisely the role of "justice" it will employ. Then, if one enters into its territory, one in effect gives consent to be bound by this rather idiosyncratic notion of justice.

to undergo the expense of obtaining permission from the former in order to do this). The question is, why would it be less expensive for the dock owner to repair his facility than for the boat owner to take defensive measures? One possibility leaps to mind. Suppose that the dock's state of disrepair consisted of protruding material sticking out into the water with a sharp point at the end of it. For example, if there were a knife edged pole which extended off the dock 20 feet into the water, this would require that the boat come equipped with a 21 foot thick coating of rubber tires. As this is clearly more expensive[50] than repairing one protruding 20 foot sharp pole, Demsetz's case is made: the dock owner should have ordered and paid for the necessary repairs. Since he didn't, and he could have done it more cheaply than bedecking the boat with a thick layer of tires, he should be liable for any resulting accident.

Demsetz reckons without one point however. What renders this example intuitively obvious is this sharp pole, sticking out into the water as it does. *That* is why it is proper to hold the dock owner liable for the accident. That protuberance offends our sense of justice; without it, we would be outraged by holding the dock owner responsible, merely because he was the least cost avoider.

This pole also makes the case for the alternative hypothesis based on blame. If the pole (attached to the dock) and a boat ram into each other, it is no longer true that "all motion is relative." On the contrary, it is now clear that one person caused the accident, and the other was the victim. Even more telling, it is by no means clear that the incident should still be labelled an accident. Surely, a dock with an extending pole is more like an accident waiting to happen (e.g., a threat of initiatory violence) than a normal accident. When one goes walking down the street waving a big pole around, if it connects with an innocent person the result is not so much an accident as it is assault and battery.

There is a much more basic attack to which Demsetz opens himself. Just as he is a road socialist, he is also a water socialist.[51] The point is that the whole problem of boat vs. dock liability arises because the water upon which both sit is an unowned resource. According to the Lockean–Rothbardian theory with which we are

[50]At least under the artificial assumptions under which we are now laboring.

[51]In characterizing Demsetz as a road or water socialist, I mean only to point to his lack of reliance on private property rights in these areas. I certainly do not mean to imply that he takes an anti-market stance on other issues, such as minimum wage, rent control, trade, welfare, etc.

contrasting Demsetz's Law and Economics perspective, this state of affairs is unnatural and improper. In this view, the law should allow for the private ownership of bodies of water, such as lakes, rivers, streams, seas, oceans, etc.[52] If it did, problems of the sort mentioned by Demsetz simply would not arise.

For example, suppose I owned a lake. And on this lake there appeared the Demsetzian dock and the Demsetzian boat. I, as owner of the body of water in which they both sit, would have the legal right to determine the liability rules for accidents. Just as the private owner of the highway sets the rules of the road, so too does the private owner of the body of water determine the laws which shall prevail on the lake or ocean.[53] Under these conditions, in one fell swoop, the whole problem would disappear. Now it may well be that if I set up the wrong liability rules I will go bankrupt. After all, I will be competing with every other lake owner in the area for customers, and if any part of my service is found wanting—cleanliness, fish stock availability, access roads, or liability rules—I will face the threat of Chapter 11 reorganization. And this is where Demsetz comes in as a force for good. It may well be that his least-cost-avoider principle—however much wanting we have found it to be on purely economic grounds—may be of some service to lake owners. If so, we may wish Demsetz Godspeed in his entrepreneurial task.

In other words, Demsetz's Law and Economic perspective serves a putative economic role under water socialism. Someone must advise judges on liability rules from an economic perspective, and his theory, no matter how problematic, at least serves this role. But under water freedom, the perspective reduces to a mere managerial technique. Here, Demsetz can take his place alongside

[52]This need be no more of a normative claim than Demsetz's view that liability *should* be assigned to the least cost avoider. What Demsetz really means by this is the positive claim "If you want to maximize wealth, then liability rules should be written in such terminology." Likewise, our claim could also be couched in this manner: "If you want to maximize wealth, privatize all resources, particularly including aqueous ones." However, while I do indeed subscribe to this claim, I *also* hold the *normative* view that it is *right* that private property rights be extended to all resources. This is because it is a violation of the libertarian legal code to prohibit any non-invasive act, and homesteading the oceans (or any other virgin territory) is certainly not invasive. On the libertarian legal code, see Hoppe (1993), Rothbard (1982a). On lake and ocean privatization, see Anderson (1983), Block (1992).

[53]Subject, of course, to the basic libertarian axiom of non-aggression. For example, no lake owner can entice the fishing or boating public to his facility, and then kill them with impunity, on the grounds that it is "his" lake. This is no more justified than the same occurrence in a private residence.

biologists who advise the lake owner on fish stocks, sanitation engineers who recommend policies on water cleanliness, etc.

Why do the Demsetzians of the world spend their time on endless ruminations about least cost avoiders? One possible explanation arises from the insight of water socialism. There is a long socialist tradition of blaming the market for what are really problems of interventionism, or the lack of markets based on private property rights. For example, they castigate free enterprise for unemployment, without realizing that this problem stems from unions, wage legislation and the lack of a one-hundred-percent gold standard; they tax capitalism with the housing (homelessness) crisis, which is actually caused by a plethora of interventions, such as rent control, welfare, zoning, urban "renewal," etc. They hold the market responsible for crime, not the government with its mismanagement of welfare, prisons, education, drugs, etc. Road and water socialists make a similar mistake. They see numerous externality and liability problems. Not realizing that these are the result of interventionistic elements in the economy, they do not see markets and private property rights as the solution. Instead, they propose further government incursions, this time judicial ones.

Of course there is an "externality problem" with street lights on sidewalks, but not in shopping malls. This is because the one does not benefit from the institution of private property while the other does. In the latter case, but not the former, the externality is internalized. In similar manner, there is a problem assigning liability to boats and docks which sit on unowned bodies of water; but this problem would not occur under privatization.

Economists see externality problems as widespread, but not within restaurants. Yet they exist there, too, at least potentially. If the tables are located too close to one another, each customer will be a negative externality to the others under the resulting crowded conditions. Management consultants are needed to give locational advice to restaurant entrepreneurs. These problems are widespread, but tend to be ignored by "welfare" and "public administration" economists, because they do not appreciate that the market tends to internalize these externalities, when (and only when) private property rights are allowed.[54]

[54]Paradoxically, Coase (1974) has done more than perhaps anyone else to show the inapplicability of the externalities model to bodies of water. One would therefore think that people who write in his Law and Economics tradition, such as Demsetz, would have incorporated these insights into his analysis.

Last Clear Chance Rule

Let us now consider Demsetz's comments on the railroad killing a trespasser by running him over. As usual, this economist is concerned entirely with least cost avoidance efficiency and wealth maximization; rights and wrongs never enter the picture, except for his view that there is nothing more to ethics *than* efficiency: "It is difficult to ever describe unambiguously other criterion for determining what is ethical" (p. 109) apart from efficiency.

The libertarian answer to the trespasser is rather straightforward. The trespasser is a thief (of services) and should be dealt with the fullest extent of the law. Certainly, there would be no question of holding the victim of this act, the railroad, guilty for going about its legal business of transferring people and goods. If the trespasser is hurt or killed by the train, the blame rests with him, not the victim of the trespass.

Demsetz, in contrast, regards the *trespasser* who is hit by the train on its own property as the victim. His rendition of his opponents' point of view is of great interest:

> Since the trespasser could avoid the accident at less cost than the railroad, it would seem that efficiency would call for liability to rest on the trespasser even if the railroad made no attempt to warn. (pp. 108–9)

Demsetz dismisses this view as "superficial." Before proceeding with his analysis in detail, I must note that this is more than passing curious. All during the course of his article (1979), efficiency has been *defined* in terms of least cost avoidance. Now, however, when Demsetz wishes to defend the last clear chance rule (unless the railroad engineer attempts to warn the trespasser, the railroad is held liable for hitting him) all bets are off. In this case, efficiency is now defined in terms of "the likelihood of saving a man's life and the value of doing so" (p. 109).

Human life is of course valuable, although this should be at least somewhat attenuated in the case of trespassers. Demsetz, however, is a neoclassical economist, one who lives or dies by the falsifiability principle. If one case can be cited where least cost accident avoiding should not in his opinion entail liability status, he must in all conscience give it up, at least as an absolute maxim. Here, he himself furnishes us with just such a case. However, instead of admitting, or even acknowledging that this concession has shot his own thesis in the foot, so to speak, he blithely moves on.

His concern, now, is with saving the trespasser's life, and with deterring anything that militates against that goal. The story now becomes more than a little difficult to follow. First, Demsetz avers that the trespasser could have avoided the accident at less cost than the railroad. (He gives no reason to suppose this, but let that pass; this is not the first time he has merely assumed the costs at issue to be greater on one side than the other.) This would seem to imply trespasser liability, at least for him. Then, he reverses field and concludes that the life of this tortfeasor is worth more than the inconvenience to the legitimate owner of the private property in question. (Again, no explanation for this calculation is offered, but let that pass, too.) Clearly, Demsetz is tailoring the rules to arrive at a conclusion he wishes to reach on other grounds.

Judicial Equity

Professor Demsetz does not claim perfection for his system. He freely concedes the possibility of error. Not for him are the niceties of perfect competition, purchased at the cost of irrelevance to the real world. He states

> I do not mean to miscalculate the difficulty of the problem, to suggest that mistakes are not made, or to underestimate the complexity of the real institutions used to resolve the problem. (p. 109)

This is all well and good, and certainly imparts a measure of moderation to the proceedings. The only problem is, given the exigencies of interpersonal comparisons of utility, how can Demsetz determine, even in principle, that a blunder has been made in any given case? The same difficulties that face the court in comparing the necessarily subjective costs of one person with another also make it impossible for the analyst open to the possibility of judicial error, such as Demsetz, to be aware of it. For example, let us suppose that a judge rules in favor of a tennis player vis-à-vis a would-be sleeper, because he thinks that the benefits of athletics during the afternoon are worth $100, while the costs foregone by the wannabe sleepers, because there are so few of them at that hour, are only $40. In his opinion, the decision "saves" society $60. Along comes Demsetz, ever ready to find "mistaken" judicial decisions. He pounces upon this one as being in error. To do this, he must make a claim along the following lines. Namely, that the benefit to the racketeer has been overestimated by the judge and in point of fact is only $70, while the costs to the insomniac have been underestimated by the jurist and are actually $90. The point is, the same necessary arbitrariness

that faced the judge in his initial determination now casts its baleful countenance upon Demsetz, in his attempt to second guess the member of the court. If the first had no objective considerations upon which to base a decision, then neither does the second (e.g., Demsetz), in his attempt to check for "mistakes."

Whether these miscalculations can be recognized or not, Demsetz thinks there is a force which can overcome this possible lacuna:

> There is reason to believe that a series of common-law type decisions will tend to converge on efficient definitions of rights because a legal decision that generates inefficiency is more likely to set in motion a stream of appeals and new cases designed to upset that decision than would be the case had the decision been correct from the viewpoint of efficiency. "Losers" generally have more to gain from upsetting a decision than "winners" have in defending that decision when it has produced an inefficient allocation of resources, and just the reverse when it has produced an efficient allocation. (p. 109)

Even at first glance this seems to be a weak foundation upon which to base the entire Law and Economics edifice. It appears especially flimsy compared with the profit and loss weeding-out system of free enterprise which tends to ensure that extant businesses are the best of an imperfect lot. It suffers in comparison to the economic market in that while the loser of what Demsetz is pleased to call an inefficient decision can indeed *launch* an appeal, whether it is acted on, or accepted, is entirely at the discretion of the judiciary, the very institution which putatively created the error in the first place. In contrast, under the free market system, the dissatisfied customer can patronize a firm other than the one which initially failed to please him.

In the case of markets, moreover, the firm that fails to satisfy consumers loses out, necessarily so. In comparison, judicial error first cannot be recognized, and second, even if it could, the tendency for mistake making judges to be shorn of their judicial robes on this ground is very weak. Judges are elected, or appointed by a relatively non-responsive political system.[55] This is hardly a recipe for accountability.

[55]Dollar voting takes place everyday, dozens of times. Political votes occur every two or four years. The former can be pinpointed as narrowly as that for different flavors of bubble gum; the latter is a package deal, where the citizen cannot distinguish between a candidate's activities on scores of fronts. There is a case, moreover, for rational voter ignorance, given the unlikelihood that any one

There is, however, a possible rejoinder open to Demsetz, but I am inclined to doubt that he will wish to make it. What if judges, too, were part of the market? That is, consider a system verging upon free market anarchy (D. Friedman 1989; Rothbard 1970, 1973, 1982a; Benson 1989, 1990) where judges are not appointed through the political process, but are instead market participants, forced to rely upon voluntary payments for their financial sustenance. Then, only the first of these problems would exist.

There is another theoretical difficulty. If it is true that losers have more to gain from challenging an inefficient decision than winners, it is equally true that they will have fewer resources with which to do so. Whether one effect swamps the other is impossible to say. But the upshot should yield little comfort to advocates of judicial equilibrium tendencies such as Demsetz.

Then, too, there is the practical problem. Business concerns which survive the market test of profit and loss are more or less efficient—no matter which criterion is used to make that determination. The same, alas, cannot be said for the political-legal-judicial process. Rather than "efficiency," the word that springs to mind is the very opposite. Furthermore, if there is an inexorable tendency for good laws and sensible court decisions to emanate from Washington, D.C. and the state capitals, why are they centers of graft and corruption? Apologetics of this sort takes a particular brand of courage, and we can indeed credit Demsetz for showing far more than his fair share of this quality.

As well, there is the legal doctrine of "stare decisis," a cornerstone of our existing judicial system. This implies a rather slavish respect for precedent, which tends not only not to weed out bad decisions, but rather to entrench them.[56] If one ill conceived finding is rendered, all similarly aggrieved parties will *not* be motivated to re-litigate the issue, as their probability of success is now *lower* than it was in the first instance. In a monopoly justice system, poor decrees discourage those with valid complaints from litigating.

Private vs. Community Property Rights

Demsetz now returns to a discussion of public goods, free riders, externalities and high transaction costs. It is on the basis of these phenomena that he tries to "rationalize a role for the state" so as

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person will be a tie breaker in an election; this of course does not apply to the consumer in a market who buys for himself.

[56]I owe this point to Karen Selick.

to solve the problem of national defense, foreign policy and clean air. His discussion leaves much to be desired.

Demsetz starts off his call for "communal property rights," i.e., government control, by citing situations "when the gains or costs associated with particular interactions are not confined to a few parties, but, instead, are spread thinly over large numbers of individuals" (p. 110).

William F. Buckely Jr. once described the conservative movement as an entity sitting athwart history, and yelling "No!" It would appear that economists who point out the illegitimacy of making interpersonal comparisons of utility perform a similar role. The problem is, this way of putting the issue runs afoul of interpersonal comparisons of utility prohibitions. How do we know when gains or costs are confined narrowly or spread thinly? Yes, we can note trespass (of people or runaway soot) and, as a result, the problem of dirty air can easily be solved by private property rights institutions. Demsetz allows that

> it is difficult to see how costs and benefits can be internalized at practical cost, as would be true with regard to air pollution in any private property rights system that I have been able to envisage. (p. 110)

The problem here, however, is not the market. Rather, it is Demsetz's lack of imagination. Perhaps some new scenarios would present themselves if he perused some of the libertarian environmentalist literature (Block 1990; Rothbard 1982b; Horwitz 1977). Here, he would learn that the reason we have dirty air is that for decades government judges refused to uphold the trespassing laws against errant soot particles—and that this has nothing to do with externalities, neighborhood effects, costs, etc. Rather, it was a philosophical failure. The point is, interpersonal comparisons of utility present no difficulties to he who seeks property rights violations as the source of air pollution problems; in contrast, it sets up insuperable barriers to the Law and Economics high-transaction-cost hypothesis.

As to national defense, the obvious rejoinder is that "one man's meat is another man's poison." Defense may well be a value to most people in the U.S.—at least as shown through public opinion polls.[57] But what about pacifists, for whom a national

[57]But if there is one thing that is certain, it is that people lie to pollsters. In the absence of markets, of course, there is no way that true preferences can be revealed, or demonstrated.

defense would presumably be a disutility? Unless one is willing to state that either there are no pacifists in the U.S., or that the benefits they receive are somehow outweighed by the losses suffered by the majority—in blatant contradiction to the strictures against interpersonal comparisons of utility—one cannot even talk about the "gains" accrued by national defense. On the contrary, this argument is incoherent (Hummel 1990).

Then, too, there is the misuse of language. By the phrase "communal private property rights" Demsetz does not refer to the decision of individuals to voluntarily pool their legitimately owned resources. Examples of such cooperation which merit the term "private property rights" include the kibbutz,[58] the monastery, churches, firms, cooperative and condominium housing developments, stock companies, partnerships, etc. In contrast, Demsetz uses this term to refer to the government's seizure of private assets for its own purposes. The proper appellation in this case is not the contradiction in terms "communal private property rights," but rather "*lack* of property rights," or "theft." To assert that a group of people has communal property rights is to imply the notion that they have a *right* to use the property in any (non-invasive) way they wish, and to exclude others from using them at all. But if the way the property came to the community in question was against the wishes of its original and legitimate owners, then this group of people most certainly does not have their right to use these resources as they wish respected. On the contrary, the rightful owners are forced to give up their property; it is then used in a manner determined by the government, or by a majority of those deemed to be members of the "communal" or "cooperative" group.

This democratic philosophy is not without its flaws. Suppose that a friend of mine and I break into your home, and you catch us in the act of absconding with your bicycle. You protest that this is theft. We criminals, being of a philosophical turn of mind, are willing to debate this issue with you. To prove our point (that this bike is now "communal private property") we hold an election. First we ask "how many people think the bicycle should be left right where it is, under the control of its [previous] owner, that is, you?" One hand goes up. Yours. Then we ask "How many think

[58]Abstracting from the fact that in Israel these organizations typically receive state subsidies. What I have in mind is perhaps best thought of as a Platonic Kibbutz, one which adheres to all the voluntary communal aspects of that kind of group, but does not receive tax money forcibly mulcted from nonmembers.

it ought to be taken away, and used for communal private property purposes, to be determined by the majority?" Two hands go up. Ours.[59] Would such a justification satisfy Demsetz? Hardly.

Ethics

With this as a jumping off point, Demsetz now begins his analysis of ethics. In the case of the familiar public goods, given high transaction costs and the free rider problem, he asserts:

> government intervention may be thought to be clumsy, costly, and misdirected, but it is seldom thought to be unethical. Similarly, the opposition to the government's use of defense forces may be based on its involvement in an immoral war, or its use of an immoral draft, but it is seldom based on the immorality of the principle of using the government to provide for the "common" defense. But when a government confiscates property rights that could have been obtained through the market, as with condemnation proceedings, the military draft, or the nullification of gold clauses during the recession of the 1930s, there is more than a hint of belief that an unethical theft of rights has been perpetuated. (pp. 110–1)

But why is the good professor so sure that none of these things can be justified on Law and Economics grounds? Surely, if we take him at his (interpersonal comparisons of utility) word, these are all empirical questions. Their answers can only be determined after a thorough and exhaustive cost-benefit analysis has been concluded. As it stands now, however, the text makes Demsetz appear as if he has adopted "religious and intuitive faith" (p. 98). After all, in his own view, condemnation of private property and gold clause nullification are not objectionable in principle. How, then, has he come to the conclusion that these acts (even if proven inefficient through empirical interpersonal comparisons of utility calculations) are an "unethical theft of rights?" This would surely surprise his Chicago colleagues.

Demsetz is clearly uncomfortable with the language of ethics. And this should occasion little surprise; after all it is he who took the view that there is no more to morality than economic efficiency. However, there is one exception to this generalization. He pulls no punches with regard to the military draft. Demsetz is on record as equating ethics and economic efficiency. If so, why resort

[59]I owe this example to Marshall Fritz.

to the language of morality at all? Why not stick to what for him is the tried and true world of wealth maximization?

A Walk Around the Block

Demsetz and I once took a long walk together around the block (as it happens, it was during a break at the meeting of the Mont Pelerin Society in Munich). As we proceeded, a lost man approached us, asking for directions. Demsetz's comment to me afterwards (since we were both strangers, we could not help him) was that this person was properly allowed by law to break into our conversation to ask directions since the information we could possibly have rendered him would likely be more valuable to him than would the trivial loss of time, and the interruption of the flow of conversation, be costly to us. My reply was that this was properly allowed by law only because it did not constitute an invasion of person or legitimately held property rights.

Several other thoughts now occur to me. First, there were two of us and only one of him. If we make the heroic assumption of equal value placed on time for the three of us, then it is likely that our loss was twice his gain. If there were 5 or 10 of us walking along and talking, then on this account the man almost[60] certainly should have been legally penalized for reducing wealth.

Second, I could probably specify conditions under which it would be improper or illegal for one person to break into the conversation of another, except, perhaps, under the most extreme of circumstances. This is a point in Demsetz's favor, as the criterion appears to depend upon to whom is the interruption more important and valuable: the interrupter or interruptee. But the problem with this is that *ex ante*, it is extremely difficult to tell. Here private property rights, contrary to Demsetz, can come riding to the rescue. In symphony halls, hospitals, during lectures, movies, the owners can specify "quiet please" rules, which prevent, or at least reduce, the incidence of vocal interruptions. Those who do this and thereby satisfy their customers, will prosper. Those who do not will not. *This* is why people feel free to break into conversations or not. On the public street, in contrast,

[60]I am forced to speak in this modest and unsure terminology given that without interpersonal comparisons of utility, we are at sea without a rudder as far as such calculations are concerned. More precisely, it is not objectionable at all to say in common parlance that had one man asked directions of five or ten, the gain to the former is likely to be less than the loss to the latter. In ordinary language, there can be no objection. As a commonsensical matter, we make interpersonal comparisons of utility all the day long. But Demsetz and I are engaged in an intellectual debate, where a certain precision of language is required.

this institution cannot work, because the streets are unowned and there are thus no legitimate private property rules which obtain there (street socialism). People are therefore forced to employ the mores learned in other contexts, with sometimes unfortunate results. For example, it is by no means unknown for young males in the inner city to kill people who have merely looked at them. This occurs on the street and in public parks, but more rarely on relatively more well guarded private property.

Paternalism

Our author now enters into a train of thought which might be seen as peripheral at best to Block (1977a) the article he is presumably debating. We shall nevertheless pursue him on these grounds since, as it turns out, there is some relevance to matters of mutual concern after all.

He starts out, reasonably enough, defining paternalism as the "coerced denial of normal contracting rights" (p. 111). One might expect that as an economist concerned with wealth maximization, he would eschew paternalism as contrary to the interests of people involved in mutually beneficial trades. If so, one would be disappointed: "it is not clear . . . that there should be no paternalism, nor how far paternalism may be carried" (p. 111). But this, to say the least, is surely incompatible with wealth maximization, assuming that we are not dealing with children or madmen. After all, if ordinary people cannot be trusted to know their own interests, who can be?

At this point Demsetz goes off into a disquisition on sociobiology. This, it would appear, is an effort to uncover people who can be trusted to act paternalistically, but to do so in the best interests of others, their wards.

The libertarian must look at this entire enterprise with a certain amount of equanimity, since he rejects paternalism right off the bat, on principle. Not so for the benevolent interventionist, such as Demsetz. To him, it is a matter of no little concern that the person assigned the paternalistic role actually carry it out for the benefit of his ward, despite the well known Acton axiom about the corruptibility of power.

Who, then, can be trusted with this delicate task? Sociobiology, according to Demsetz, offers a recommendation: "To a large extent, altruism is limited to kinship relations" (p. 111). Say what you will about this initiative, his defense of "kinshipocracy" is at least novel and inventive. The problem is, there is much more that can be said about Demsetz's view of it, none of it too positive. From

a libertarian point of view the notion of paternalism must be completely negative; but it is even problematic from his own Law and Economics perspective. Where is the argument that paternalism will actually promote wealth maximization? If anything, the reverse should be apparent. Setting aside a man's decision because his brother, or all five of his siblings together will it, is hardly a guarantee of welfare improvement in his behalf. Nor is there even an expectation that this goal would be attained. If is of course likely that a stranger, or any five people picked at random from the general population, would do far worse than the man's kin. Sociobiology does give strong evidence for that contention. But so what? Demsetz's self-claimed brief is to improve economic welfare, not to advance policies that disrupt wealth creation less than even worse alternatives.

There is his positive claim in this context: "Paternalism is, in fact, largely limited by natural selection to intrafamily relationships" (p. 112). Stuff and nonsense! The biggest paternalist the world has ever known, the most thoroughgoing, and, as it happens, the most vicious and depraved, is of course that very institution Demsetz seems so intent on defending: the government. George Washington may have been called the "Father of our country," but this is meant only in a figurative sense. He and his successors are certainly no kin to the rest of us. And yet, particularly in the last 100 years or so, governments have been exercising more and more paternalistic powers over the entire citizenry.

How else can we interpret the actions of Stalin or Hitler? Each was doing what he thought was his level best for his "kinfolk" (respectively, proletarians and Aryans). Of a more benevolent variety, the actions of such leaders as F.D.R., Kennedy, Johnson, Bush and Clinton may also be interpreted as paternalistic. Yet it is hard to see how the reductions of economic freedom they brought about were actually beneficial.

Competition

If any further evidence of Demsetz's moral myopia were needed, his discussion of competition more than fills the bill.

He begins by describing the phenomenon:

> There are a multitude of methods for competing, ranging from a brick through a rival's place of business to a reduction in price to the introduction of a superior product. (p. 112)

Even at this level, objections must be registered. In economics, competition is a way of *cooperating*. Paradoxically, even though business rivals may go "hammer and tongs" at each other, their activity is part and parcel of the market, and such commercial interactions are a cooperative endeavor melding together the goals of millions of people. Its reach is limited only by the extent of the division of labor. Many people think that professional athletic teams are only competing with one another. But economically speaking, they are in a deeper sense engaged in mutual cooperation, putting on a show for the paying customers. For all of the fabled rivalry which occurs in this venue, they cooperate with each other precisely as much as member of other large firms which entertain the public: symphony orchestras, movie companies, etc.

The point is that they refrain from aggression; competition, at least in the economic sense, is limited to non-invasive acts. This even includes boxing. Superficial appearances to the contrary, no aggression takes place in the ring (apart from purposeful head butts, hitting below the belt, and other such rules violations). The ordinary right cross, which in most other contexts would count as aggression, does not qualify as such in this context. For both pugilists, agreeing to take part in this athletic contest, have mutually rendered what would otherwise be considered assault and battery into voluntary, "cooperative" behavior.

Paradoxically, the more competitive is the athletic contest, the more economic cooperation occurs. No one would regularly pay good money to see games with scores like 150 to 0. Thus, without a fiercely battled contest, where the identity of the winner is not a foregone conclusion, little if any economic cooperation will take place.

Given that competition is at bottom a cooperative effort,[61] we can immediately see that there is no "multitude" of competitive models, at least not along the lines sketched out by Demsetz. Lowering prices and introducing better products? Yes, of course. But throwing a brick through a rival's plate glass window? How can that be competitive? If it isn't cooperative, it cannot be competitive either, at least not in the legal and economic sense. What is it then? It is a private property rights violation, pure and

[61]This of course is not to deny that rivalry may well, and often does, exist between the competitive parties.

simple. It doesn't deserve to be listed alongside such peaceful activities as price and quality competition.[62]

Demsetz does concede that "social scien[tists] and the humanist philosophers" (p. 112) make an ethical distinction between the tossed brick and the lowered price. But biologists do not. Even apart from his glowing rendition of sociobiology, it is clear where Demsetz's loyalties lie, academic discipline-wise: with the latter.

Am I being unfair to Demsetz? He does, after all, allow that "there is a strong correlation between the efficiency consequences of various forms of competition and the degree to which they are judged to be proper or ethical" (p. 113). He could scarcely make that point if he absolutely refused to draw ethical distinctions between the brick and the lowered price. However, he takes this all back (and more) when it comes to his analysis of monopoly:

> The securing of monopoly through legislated protection, however, seems much less likely to yield these gains than the securing of monopoly through superior products. It is difficult for me to see how to distinguish these two sources of negatively sloped demand curves other than by judging their likely contributions to real wealth, and it is only when judging that ethical considerations become relevant. (p. 113)

Here he is, back at the same old ethics-consists-of-no-more-than-efficiency lemonade stand. If he can't see a *moral* difference, over and above "likely contributions to real wealth" between attaining single seller[63] status by legislative fiat and by satisfying customers, it is hard to see how it can be claimed that he has any moral faculty at all.

There are those, moral relativists, who think that by definition every society, every culture, and even every individual absolutely must[64] have a moral faculty. Even the Nazis and Communists, who killed millions of innocent people, are defended in some quarters as having a moral sense. To the query "How can this be?" they reply "They just have a *different* sense of morals."

[62]To be sure, one can define competition to include both invasive and non-invasive activities. Stipulative definitions cover a multitude of opinions. But to conflate these very different kinds of behavior is at least problematic from the point of view of precision of language. It also leaves a large moral vacuum, in that these activities have very different ethical implications.

[63]For an explanation of why I refuse to employ the word "monopoly" to describe market success, see Armstrong (1982), Block (1977a), Armentano (1972, 1982) and especially Rothbard (1962).

But there is a fallacy here. Suppose we come across a new breed of creatures, who speak an entirely different language.[65] Our first task in setting up relations with them is to create and English - X language dictionary. We begin by pointing to an object, and saying "cup." They are accommodating, and point to various cup like objects, and say "plunk" as they do so. They apply "plunk" to glasses, bowls, pots and pans and wastepaper baskets. They refuse to apply it to apples, bananas, bicycles and pencils. We conclude the "plunk" and "cup" are rough translations. Next, we point to the appendage at the end of our leg, and say "foot." They point in the same direction on themselves and say "garr." We say to ourselves, "aha, 'foot' and 'garr' are equivalents in our two languages." But then, rather to our dismay, they point to a rock, a rowboat and a giraffe and use the same word "garr." What are we to make of this? Are we to still maintain that "garr" and "foot" are the same, only that their understanding of "foot" is *different* than ours? Not a bit of it. We must, reluctantly if need be, conclude that they simply do not *have* a concept of "foot" in their language, at least not commensurate with our own.

Now suppose we meet a "Martian." We are trying to determine whether this creature has a concept of morality or ethics. Thanks to our previous considerations, this is by no means a foregone conclusion. Like good logical positivists, on the contrary, we are going to *test* this proposition. We start out well enough. We maintain what we take as a paradigm case of morality: "It is wrong to kill an innocent baby." Now we invite the Martian, who we have reason to believe speaks the same language, to give us another instance of an ethical statement. He starts off on a good note with "a thrown brick . . . and . . . a reduction in price . . . [are] not viewed as equally ethical" (p. 112). At least this Martian is clearly making the crucial distinction. However, then he goes and ruins it by saying:

> Efficiency seems to be not merely one of the many criteria underlying our notions of ethically correct definitions of private property rights, but an extremely important one. It is difficulty even to describe unambiguously any other criterion for determining what is ethical. (p. 109)

In other words, "ethical" is exhausted completely by "efficient." Alternatively, "ethical" means no more than "efficient." Are we to say that the Martians have a perfectly reasonable, coherent,

[64]Note the contradiction here?

[65]I owe this example to Martin Lean.

sensible understanding of the moral realm, it just happens to be somewhat different than our own? Not at all. The plain fact of the matter is that Demsetz lacks an understanding of ethics, in the same way an atheist does not have an appreciation of God, or a color blind person of color, or a tone deaf person of music. Even his distinction between brick throwing and price reducing can now be understood in this vein. He *means* by it (or at least denotes) no more, and no less, than that bricks are far less *efficient* in an economic sense than are price alterations. The logical implication is that if this situation were somehow reversed, that is, that brick throwing became a better means to achieve wealth maximization than diddling with prices, then Demsetz would line up behind the former and eschew the latter. Nor would it be a matter, for him, of *balancing* the moral against the efficacious; reluctantly accepting the wealth maximization goal, but regretting the loss of morality. In the Demsetz world view, the two are precisely the *same*. There is nothing to regret. There is no trade off. If brick throwing gets us out onto the highest indifference curve possible, well by gum and by golly, that is the very meaning of ethical behavior.[66]

Conclusion

This way of interpreting Demsetz is buttressed by his concluding remarks. Here we are treated to yet another version of ethical relativism: "The ethical weight accorded efficiency in property rights assignments is thus dependent on the ethical properties of prevailing tastes and preferences" (p. 114).

These tastes and preferences, in turn, are determined by survival. "Life styles that promote survival come to be viewed as ethical. . . . Our present preferences and tastes must reflect in large part their survival promoting capabilities" (ibid.). This means that survival, a sort of "super efficiency," is what ethics amounts to.

Now, there is a good bit of truth to this. Our moral codes hardly amount to a recipe for mass suicide. On the contrary, the rules of the Bible, the Talmud, and other religious documents have passed the test of time; those societies living in at least rough accordance with them have prospered to a far greater degree than those which have not. However, this is no warrant for *equating* human

[66]No doubt there are many more people who equate wealth maximization with ethics than Demsetz. My first experience with this phenomenon, however, was with Henry Manne at a Liberty Fund conference in 1988 who maintained through thick and thin that economic freedom consisted of no more than maximizing GNP and its rate of growth. See statements by Manne in Block (1991), pp. 12–14, 49–50, 125–26.

survival with morality. Suppose, just suppose, that there were hundreds of intelligent species besides our own in the universe, and that for some perverse reason our survival depended upon killing them all, even though they did not in any way directly threaten our survival. (For example, a Super Being such as "Q" in the Star Trek series demanded that we kill everyone else, or he would kill us.) Here is a case where no facile equation of morality and human survival could pass muster.

Demsetz imparts a morally relativistic "spin" to his understanding of the relationship between survival and ethics. It depends on time, or place, or war, or peace, or population size, or the degree of wealth or poverty. He states:

> what has survival capability in one environment, or century, may not do so well in another. A command social structure is likely to do better in small tribal societies than in large complex societies. War and peace are likely to bring forth different ethical precepts. A society of plenty can tolerate more altruism toward special hardship cases than can a society of poverty. We are bound to view the proper resolution of legal problems from the perspective of what presently seems efficient. (p. 115)

Yes, yes, different things may be required for survival in different contexts, but this doesn't make what is moral in one case immoral in another. It doesn't matter that a command economy can do more harm in large complex societies than in small simple ones. It is wrong in both cases to violate economic freedom. It is simply not true that rape, theft, brutality, etc., which are far more prevalent in war than in peace become moral on that ground. Charitable giving is easier to finance (and less needed) under general affluence than poverty, but it is still a moral act in both cases.

In contrast to the amoralism emanating from Demsetz, Knight is a pillar of objectivist rectitude on this matter. Says he:

> The conditions of survival are merely the laws of biology. It may well be the part of prudence to act in accordance with them, assuming that one *wants* to survive, but it can hardly be associated with the notions of right or duty, and if these have no meaning beyond prudence the realm of ethics is illusory. (p. 115)[67]

[67] Knight 1935 (p. 71), quoted in Demsetz (p. 115).

Needless to say, the present author warmly supports this view. The problem is, Demsetz offers this citation only to criticize Knight. His criticism amounts to little more than a rehearsal of sociobiology, only applied, now, to ethics itself: "it is the set of ethics that does survive and prosper that will identify what is efficient and what is not" (p. 115).

Demsetz ends his essay on what can best be described as an uncertain note. On the one hand, he seems to see the present debate—between he and Coase on the one hand and Rothbard and myself on the other—as wasteful:

> Those who value freedom highly would seem to be wasteful of their efforts and those of others to issue a call to debate where no substantial issue of freedom is involved; the choice between alternative private property definitions would seem a case in point. (p. 116)

But this is unacceptable. It is not true that no substantial issue of freedom is involved in this disagreement. On the contrary, there is a chasm as large as the Grand Canyon separating the two sides. In my own view, what Demsetz is pleased to call his "alternative private property definition" is no such thing. Rather, it is almost a complete abnegation of property rights. Moreover, it is a chimera. It is an attempt to define property not in terms of past accomplishments—homesteading, trade, etc.—but on the basis of supposed future consequences. It is based on a judge's arbitrary opinion as to who can best utilize a given resource. Demsetz, for his part, is equally critical of the Locke–Rothbard view. He cannot paper over this dispute in the last paragraph of his essay after devoting all of his efforts to a critique.

On the other hand, appearing to take this all back, he seems to find some value in debate, "as in arguing for deregulation" (p. 116). This, too, is hard to follow, as the entire Demsetzian edifice is based on a call for regulation of markets, albeit by judges, not by politicians, bureaucrats, licensing boards, wages and price controllers, and other more typical regulators.

Consider the counterargument: Demsetz doesn't at all call for regulations; he merely favors a different kind of decision in property rights disputes. However much one may disagree with his views, it is improper to call them akin to a defense of economic regulation.

The problem with this defense is that regulations, too, are "merely a different kind of decision in property rights disputes." Take rent control for example, the very paradigm case of an

economic regulation. Is it not true that this is "merely a different kind of decision in property rights disputes?" The landlord wants to charge $500. The sitting tenant thinks that it would be more fair for him to pay only $300. Is this not a property rights dispute?

But couldn't this also be said of the free enterprise answer to the dispute—to which undoubtedly Demsetz would agree—namely, that the landlord should be able to set whatever rent he wishes for his property? No. It would be a travesty of language to maintain that defending the landlord's right to own his property, and to demand whatever rent he wishes for it is tantamount to regulating his business.

As it happens, it is inconsistent with his general philosophy for Demsetz to take an anti-rent control stance, however much he may wish to do so in other contexts. For if he is to remain true to the Coasian Law and Economics doctrine, he cannot blithely condemn all rent controls. On the contrary, he must first determine whether the landlord's use of the rental fee of $500 will benefit him more than the loss of this money will negatively impact on the tenant. Who says, after all, that the landlord is the "rightful" owner of the property in question? For the Demsetzes of the world, this should always remain an open question or perhaps a meaningless one. It is for the judge to decide upon this, and he should do so, as we have seen, based upon which decision will maximize total wealth. There is absolutely no reason to suppose that this *always* implies that landlords should be allowed to keep their property, let alone unilaterally set the rent level. It must of course be conceded that Demsetz and his colleagues have been in the forefront of the effort to marshall evidence showing the deleterious effects of rent control. However, as a consistent Demsetzian, he cannot universally condemn this law.

Our author ends his essay with a ringing call for freedom. But what can this possibly mean, if freedom consists of no more than wealth maximization? I would find his well spoken call for freedom far more eloquent if for Demsetz there were some *difference* between freedom and economic efficiency.

As I see matters, far from there being no real disagreement between us, we have only begun to scratch the surface of disputation. What we sorely need is more debate, not less. I therefore invite Demsetz and other devotees of the Law and Economics philosophy to continue the discussion. It is the only hope of attaining the truth on these very interesting and important matters.

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Information and the Market Economy: A Note on a Common Marxist Fallacy

Nicolai Juul Foss

Marxists have seldom been noted for much economic sophistication in their critique of the capitalist market economy. Marxist reasoning was essentially easy game for Mises ([1920] 1990) in his classic initiation of what came later to be called "the socialist calculation debate." However, later market socialist contributions to this debate were for a long time believed to have provided the definitive answer to Mises's challenge. As we all know well today, this understanding is completely fallacious (Lavoie 1985; Salerno 1993; Steele 1993), and as result of the Austrian critique of socialism, many contemporary socialists have become unsure of the viability of the socialist project (for example, Gamble 1986; Hahn 1990).

However, socialists have certainly not given up hope. In a relatively recent article, the Marxist John O'Neill (1989) put forward a radical critique of the market order; one that has often been given more implicit articulation by other socialists, but had not been given its fully explicit statement until O'Neill's article. I will here argue that this critique amounts to a fallacy.

Although O'Neill's critique was directed towards the increasing prominence of market socialism, he primarily argued against perhaps the best known Austrian defense of the market, that is to say, Hayek's conceptualization of the market as an information providing mechanism. Hayek's conceptualization and corresponding defence of the market in knowledge terms is well-known and influential among recent market socialist writers.

Mises's ([1920] 1990, 1949) different and even more fundamental conceptualization of the calculation problem as one of

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appraisal, rather than optimal provision of information (Salerno 1993), has not been noticed or separated from the Hayekian argument. It is doubtful whether O'Neill's critique can be directed against Mises's understanding of the calculation problem as one of appraisal.

Furthermore, in this note, I argue that O'Neill's argument has a little bite against Hayek's arguments in particular and the capitalist market system in general. I wish in this connection to call the attention of Austrians to the important work of the British subjectivist economist, George Richardson, on the coordination of producers' plans and how the market economy allows rational plans to be made (see also Foss 1994, 1995). This is probably best done by later demonstrating the pertinence of Richardson's insights in the present context. Let us begin by briefly examining O'Neill's argument.

O'Neill on Information in a Market Economy

According to O'Neill the Austrian (Hayekian) conceptualization and defense of the capitalist market system is untenable. In fact, it is vulnerable to an essentially Marxian critique: the market is "anarchic," precisely because it *fails* to distribute the information that is necessary for rational decisions with an intertemporal orientation. Specifically,

> that information that is relevant to economic actors, in order that they be able to coordinate their activities, is not communicated, and . . . no mechanism exists to achieve the mutual adjustment of plans. The market *in virtue of its competitive nature* blocks the communication of information and fails to coordinate plans for economic action. That feature of the market is specific to the market as a system of independent producers in competition with one another for the sale of goods. It is not a consequence of complexity or change. (O'Neill 1989, p. 109)

What is here meant by the expression "in virtue of its competitive nature" is that "independent producers in competition with one another" have little or no incentive to disclose much of the information that is relevant to their decisionmaking. This is argued in terms of the (one-shot) prisoners' dilemma: "Given that all parties are self-interested, the competitively stable strategy is non-cooperation" (ibid.). Mutual exchange of information may benefit everybody, but instead the suboptimal situation is realized.

The reasoning behind this seems to be the following: In the absence of communication of information on future-directed production plans, producers in a market may, for example, invest too much, and realize losses when the new more roundabout processes of production mature with a larger output that drives prices down. The new equilibrium price is much lower than the price that would have resulted from the communication of information on investment plans.

In contrast to Hayek, prices will *not* act to satisfactorily coordinate plans, for prices only reflect past and present wants and scarcities, not future ones. (Note that this critique cannot be directed against Mises's future-oriented conceptualization of the calculation problem.) As a result, plans will not be coordinated, and the door is open for Marxian business cycles caused by maladjustments of producers' plans (somewhat reminiscent of ordinary pig-cycles). Since they are fundamentally based on market organization, market socialism schemes are also vulnerable to such objections. The solution lies in some cooperative, socialist economy with a mechanism that efficiently distributes information, and thereby "does the job that Hayek falsely claims the price mechanism performs" (O'Neill 1989, p. 109).

O'Neill's assertions are open to critique on numerous counts For example, he neglects that current prices to some extent reflect producers' plans, since these plans result in factor demands that are registered in prices. Also, forward markets exist for some products and services. Finally, producers may form reliable expectations based on competitors' past actions. To some extent, all this dampens the severity of intertemporal coordination failures.

Here I shall, however, restrict myself to the following critique of his reasoning: it is not true that the capitalist market system lacks mechanisms for coordinating plans among independent but not interdependent producers. To believe so is to operate with an impoverished understanding of "the economic institutions of capitalism" (Williamson 1985); an understanding that is, ironically, best represented by older versions of neoclassical economics. In fact, the capitalist market system does contain cooperative mechanisms for information dissemination.

In other words, while O'Neill's critique may be pertinent in connection with specific (and outdated) economic models, it is much less pertinent in connection with economic reality and with sophisticated theories of this reality. In the following section I

[1]See Steele (1993, pp. 248–53) for some points not recounted here.

draw primarily on the work of George Richardson and also refer to the so-called "new institutional economics" in order to underscore this assertion.

Hayek, Richardson, and the New Institutional Economics

O'Neill's discussion largely centers around the work of Friedrich A. Hayek. In his article, "The Use of Knowledge in Society," Hayek explained how the price system solves "the economic problem of society" by making all the dispersed pieces of knowledge that underlie decisionmaking mesh. By providing incentives to react rationally to changing scarcities, for example, substitute one raw material for another, the price system may in some strained sense be said to transmit information. But notice that producers do not actually receive the information that caused prices to change. To borrow Hayek's famous example, when a tin mine closes down, it is not necessary for the efficient functioning of the economy that *this* information should be disseminated. What is, however, necessary is that the price system should register the diminished supply of tin. Hayek's claim is that the price system in fact does this, and that the market economy therefore operates with an information minimum, that is to say, economizes on information costs.

Now, Hayek can in fact be understood as talking about one very special situation, though one that neoclassical economists are traditionally very fond of: perfect competition equilibrium. Seemingly, he says that the *only* signal producers need in order to make a rational decision that dovetails with the decisions of other producers is the price. If that is what he says, he is talking about an perfect competition equilibrium situation; for it is only here that price provides sufficient guidance to action. Outside of this situation, producers will have to think strategically, that is form conjectures on each others plans and actions. They will have to perform appraisals. But can they do this? Can they form reliable expectations on each others plans and actions? O'Neill denies that. However, as we shall see, this inability to coordinate actions is a feature of a specific economic model; it is not a feature of reality. In order to criticize the perfect competition model on grounds that are closely related to O'Neill's critique of the market system, George B. Richardson in his 1960 contribution, *Information and Investment* suggested the following *Gedanken*-experiment: suppose that producers under perfect competition—but without any forward markets—are suddenly hit by some increase in demand that affects them all and is expected to persist. What will be their

responses?; how much plant should they order? The problem is that the information on other firms' investment decisions that would be necessary for calculating optimal investments is not available to anyone, given the assumptions of the model. Firms may guess, of course, but those guesses must involve the guesses of other firms, which would seem to lead into an infinite regress. The endogenous uncertainty thus created implies that there is no equilibrium in the sequence of guesses. On the whole, producers are logically unable to make any rational decisions, specifically, to rationally invest.

It could be argued of course that the reason for the result lies in the particular set-up chosen, namely the perfect competition model with its assumption of strictly local information, etc. True, the result depends on the setup—which is in fact precisely what Richardson wishes to demonstrate. Richardson's main, and constructive, point is that a number of institutions, practices, norms, etc., that exist in the reality of the capitalist market system, but are completely inexplicable within the perfect competition model, in fact has the beneficial consequence that the severity of the coordination problem is strongly reduced.

The importance of "imperfections" for the effective working of the economy is perhaps most obvious in the case of the coordination of investment projects that are *complementary* to each other, in the sense that the sum of their returns when undertaken simultaneously is greater than if they are undertaken in an isolated way. Richardson denies that the price-mechanism generally will do the job of coordinating complementary investments unassisted. However, "imperfections" such as reputation, trust, and contractual agreements perform the tasks of easing knowledge flows over stages of production and contributing commitments, that is, they reduce information costs and align incentives. This promotes the coordination of investment plans.

In the case of *competitive investments*, the kind of investments O'Neill seems to be talking about, cartel arrangements, price notification schemes and numerous other "restrictive" trade practices allow producers to anticipate each others actions, for example, by providing information (e.g., price notification schemes). Thus, Richardson suggests a rationale for a much less restrictive antitrust attitude towards such arrangements; a view that any Austrian would clearly endorse. His basic position is that markets and their so-called "imperfections" are essentially information structures, and that overly interventionist public policies may destroy this information provision. Arguably, this view dates back to the pro-business views of Alfred Marshall (Foss 1995).

In Richardson's celebrated 1972 article, "The Organization of Industry," he strongly emphasizes that this "Organization" is in reality more than hierarchical direction and is more than the operation of the pure price mechanism; to a large extent it is a matter of all sorts of cooperative relations between firms. Industry, says Richardson, can be thought of as composed of numerous "activities" (research and development, manufacturing, sales and service, etc.), which have to be carried out by firms with the requisite "capabilities." Thus, Richardson is inviting us to see the firm as a pool of productive and organizational knowledge (some of which may be tacit). Activities which require the same or closely related capabilities are "similar." Firms find it expedient, for the most part, to concentrate on similar activities, since incorporating "dissimilar" activities under the corporate umbrella implies numerous inefficiencies. This forms a basis for a theory of "cooperation," that is of inter-firm relations, such as long-term contracts, joint ventures, licensing agreements, etc. Firms enter into cooperative relations when they need access to complementary but dissimilar activities. Inter-firm coordination schemes also serve to stabilize the economic system.

To sum up on Richardson's work, a number of the economic institutions of the capitalist market system exist and have the beneficial effect, and may in fact exist because of this effect, of making interaction coordination problems much less severe.

This basic insight also informs much of the recent economic literature on institutions ("neo-institutionalism"). Although Robert Sugden's (1986) work on norms and Oliver Williamson's (1985) work on the contractual institutions of the capitalist market system—to settle on two of the most prominent examples—are in many ways far from each other, they are agreed on the basic insight that institutions can be understood as responses to social interaction problems á la Richardson's investment coordination problem. It is now a very general recognition in this literature—and in fact in economics in general—that in addition to information contained in market prices, social norms and in particular business practices, imposing some restrictions and coherence on the individual decisions and information generated by institutions external to the market, play important roles in achieving order in market processes.

Is this contrary to the Austrian vision of the market order? Not at all. Notice that Hayek's and Richardson's work are complementary. Richardson adds to Hayek's picture by pointing out that stocks of knowledge (capabilities) may not only stand in a

competitive relation to each other, but in reality may also be complementary. However, much of the knowledge that is relevant to economic affairs is tacit, a point that both Hayek and Richardson are eager to drive home. Partly because of such tacitness, individual firms will normally not have superior or even precise knowledge about the whole of the production process into which their products enter. It is likely that nobody will in fact possess all of this knowledge. Of course, this does not mean that "the industry" does not "know" how to produce. To paraphrase Hayek (1945) with a bow to Richardson, the marvel is precisely that competition *and cooperation* ensure that effective use is made of capabilities that are not possessed by any single firm. But firms are not completely self-contained; as Richardson points out (1972, p. 855), effective cooperation will normally require some knowledge of "neighboring" capabilities—those possessed by other firms— so that "their limited individual fields of vision sufficiently overlap so that . . . the relevant information is communicated" (Hayek 1945, p. 86).

Richardson also links up with the Austrian understanding of the market in a somewhat different way. In Richardson's perspective, much of "the organization of industry" is a matter of discovering which capabilities are best for you as a producer, where and when. Now, Hayek saw "The Meaning of Competition" as primarily a matter of teaching us "*who* will serve us well; which grocer or travel agency, which department store or hotel, which doctor or solicitor, we can expect to provide the most satisfactory solution for whatever particular personal problem we may have to face" (Hayek 1946, p. 97). In other words, one of the benefits of the market system, including its modes of competition and cooperation, is precisely that it makes *capabilities* visible to the participants. This is completely contrary to O'Neill's analysis; however, it is decidedly much closer to reality than O'Neill's understanding of the capitalist market system.

I conclude that O'Neills' information-based critique of the market economy, whether capitalist or socialist, does not hold water. His critique may justifiably be directed against the perfect competition model; however, it cannot be directed against neither real-world market systems nor recent neo-institutionalist economics. In reality numerous institutions support the operation of the pure price mechanism, thus stabilizing the social landscape and assisting the coordination of plans, partly through disseminating information. This is demonstrated in the work of George Richardson, which, because of its many affinities to Austrian economics, deserves to be more recognized among Austrians. In

other words, O'Neill's attempt to revive the Marxian theory of the business cycle, his critique of Austrian economics and his critique of market socialism are open to strong doubts. This is because they are based on a lack of understanding of both economic reality and recent economics.

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Book Review

Ethics and Economic Progress. By James M. Buchanan. Norman, Okla. and London: University of Oklahoma Press: 1994.

A line of tension runs through much of James Buchanan's work on ethics and economics. On the one hand, he views ethics as subjective: he appeals to no external standards that dictate to individuals what they ought to prefer. Thus, he makes no attempt, in the present book, "to say just how much 'should' be saved, in the aggregate, despite the proposition that we 'should' save more than we do" (p. 35).

On the other hand, he refuses to leave individuals entirely to their own devices. Quite the contrary, he has strong ethical views of his own, which he does not hesitate to recommend. Here lies the tension: if ethics is subjective, why are Buchanan's recommendations more than a reflection of his own tastes? In *Ethics and Economics*, he launches an ingenious, though I think unsuccessful, attempt to show that he can justify certain ethical prescriptions without casting aside subjectivity of preference.

His argument proceeds as follows: If people increase their hours of work, then, other things being equal, they will benefit others as well as add to their own stock of goods. As people work more, the market expands; this permits the division of labor to proceed apace. Buchanan appeals here to Adam Smith, who "advanced, as a general principle, the notion that the division of labor depends on the extent of the market" (p. 15). Those who labor generate positive externalities for others, but not so those who withdraw into idleness.

If increased work leads to such benefits, a further question arises: How may individuals should be induced to accept the

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gospel of work? Buchanan looks to the Puritan ethic: if certain virtues associated with the Puritans receive due attention in popular moral education, the blessings of an expanded market lie within reach. Thus, Buchanan can "suggest that individuals, acting strictly in their own interest," should follow the course of action he advocates.

Buchanan's description of the Puritan ethic is in one respect unusual. He remarks: "Much the same logic . . . could be extended to those familiar precepts that call for honesty in dealings, for promise keeping, for truth telling, for respect for person and property, for sobriety, for tolerance. In short, we could readily include the whole set of constraints summarized within the rubric 'the Puritan virtues' " (p. 79). The Puritans have rarely been praised for their exceptional tolerance; Buchanan's inclusion of this trait as a Puritan virtue would surely surprise Roger Williams. Fortunately, Buchanan's slip leaves his main argument unharmed.

That argument must face an obvious objection, one which Buchanan knows full well. In a competitive economy, individuals balance the benefits of labor and leisure as they wish. If someone wishes to play golf rather than work an extra hour in his medical consulting room, how can Buchanan say that he would be better off, from his own point of view, if his preferences shifted?

Buchanan replies that the "basic neoclassical model," on which the objection just given rests, fails to apply to the case at hand. In the neoclassical model, someone who works an increased amount "receives precisely the value of the addition to the value of product that the extra work generates" (p. 22). This holds true only if inputs are assumed fixed; since the economy in fact grows as labor time increases, the decision to work more benefits others besides the worker himself.

Buchanan's point may be granted, but it fails adequately to respond to the objection. Even if the person who works more does generate positive externalities for others, the question remains: is he better off, in his own eyes, after doing so? Unless the move accords with his own preferences, the answer appears to be no. The economy may be larger; but unless *his* share of goods rises sufficiently to compensate him for his loss of leisure, *he* has failed to benefit.

Buchanan notes and explores a tendency among economists to take preferences as given. Although economists should consider preferences for most purposes "relatively absolute absolutes" (p. 76), this does not require them to abandon all questions

of preference formation to the psychologist. Economists must be free to analyze how changes in incentives alter preferences.

Once more Buchanan's point may be granted, and once more the key objection remains without answer. However flexible or subject to analysis an individual's preferences may be, he cannot be pried apart from the actual set of preferences he has. To say, as Buchanan does, that someone *would* be better if he had other preferences misses the point. For a consistent subjectivist, gains or losses in utility can be assessed only against a set of preferences. Put bluntly, for the economist an individual *is* his set of preferences. To compare someone's actual utility with his utility under different preferences stands on precisely the same footing as an interpersonal utility comparison. If Buchanan thinks that people should work more, or save more, these are ethical judgments of his own, not the outcome of *wertfrei* economic analysis. Insofar as he makes value claims, Buchanan is an ethicist or he is nothing: *tertium non datur*.

Further, Buchanan has pushed his argument for more than it is worth. Suppose he is right that increased work generates positive externalities, while increased leisure does not. In like manner, let us assume him correct on the benefits of saving against spending, which he defends by an analogous argument. Has he shown that individuals who wish for a more productive economy should work rather than loaf, save rather than spend? I do not think so. He has at most shown an advantage of working and saving against their respective alternatives. This hardly suffices for an assessment of total benefits and total costs—one advantage does not make an evaluation. Professional wrestling exacts more physical demands than does teaching (except in the inner cities); does it follow that teaching is 'better'?

And is Buchanan correct that working more generates positive externalities? Yes; but on one condition. The "externalities" add to utility only if consumed; as Adam Smith long ago pointed out, the end of production is consumption.

This obvious truth does not show that Buchanan errs in calling for more work and saving. But it limits the scope of his conclusion: his analysis holds valid only if some people actually consume the increases in productivity his Puritan virtues make possible. (I omit here the complication of satisfaction just from an increase in work—Puritanism with a vengeance). If they do not, Keynes's famous image of the capitalist cake growing ever-larger but never being eaten, though false for nineteenth century Britain, will apply to Buchanan's Puritan Commonwealth.

One last step in Buchanan's case requires a closer look. Suppose, once more, that he is correct about the benefits of increased labor. It does not follow at once that preaching the Puritan virtues has been justified. This is so even if the preaching effectively inculcates the desired values. Once more, Buchanan has not considered the full picture: what has become of the costs imposed by the training in Buchananite virtue? Buchanan tells us that he was able to justify watching four professional football games in one weekend only when he thought of the happy expedient of cracking walnuts as he viewed the games. Thus he assuaged his guilt about wasted time (pp. 7–8). The increased self-consciousness and anxiety, what one might term the 'internal Taylorism," that Puritan education seems liable to produce, must be weighed against its good effects.

Buchanan's short book includes an application of his ideas to taxation policy and a criticism of personal service work, in which the notion of increasing returns figures prominently. His originality and ability to apply economic theory to new subjects inspire respect and admiration; but I cannot think that his revamped Moral Rearmament offers much promise.

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The Review of Austrian Economics, the predecessor to the *QJAE*, was founded and edited by Murray N. Rothbard and functioned as the premier Austrian School scholarly journal between 1987 and 1997. After 1995, it was edited by Walter Block, Hans-Hermann Hoppe, and Joseph T. Salerno. Published first by Lexington Books and later by Kluwer Academic Publishers, the journal played a central role in attracting a new generation of economists to the theoretical foundations established in the work of Carl Menger and Ludwig von Mises.

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