

# NEW PERSPECTIVES ON POLITICAL ECONOMY

## A Bilingual Interdisciplinary Journal

Vol. 16. No. 1-2, 2020

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# **NEW PERSPECTIVES ON POLITICAL ECONOMY**

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### **Published by CEVRO Institute Academic Press**

New Perspectives on Political Economy CEVRO Institute, Jungmannova 17, 110 00 Praha 1, Czech Republic

Manuscripts should be submitted electronically to [nppe@vsci.cz](mailto:nppe@vsci.cz).

Full text available via DOAJ Directory of Open Access Journals and also via EBSCO Publishing databases.

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**ISSN 1801-0938 (on-line)**

**ISSN 1804-6290 (print)**

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# **An Alternative View on Saving and Investment From an Austrian Economics Perspective**

Youliy Ninov

**T**he contemporary Austrian economics views about saving and investment are derived from a basic Robinson Crusoe type of economy. The latter leads to oversimplification, and the alternative ways to save and invest observable in any contemporary economy can not be accounted for. In a monetary, capitalistic economy, the process of saving does not require that consumption goods or their intermediate products be accumulated in advance for investment to take place. We also show that any economy possesses an amount of free capital, which is self-sustaining and can be used exclusively for capital substitution and investment, thus avoiding the necessity for constant saving on the part of the economic agents. Secular economic growth becomes possible without net saving.

## **Introduction**

The standard Austrian economics view about what constitutes saving can be found in many scholarly texts. It begins with the statement that saving is the postponement/curtailing of consumption. The latter statement is beyond reproach, but its continuation, i.e., the explanation of how saving is transferred into investment is questionable. In particular, we will argue that the standard Austrian view on the matter is very narrow, i.e., that it applies only to the particular case of a barter economy that does not possess capital, i.e., to a basic, Robinson Crusoe type of economy. In a contemporary economy, the processes of saving and investment do not require the prior accumulation of consumer goods or their intermediate products.

Once we have shown how saving and investment function from this perspective, we will deal with the problem of how savings are accumulated and used in a contemporary economy, i.e., an economy that possesses money and physical capital. We will show that every economy has an "investment fund" of capital, which is used for capital substitution and investment. Based

on this view, we will also show how this fund can compensate for the capital depreciation, thus avoiding the necessity for net saving on the part of the economic agents. In other words, we intend to show that net saving is not a prerequisite for economic growth.

## **Saving in a monetary, capitalistic economy**

In order to reveal the real problem, we will make use of the standard example used to introduce saving, namely, the case of Robinson picking berries to feed himself. Robinson lives on a deserted island, and the only way for him to survive is to pick berries from the trees. His problem is that he cannot get many of them and must work most of his time just to survive. If Robinson had a suitable stick, he could pick berries with less effort and, therefore, either get more berries in a single day or work less time for the same number of berries he used to eat before. The problem is that in order to create a suitable stick, Robinson needs time just for this purpose, but this will prevent him from picking berries, and he will starve. The way out of this unfortunate situation is for Robinson to save some berries, i.e., to curtail his current consumption and create a stash of berries over some days, which he could use to sustain himself during the period of stick production. After the necessary amount of berries has been accumulated, he creates his stick and becomes much more productive.

We must note several apparent facts. First, the Robinson economy does not possess any capital, and second, it does not use money (i.e., a barter economy). In economic terms, what Robinson does can be explained in the following way: He produces the usual amount of consumer goods (berries) for some days but sets some of them aside. In a later period, he consumes his saved consumer goods (berries, now considered capital goods) while producing fixed capital (a stick) in the meantime. He invests his effort and capital (stashed berries) into the production of a durable capital good.

The above describes the simplified view that determines the contemporary ideas about what saving and investment are. The problem with it is that it is derived for the most simple, basic case of an economy, and due to this fact, alternative ways to implement saving/investment cannot be observed. In other words: the model used is oversimplified. In particular, we note that in order to save, Robinson must first produce the berries, and just then, when the stashed berries are available, can he use them. In a contemporary economy, the process of saving includes money, however. Thus Robinson would save not berries but money. However, whereas berries constitute a consumption (or a capital) good, money does not. Money is not used up in consumption or production; it is the ultimate exchange good. Thus when Robinson saves money,

he does not implicitly save consumption goods. Besides, since he has curtailed his consumption (does not spend the money on consumer goods), fewer consumer goods are produced on the market. However, what immediately follows is that if he lends his saved money to a capital good producer, he does NOT implicitly transfer consumption goods. The reason for the latter is straightforward: by not consuming, he has decreased the demand for consumer goods, and in a short transitional time, the consumer goods produced by the market will decrease in order to comply with (match) this fact. The act of saving is indeed preceded by the production of consumption goods or their intermediate products. Still, this does not mean that these consumption goods will be accumulated in order for the investment to take place. In practice, the unused consumption goods will be sold either at a loss or at prices corresponding to a rate of profit below the prevalent one in the economy at that time. The latter will immediately force the producers to cut down production soon.

What we explained above stays in stark contrast to the contemporary economic views that Robinson hands out consumption goods to the capital producers for investment. The contemporary Austrian economics views assert that Robinson gives the capital producers consumption goods that they use for paying their workers and for sustaining themselves. Let us quote Ludwig von Mises (1990, ch.4): "Capital goods come into existence by saving. A part of the goods produced is withheld from immediate consumption and employed for processes the fruits of which will only mature at a later date". Alternatively, we can quote Huerta de Soto (2012, pp.275) (more explicit): "Saving always results in capital goods, even when initially these merely consist of the consumer goods (in our example the "berries") which remain unsold (or are not consumed). Then gradually some capital goods (the berries) are replaced by others (the wooden stick) as the workers (Robinson Crusoe) combine their labor with natural resources through a process which takes time and which humans are able to go through due to their reliance on the unsold consumer goods (the saved berries). Hence saving produces capital goods first (the unsold consumer goods that remain in stock) which are gradually used up and replaced by another capital good (the wooden stick)".

As we explained, however, this is simply not the case in a contemporary economy for the following reason: Robinson has decreased his consumption of consumer goods, but instead of these goods being produced first and handed out to the capital producers later (as in the basic Robinson economy) they are simply NOT produced. However, something which is not produced (does not exist) cannot be given to anybody. Let us give an example to clarify the situation. In a particular economy, the consumers are used to going to a restaurant on average

once per week. Suddenly they decide to eat out once every two weeks. The result will be that if the restaurants have produced  $X$  amount of services before, they will have to produce half of that amount ( $X/2$ ) after consumer preferences change. The non-produced restaurant services, however, simply do not come into existence. However, since they are not created, there is no way for them to be transferred to somebody else (i.e., to the capital producers). Note that we have purposefully used services in our example, but the same situation can be described with material goods.

The quotation from Huerta De Soto above shows in particular how the Austrian economic theory has generalized from an oversimplified model situation of an isolated individual to a general economic model valid for the whole economy. Further examples for the latter can be found in Rothbard (2009, ch.1/8,9).

## **How saving turns into investment in a monetary, capitalistic economy under invariable money**

After we explained what the real problem with the contemporary views is, we can try to clear up the confusion. Let us figure out what happens in a contemporary economy when Robinson saves money out of his monetary income. The first direct consequence will be that the demand for consumer goods will go down. After some (transitional) time, the consumer goods producers will realize that the demand has slackened. They will adjust to the new market situation by producing less, and therefore they will curtail the production of consumption goods. Lowering their prices permanently is not an option for them since this will either entail direct losses or simply diminish their profits below the going rate of profit typical for the particular economy. What that means is that resources will have to be freed. In the case of the previous restaurant example, this means the following: People will be laid off, buildings will be left free (the restaurants themselves), the capital equipment used for the restaurant business will not be used (bought). In addition, intermediate capital goods, such as meat, flour, and oil, will not be used (bought). Note that the above represents all basic types of capital: original means of production (land and labor), fixed (houses, cooking stoves, tables, etc.) and circular (unprocessed meat, etc.). However, let us now imagine what will happen to the suppliers of these restaurants. The suppliers of restaurant equipment (of stoves, for instance) will also realize that their products are not needed. Thus they will also curtail production, again releasing people, production facilities, etc. Later their suppliers (of metal parts for stoves) will also have to do the same. And the suppliers of the suppliers (which create the metal for the metal parts) will also have to release resources. What we observe is the following: the initial act of saving causes the release of capital

(original, i.e., land and labor, fixed and circular one) up the production chain. A simple change of consumption habits affected all branches that produced intermediate capital goods geared towards the production of consumer goods and services (restaurant services in particular).

To summarize what has happened: The act of saving led to a release of capital of all sorts in the industries, which were dependent on the production of the particular good, whose consumption has decreased. This is precisely the capital that can be used for investment afterward. Up to this moment, it was geared towards the final production of consumer goods, but once released, it can be geared into another direction, namely towards the production of fixed capital goods such as trucks, oil-tankers, etc. The latter will happen because the saved money will fill the bank coffers (to keep the situation simple). Banks will lower the interest rates and extend credit to producers of durable capital goods. For example, the building of a new shipyard will be started. Thus a part of the resources will flow towards shipbuilding (i.e., labor, building materials, machines, etc.). The needs of the ship-builders will have to be matched by their suppliers, however. Thus another part of the freed capital will flow towards the suppliers and later to the suppliers of the suppliers. As we see, the released capital will find new uses, all of them with the final goal to produce durable capital goods. Note that no additional consumer goods for support during the transition period and during the time necessary for the shipyard production are required. The same people who worked in the restaurants before will now work in the shipyard (for example), and since they are employed and paid, they can provide for their existence. No previously accumulated quantity of consumer goods is needed. The overall production of consumer goods has decreased, and that is why the consumption of the workers from this moment on will be lower for some time (until the additionally accumulated capital gets operational and raises their incomes). They had voluntarily agreed to consume less than before the transitional process took place in order to be able to consume more in the future. Thus the so-called "subsistence fund" (Mises 1912), which supposedly consists of saved consumption goods or alternatively of saved intermediate products used for producing consumer goods, does not play any significant part in a contemporary monetary, capitalistic economy. Providing for the needs of the economy out of current production is the most efficient use of capital possible since no capital is idle at any time, i.e., no consumer goods need to be stored.

The building of an industrial plant can serve as an example. Building a plant takes at least several years. During this time, the people working on it must be fed, and this happens from current production, not from some previously saved amount of food for consumption or from saved (delayed) intermediate products for food production (such as saved wheat) that are



brought to completion. The same applies to the materials used for building the plant. Steel is being created on-demand, i.e., iron ore is typically mined and processed to steel in the same year (time period) in which it is needed. No previously accumulated amounts of steel or iron ore (an intermediate product) are necessary.

Note that the above-given description is simply a description of a transition of an economy that moves from producing less to producing more durable capital goods. How secular growth happens and what the differences are will be handled in the subsequent part of the paper. Still, we must note some significant differences when comparing the discussed process to the one present in the simple Robinson Crusoe economy. In the Robinson case (no capital, no money), we need to produce consumption goods first, and only then can we start producing new capital goods. In a contemporary economy, however, this is simply not necessary. The intermediate step (producing consumption goods for sustaining Robinson) is simply passed over. What this shows is that the contemporary economy is much more efficient in using the available capital. In particular, less capital will be used (just the one necessary for the production of the final durable capital goods), and much less time will be needed (no time for the production of consumer goods is required). A contemporary economy has more degrees of freedom than the basic Robinson Crusoe economy. It has a capital structure and money, i.e., additional ways for capital redistribution exist. In other words, a contemporary economy is much more flexible and efficient with respect to the capital transfer and capital usage.

## **Accumulation of savings, capital depreciation and growth in a monetary, capitalistic economy under invariable money**

Once we have dealt with how net saving is converted into investment in a contemporary economy, we could deal with how these savings are accumulated and used. The necessary simplification for the following discussion is to consider an economy with invariable money only, i.e., the case of 100% fractional reserve with no new money creation. The case of increasing money supply will be omitted for the sake of simplicity of explanation. Furthermore, we will limit most of our discussion to the case of extensive growth, i.e., we intend to show how the overall capital in an economy can grow without considering the technological progress. The accumulation of information and technological knowledge are essential drivers of growth, but we intend to show how simple capital accumulation can happen even in their absence.

In every economy, the amount of capital available and the fixed capital in particular (machines, tools, buildings, etc.) continually depreciates. In other words, this capital wears out and needs

substitution if the particular economy is expected to grow. Presently there are two significant Austrian economics views on how an economy can compensate and overcompensate this loss of capital so that economic growth becomes possible. In the first one, represented in Hayek (1967) and Rothbard (2009), the rate of interest must always go down for sustained economic growth to take place. Thus the economic agents are supposed to not only save but save progressively more with the growth of the economy. In the second, more popular one (Garrison 2002), the rate of interest can stay the same, but the economic agents must nevertheless save some part of their monetary income. What is common between these two views is that net saving is always necessary for an economy to grow ( increasing in the former case and constant in the latter). Both theories claim that net saving is necessary to offset the real depreciation and allow the economy to grow. From here, it follows that both ordinary workers in companies and the businessmen who run these companies must put a part of their monetary income/profits either in a bank account or in another saving option (for instance, by buying company bonds or shares). The latter must happen on the average (i.e., not everybody needs to save) and must be continuous (i.e., saving never stops).

We intend to discuss the consequences of the above-given view for a banking system in an economy with invariable money. We will further accept that under invariable money, the banking branch of the economy functions in the same way as any other economic branch (i.e., retail, ore-mining, etc.). In other words, we will presume that the conclusions we derive from the banking system will apply to the other branches of the economy as well. We have singled-out banking because the processes we will describe are simpler to observe and more evident in this particular case from an economic standpoint.

Banks always have some amount of own capital, but most of the capital comes from outside, i.e., from savers who entrust the bank with the task not only to protect the amount of money they have put in it but also to increase it (i.e., they expect to be paid interest on their bank account balances). Banks on their side lend the money they have obtained against interest (note again that the discussion takes place under invariable money). They are motivated to protect the monetary capital they have, and therefore lend it at such a rate of interest and choose their clients in such a way that they generate profit. Thus on average, the capital in the banks does not decrease. What this implies is that whatever capital is being lost ( e.g., bad loans and bank capital depreciation) will have to be compensated. And it is being compensated by a part of the banking revenues. Let us, however, assume the contrary and see what follows from it. We will first presume that bank capital depreciation must be compensated by additional savings

on the part of the banking clients. Savers, however, will expect that the additional money they put into their savings accounts is also protected, i.e., they will expect that their money does not decrease, i.e., that it is not lost. If this were not the case, they would simply withdraw their money from the bank. However, the latter would imply that the banks cannot use the additional savings to compensate for the depreciated/lost capital. What is more, for steady growth in time, we must presume that savers never stop saving. Still, reality shows that savers save up for something ("SUFs," as discussed in Garrison (2002), pp.40), i.e., when a particular amount of savings is reached, then people stop saving on the average. Still, they should never stop saving if the depreciated capital is to be continuously compensated. All of the above leads us to a contradiction, which implies that our initial supposition is not correct, i.e., that the depreciated/lost capital in banking is not compensated by net saving on the part of their clients.

Up to this moment, we showed that external savings (from clients) could never be used to compensate for the depreciated/lost capital, which by itself is a significant conclusion. But what about the banks themselves? Maybe they save and compensate for the mentioned depreciation? The answer to this question is negative since banks (and businessmen in general) view the money used for compensating the depreciation as explicit costs. In the same way, as for ordinary workers, net saving comes out of net income, in the case of businessmen net saving can come only from profits, which are the difference between revenues and costs. However, since the money for capital maintenance represents explicit costs, it can never come out of net saving on the part of the businessmen. Therefore depreciation cannot be a cost and net saving at the same time. In other words, depreciated capital cannot be restored out of profits. Note that the usage of net saving for capital depreciation contradicts the view that savings represent accumulated purchasing power to be exercised later. If net saving was used to compensate the capital depreciation, it would be lost forever, i.e., the purchasing power could neither be accumulated nor exercised later.

This general point is important and needs further discussion. Suppose that we have a company, which up to this moment has had costs  $X$  and revenues  $Y$ . Suddenly something adverse happens, and it loses some capital. Of course, the company will have to cover this unexpected loss from the revenue  $Y$ , and consequently, it will have to make do with a lower profit. This one-time loss, however, will not lead to a permanent drop in the profits. The company will raise its sales prices in the future so that it can compensate for such (regular) losses. Since the depreciation is predictable, it can be taken into account, and the sales prices which the company asks for can be set high enough to compensate for this particular loss. We wish to stress that the average

rate of profit for the company is determined by the going rate of profit in the economy and cannot be permanently lowered because of the depreciation losses.

What all of the above shows is that this branch of the economy can protect its capital without the need for net saving in general. Still, depreciation must be compensated somehow, and companies do it by passing their depreciation costs to their clients, i.e., by raising their sales prices, as a part of their revenues, but not at the expense of their profits.

A corollary from the above discussion is that capital depreciation losses are identical to the general capital losses (due to bad management decisions, economic disasters, bad luck, etc.). All of these losses are being covered by the revenues of the (successful) companies. Thus singling out depreciation as the only loss in an economy, which is to be compensated, is a wrong approach. One should ask himself how all the losses inherent to an economy are to be compensated. As a side note, it must be pointed out that even the production of intermediate/circular capital goods entails production losses. These losses are covered in the same way as depreciation, namely, through raising the production sales prices. An example: A mining company produces iron ore. A part of the produced ore gets lost during the transportation process from the mine to the flotation facilities and during the flotation process itself. This loss is added to the production costs, i.e., taken into account when forming the end product price. Thus if the iron ore production losses increase for whatever reason, the end price will increase, but if a new technology, which has lower losses, is introduced, the end prices can decrease (typically due to competition). As we see, compensating losses of all kinds is done by increasing the sales prices at the expense of the company's clients. These losses become a part of the cost of production (the cost of doing business). Despite all of the discussed, we will continue considering depreciation as the only form of capital loss in order to adhere to how this is traditionally done in the economic literature. And the reason will be that the extension to the case when we include all losses is straightforward and will change nothing in the line of reasoning or final conclusions.

Up to this point, we were discussing only banking. The rest of the branches of the economy however, are not supposed to work differently under invariable money. Thus in them, capital depreciation will also be compensated by their revenues. From here, we can generalize that since an economy is all economic branches taken together and since no net saving is required in any branch, then net saving is not necessary for the existence of the economy in general. In other words, net saving is not necessary for compensating the economy-wide capital losses.

Once we have dealt with the net-saving issue, we can discuss the source of capital used for compensating the capital depreciation. As we discussed above, depreciation losses are being compensated by the revenues. Thus we have to explain how on a macro level, there is an excess of capital available for compensating losses (and depreciation in particular). In other words, how companies can pass their losses to their clients without decreasing the amount of gross savings in the economy as a whole. Here comes the contribution of George Reisman [Reisman 1990], who noticed that gross saving is able to reproduce itself. In particular, Reisman noticed that an economy produces not only consumer goods but also fixed/final capital goods. The latter is not clearly visible in the contemporary views about the structure of an economy, i.e., in the Hayekian triangle [Hayek 1967]. In such a structure, the fixed/final capital goods are supposedly just an intermediate station towards the production of consumer goods. They are not explicitly shown (and can not be shown in general), which makes them practically invisible, but still exist. Note that it is the fixed capital goods that depreciate in an economy, not the circular capital goods or the original means of production (land and labor). However, if we admit that an economy produces final/fixed capital goods, then we must realize that these newly produced fixed capital goods can be used to compensate for the depreciated/lost ones. Then it becomes a matter of quantitative difference between the produced and depreciated fixed capital goods to determine if an economy retrogresses, is in a stationary state, or grows. If we manage to reach the state where the produced fixed capital goods compensate for the depreciated/lost ones, we will find ourselves in a situation where the economy self-supports itself. Once we have reached it, we need not put any additional effort in order to create capital goods, i.e., no net saving will be necessary. The process will become self-sustaining, i.e., it will feed on itself. In the exact sciences, such systems are called positive feedback systems. These systems do not require to be driven; they drive themselves.

Now the question we have to ask ourselves is how to reach such a state, in which an economy produces more fixed capital goods than it loses. Let us remind ourselves that the production of capital goods and consumption goods are complementary ones. In other words, we can only produce more of the one type at the expense of the other type. At any moment, however, the overall productive ability of the economy is limited. The latter is best exemplified with the famous Guns and Butter graph [discussed in Garrison 2002]. We can use the available resources for producing different goods in an economy at a particular stage of development, but we have a technologically determined limit, which we cannot surpass. Still, it is a matter of our choice where we decide to be on this particular graph. Thus every economy has a choice to produce more capital goods (fixed capital in particular) at the expense of consumer goods or vice-versa.

Note however, that the particular amount of capital that the economy possesses will depreciate in the same way, independently of what we produce. Thus the depreciation rate is fixed, but how much new fixed capital we produce depends on us. Therefore, if we decide to place ourselves in a situation (on the graph) where we produce enough capital goods to counter the depreciation, we will find ourselves in a stationary economy. In the same way, if we decide to produce more capital goods than the ones being lost due to the depreciation, we will find ourselves in a growing, self-sustaining economy of the positive feedback type discussed above.

What we established so far is that an economy can grow by self-supporting itself, which in practice means that no net saving will be required on the part of the economic agents. Thus an economy can have zero net saving and still have a positive net investment. Still, the question stays how we move the economy from producing fewer capital goods to producing more so that we compensate for the lost/depreciated capital. The answer to this question is simple: by saving, as described in section 3. Thus if we do not produce enough fixed capital goods to offset the existing depreciation, we start saving, i.e., let net saving get positive. What will happen is that fewer consumption goods will be produced, and the released economic resources will be re-targeted towards the production of fixed capital goods. But once we find ourselves in a situation where we produce enough fixed capital goods to over-compensate the depreciation/losses, we can stop net saving, and the economy will still grow.

From now on, we will call the amount of capital used for capital substitution and investment "the investment fund." In contrast to the "subsistence fund," the investment fund consists of all types of economic resources, not only of consumer goods. The investment fund includes all three basic types of capital, namely, original means of production (land and labor), fixed and circular capital used in all the stages of production. The latter can be observed when one realizes that banks give loans for hiring labor (original means of production), for buying machines and buildings (fixed capital) and for buying supplies for production (circular capital). The "investment fund" is self-sustaining, and it is constantly invested and reinvested. It is the extension of the concept of "subsistence fund" into an economy that, in contrast to the one of Robinson, possesses capital and money. As such, the subsistence fund is meaningless for a contemporary economy and cannot be a part of a modern theory of capital.

It is instructive to describe how new investment is possible in a simple economy that grows with zero net saving. A simplified example is an economy under invariable money in which the only way to save and invest is through the banking system. In other words, we presume that the profits in the economy for the regular companies are entirely consumed, and the

only money available for investment can be obtained through the banking system. Thus banks have a constant amount of money, which they use for investment into the economy. However, there is no net saving, since on the average economic agents will not save. The saving of some (e.g., young people, saving for retirement) will be offset by the dissaving of others (i.e., retirees drawing down their savings). The latter will guarantee that the amount of bank money used for investment purposes will stay constant. As already discussed, banks can cover their capital depreciation losses from their revenues. We observe that funds will be invested, i.e., some companies will get loans to support their future operations, thus being able to invest in new technological processes. Still, the latter happens without the presence of net saving. Once the loans extended for investment are paid back, the same money will be lent out again, thus ensuring the continuity of the investment process in time. All of the above stays in full compliance with George Reisman's views (Reisman 1990, ch. 15) but described from a different perspective.

Given all of the above, we can generalize that an economy can grow with positive net saving (well known), with zero net saving (just discussed) and even for a while with negative net saving. The latter may happen if the investment fund has initially been big enough to guarantee economic growth and its decrease due to the negative net saving has not brought it to equality with the depreciation yet.

We could contrast the process of secular growth we just described with the transitional process we described in section 3. During the transitional process, net saving was present, and it led to re-directing resources from lines of production, leading towards final consumer goods to lines of production leading towards durable (fixed) capital goods. A shift of capital towards the investment fund happened. During the process of secular growth described above, no net saving is present, but net investment still exists. No capital gets shifted in or out of the investment fund, but still, the economy grows because investment in all production lines is present.

## **Conclusions**

In a contemporary economy, the processes of saving and investment are based on money. Thus the availability of a previously accumulated amount of consumer goods or of intermediate products of the consumer goods to make investment possible is simply not necessary. In this way, in contrast to a Robinson Crusoe economy (no capital, no money), saving-induced investment takes place without producing consumer goods first.

We showed that every contemporary economy has an “investment fund,” i.e., an amount of free capital that is self-sustaining and is used for capital substitution and investment. When the size of this investment fund is big enough, it can compensate for the existing capital depreciation and let the economy grow without net saving being present. In this way, we show that an economy supplies by itself the necessary funds for compensating capital depreciation and all economic losses in general.

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## Bio

### **Youliy Ninov**

Independent scholar





# Income Inequality and Poverty: Are We Asking the Right Questions?

Bradley K. Hobbs, Clemson University  
Nikolai G. Wenzel, Fayetteville State University

**I**t is frequently taken for granted that income inequality is a problem in the US. This paper examines the data and confirms that income inequality does indeed exist in the US – and has been rising in the past 40 years. There are, however, two problems. First, the rise in income inequality masks a significant improvement in the lot of the poorest Americans. Second, government efforts to reduce inequality – much like government efforts to reduce poverty – are likely to have unintended consequences that hurt the poorest. The paper concludes with international data and general analysis. Too much poverty persists and income inequality can have some negative consequences; however, government efforts should not target inequality, but should instead focus on reducing barriers to earning.

## Acknowledgments

*For comments and feedback, thanks to Nathan Schlueter, Steve Horwitz, Shane Courtland, John Tomasi, and participants at colloquia at the University of Minnesota-Duluth, Western Carolina University, Florida Gulf Coast University, and the Asia Institute for Political Economy at Hong Kong University. We also thank two anonymous reviewers. The usual disclaimer applies.*

## Introduction

Income inequality has galvanized many Americans, including economists and public intellectuals. The issue is inevitably more complex than a news soundbite. First, we need to ascertain the breadth and depth of income equality. Second, in the classical liberal tradition, we must recognize that any policy addressing inequality will inevitably trigger a cascade of the ubiquitous unintended consequences accompanying any government action. In short, it is prudent to tread cautiously in adopting policies, lest the unintended consequences overwhelm the intended ones.

We will argue in this paper that income inequality has indeed been rising in the US over the past 40 years, but (a) it is not the problem that many say it is; and (b) efforts to reduce income inequality will likely end up hurting the poorest Americans. There is too much poverty in the US (if only in the sense that it is largely avoidable, if only the economy were allowed fully to lift up the poorest) – but income inequality is the wrong problem, and most policies to reduce it will ultimately be detrimental, especially to the poorest.

We address the problem of income disparity in four sections. Section one discusses income disparity trends in the US over the past 40 years. Section two examines the economic importance of these trends. Section three examines the costs of addressing income inequality. The final section concludes.

## Income Inequality in the US

Prior to any policy discussion on income inequality, we need to assess its current status.<sup>1</sup> We begin by examining income statistics in the U.S. from 1970 to 2007. This 37-year period is sufficiently long to be representative. But we intentionally end the table’s data in 2007, because of the distortionary effects of the housing bubble, recession, recovery, and bailout.<sup>2</sup>

SHARE EARNED					
Year	Lowest Fifth	Second	Third	Fourth	Highest Fifth
1970	4.1	10.8	17.4	24.5	43.3
1980	4.2	10.2	16.8	24.7	44.4
1990	3.8	9.6	15.9	24	46.6
2000	3.6	8.9	14.8	23.4	49.7
2007	3.4	8.7	14.8	23.4	49.7
<b>% Change</b>	<b>-0.7</b>	<b>-2.1</b>	<b>-2.6</b>	<b>-1.1</b>	<b>6.4</b>

**Table 1. U.S. income by quintile, 1970-2007<sup>3</sup>**

1 We note that inequality is ultimately about consumption opportunities; but production (income) must precede consumption, so we discuss that first, and turn to consumption in the next section.

2 We speculate that the recovery process favored political activity over economic activity, thus increasing income inequality – as did the growth of government. But the issue is sufficiently complex to make for a separate paper.

3 <http://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html> Table H-2

Table 1 shows U.S. income divided amongst five quintiles of income earners. Note that we are intentionally using *earner*, indicating that income is “earned” rather than “taken.” Indeed, Hazlitt (1973, 186) reminds us that “the real problem of poverty is not a problem of ‘distribution’ but of production. The poor are poor not because something is being withheld from them, but because, for whatever reason, they are not producing enough. The only permanent way to cure poverty is to increase their earning power.” We should note that in a world of high barriers to labor entry, including licensing requirements, something *is* indeed being withheld from the poor: the opportunity to make an honest living (we discuss this below). But in a society honoring private property and the rights of individuals, income must be earned through production, not expropriated or taken.<sup>4</sup> Under an economic system honoring these – capitalism – one earns by producing goods and services and trading their production (or the income earned from production) under mutually-agreed upon, voluntary terms of trade. As does Hazlitt (1973, 56), we prefer to use the more accurate expression “income variation” rather than the popular moniker “income distribution” (which implies that economic output is a given, and that some entity is taking, and then distributing, income).

From Table 1, we see that there has been an obvious increase in income variation in the U.S. The share of income earned by the lowest quintile of earners has fallen from 4.1% to 3.4%, a drop of 0.7% of the total, from 1970 to 2007. Likewise, the share of income of the bottom four quintiles has also fallen. The share of income earned by the highest quintile increased from 43.3% in 1970 to 49.7 percent in 2007, an increase of 6.4%. It is beyond dispute that income variation has increased in the past 40 years. It is also beyond dispute that the highest quintile of earners is earning almost half of national income.

However, some observations are worth noting about this quick snapshot. Income mobility is a bigger, separate question; but we note here that a majority of people in the bottom 20% have also been in the top 20% sometime in the past 30 years. Less than 1% of the American population remains permanently in the bottom 20% of income earners. Of those in the middle quintile in 1996, 42% moved to a higher quintile by 2005, 25% went down, and only one third remained in the middle quintile (Sowell 2015, 182).

Horwitz (2015) notes the importance of looking at the dynamic aspects of income distribution, and in particular, upward mobility in the US: “the story is the same for most US households:

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<sup>4</sup> Assuming the US is indeed a capitalist system, although one third to one half of the economy controlled (directly or indirectly) by the state, and political activity increasingly rewarded over economic activity. We discuss the effects of cronyism below.

they enter the income ladder near the bottom and, over time, work their way up through several of the quintiles. As existing households move up the ladder, the bottom is filled in by new households just entering the process. That's why more households can move up than down – the set of households changes year to year.”<sup>5</sup> The numbers are the same for the poorest as for the middle class. Iceland (2013, 48) reports that 45-59% of those in poverty are in poverty for only one year, 70-84% for four years or less, and only 12% of those in poverty remain there for 10 or more years.<sup>6</sup> This indicates high fluidity within the distribution, a fact that is linked to life cycle patterns on both earnings and expenditures.

As we look at statistics, we also must be careful about the typical data used, which measure households rather than individuals. For instance, there are 39 million people in the bottom 20% of households, while there are 64 million people in the top 20% of households.<sup>7</sup> While there may be good reasons to choose household income over individual income, we simply want to acknowledge that assumptions will significantly affect these statistics. Given the passions surrounding income variation, this is particularly important to address forthrightly.

## **Poverty and Inequality: Are We Asking the Right Questions?**

The major question that is sidestepped by the statistics on income variation is the distinction between *absolute* income, and *relative* income variation – that is, the lot of the poorest and their ability to purchase basic necessities, rather than their status compared to others. Perhaps the biggest puzzle – and marvel – lies in explaining how large swaths of humanity slipped the chains of poverty at all. To be blunt, until the mid-18<sup>th</sup> century there was too little income for anyone to worry about questions of “proper” variation. For almost all of humanity, the norm was deep, omnipresent, and dire poverty. Income disparities have been common for thousands of years, and were far more egregious prior to the growth of modern capitalism (see Sowell 2015, 1). What, then do income disparities over the past 40 years tell us – and what do they hide about the deeper, more important problem of poverty?

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5 For an alternate explanation to income disparity – beyond upward mobility or cronyism, see Goodhart et al. (2015), who simply point to demographic trends affecting returns to labor versus capital.

6 Iceland (op. cit.) also indicates that there is a high risk of return to poverty. I leave details to further work.

7 On household composition generally, see Russ Roberts, „Inequality and Stagnation,” <http://cafehayek.com/2012/02/inequality-and-stagnation.html>

	SHARE								
	<u>Lowest</u>				<u>Highest</u>	<b>GDP<sup>8</sup></b>	<b>% Change</b>	<b>GDP/CAPITA<sup>9</sup></b>	<b>% Change</b>
<b>Year</b>	<b>Fifth</b>	<b>Second</b>	<b>Third</b>	<b>Fourth</b>	<b>Fifth</b>				
1970	4.1	10.8	17.4	24.5	43.3	4269	n/a	24,000	n/a
1980	4.2	10.2	16.8	24.7	44.4	5839	37%	30,000	25%
1990	3.8	9.6	15.9	24	46.6	8033	88%	37,000	54%
2000	3.6	8.9	14.8	23.4	49.7	11226	162%	<b>46,000</b>	92%
2007	3.4	8.7	14.8	23.4	49.7	13206	209%	52,000	117%
<b>%</b>							x3		x2
<b>Change</b>	<b>-0.7</b>	<b>-2.1</b>	<b>-2.6</b>	<b>-1.1</b>	<b>6.4</b>				

**Table 2. US income by quintile, with real GDP growth, 1970-2007**

We can start this discussion by looking at table 2, which replicates table 1, but with the addition of inflation-adjusted (real) US GDP and US GDP/capita for the years in question. We have already noted changes in income disparity over that time. But it is also important to note that real GDP in the US increased *by a factor of three* between 1970 and 2007. Contributing factors included a dynamic economy that achieved productivity gains, globalization of trade, significant advances in technology, increased workforce education, and accumulations of capital (including complementary capital that further increased labor productivity). This means that from 1970 to 2007, while the lowest fifth of earners in the U.S. did earn a slightly smaller slice of the economic pie, they were enjoying a slice from a much larger pie. Specifically, the lowest fifth of income earners in the US, from 1970 to 2007, went to earning 0.7% less of national income, but that income had increased by a factor of three. The gains are slightly lower if we account for population growth by examining GDP/capita, instead of GDP, but the general lesson is

8 Billions, 2005 dollars

9 Billions, 2005 dollar (rounded average over four quarters); <https://fred.stlouisfed.org/tags/series?t=gdp%3Bper+-capita%3Busa>

the same. This pattern holds true for all four of the bottom quintiles of income; each earned a slightly lesser *relative* share of a real national income that had tripled – we will return to these *absolute* gains below. This is particularly important because, those at the bottom of the income variation benefit the most from general growth; as Hazlitt (1973, 53) explains, if “everybody’s real income doubles... the marginal satisfactions of those at the bottom of the income scale are increased by more than the marginal satisfactions of those at the top. The latter merely buy more luxuries, or save more; the former can afford more necessities. Hence even a merely proportional increase in unequal incomes tends to reduce inequalities in real welfare. Or to put it another way, the proportional inequalities tend to mean less.”

Mean Income in 2010 Dollars					
Year	Lowest Quintile	Second	Third	Fourth	Top Fifth
1970	10,854	29,403	47,348	66,740	118,155
1980	11,808	29,388	48,494	71,444	127,381
1990	12,608	31,723	52,399	79,003	153,315
2000	13,979	34,903	58,125	90,357	195,803
2007	13,205	33,656	57,120	90,435	192,014
Change	<b>22%</b>	15%	21%	36%	<b>63%</b>

**Table 3. US mean income by quintile, 1970-2007<sup>10</sup>**

A similar result comes from table 3, which shows inflation-adjusted mean income in the US from 1970 to 2007. Not surprisingly, given the tripling of the size of the economy, mean income has increased significantly for all quintiles. For example, the inflation-adjusted mean income of the lowest quintile of earners went from \$9,982 to \$12,147, a real increase of 22%. While income gains have indeed been largest for the top quintile, we should also note that mean income has increased by 15 to 20% for the lowest three quintiles, and has increased for all quintiles. In short, the oft-stated and well-trotted idiom that “the rich are getting richer, while the poor are getting poorer” implies that only the rich have gained. This static view of economics as a zero-sum game is as inaccurate as it is misleading.

<sup>10</sup> <http://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html> Table H-3

Year	Inflation-Adjusted Median Income	Growth
1970	47,281	n/a
1980	48,518	2%
1990	52,684	11%
2000	57,790	22%
2007	57,423	21%

**Table 4. Inflation-adjusted US median income growth, 1970-2007<sup>11</sup>**

We now turn to table 4, which gives data on real median income. In 1970, inflation-adjusted median income was \$47,281; in 2007 that figure had increased by 21% to \$57,423.

One last point rounds out our analysis of income variations: the drop in the consumption gap. “Poor Americans today live better, by...measures [of consumption] than did their middle class counterparts in the 1970s” – “as a result, inequality of consumption is far less than inequality of income or wealth” (Horwitz 2015). This increased consumption comes from several sources: first, worker productivity gains (leading to increased purchasing power per hour of work); second, lower inflation-adjusted prices for many of the goods consumers purchase, due to greater manufacturing productivity;<sup>12</sup> and third, diminished barriers to trade, which have allowed producers to produce at lower opportunity cost, and thus lower prices (Horwitz 2015). It is important to note that the first two factors originate in physical and human capital accumulation, a point to which we return below.

Horwitz (2015) gives examples of the impressive changes in consumption opportunities.<sup>13</sup> A basic bundle of household appliances cost the average worker 885.6 hours of work in 1959, versus 170.4 hours of work in 2013.<sup>14</sup> During that time, the “hours-of-work” cost at the average

<sup>11</sup> <http://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html> Table H-6

<sup>12</sup> Between 1987 and the first quarter of 2017 real output in manufacturing rose by approximately 85% while employment in that sector fell from 17.5million to 12.4million . < <http://www.pewresearch.org/fact-tank/2017/07/25/most-americans-unaware-that-as-u-s-manufacturing-jobs-have-disappeared-output-has-grown/>>

<sup>13</sup> A counter-argument to this line of reasoning holds that consumption is a skewed measure, because the poorest are financing this consumption with debt. We acknowledge that low savings rates, loose monetary policy, lax lending standards, and shifting norms on debt are worthy of further research. For present purposes, we note that income has increased, and prices have diminished, so the rising income gap hides a falling consumption gap.

<sup>14</sup> Beyond consumer goods, Horwitz (2015) also discusses the rising real prices of healthcare, housing, and education. He notes that all three of these sectors are heavily subsidized and regulated, which accounts for the rise in price. And, at least for healthcare and housing, the quality of goods available has increased dramatically, along with the price; the same is not true of education, where professional administrators and government bureaucrats are increasingly impeding teaching in

worker's wage fell from 100.5 to 23.3 for a washing machine; 90.9 to 20.7 for a dishwasher; and 127.8 to 20.7 for a color TV – and all these examples do not even consider quality change within the goods themselves. This is compounded by considering one extraordinary fact: the “whole range of items commonly found in US households, including poor ones, that *did not even exist* a generation ago” (Horwitz 2015). The readily available necessities of today's millennials was the stuff of science fiction for their grandparents.

Another way of looking at the increased consumption available to the lowest-income groups involves looking at the percentage of households that had certain consumer goods just 30 years ago versus now. In 1984, 58.2% of poor households had a washing machine; in 2005, 68.7% did (and 84% of all households; Horwitz 2015). During that same period, household ownership of air conditioners in the lowest income groups went from 42.5% to 78.8%; for computers (not including smart phones), from 2.9% to 42.4%, and the list goes on. Similarly, Iceland (2013, 27) notes that food expenditures have fallen from 1/3 to 1/8 of income for the average American household in the past century; the USDA reports that, from 1970 to 2007, food expenditures as a percentage of income fell from 14% to 9%.<sup>15</sup> In sum, the consumption baskets available to *all* income quintiles in the US have expanded rapidly in real ways, with diminished costs and increased quality. Again, we are not trying to dismiss poverty in the US (poverty, after all, is our primary motivation), but to contextualize it.

## The Cost of Fighting Inequality

### Is Income Inequality a Problem in the First Place?

Given our claim in the previous section – that there has been a clear increase in the *absolute* well-being of all income quintiles, just as *relative* income inequality has increased – it bears pausing a moment to examine some of the rationale behind the prevalent deep concern for income inequality. We identify three potential problems with income inequality.

First, there seems to be a tribal, visceral reaction against inequality, generally. To many, it just doesn't seem right that some should have more than others (see Schoeck 1987 on envy). But some level of inequality is inevitable. Indeed, people are diverse in many ways, including their interests, abilities, skills, luck, and choices in consumption versus saving. Relativist perspectives

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favor of process. We leave details to a separate paper.

15 USDA, Economic Research Service, Food Expenditure Series, Table 7. <http://www.npr.org/sections/the-salt/2015/03/02/389578089/your-grandparents-spent-more-of-their-money-on-food-than-you-do>



can easily lead towards a spiraling trap of envy without perspective on the real, tangible, and absolute improvements in the lives of the poor (improvements that we consider to be insufficient, and that we want to expand, rather than worrying about relative standing). We argue instead that *relative* standing is a distraction from a much more important question: the level of *absolute* well-being in our society, and specifically of the poorest among us. Beyond obscuring the real problem of absolute well-being, envy leads to greater demands for redistribution at the ballot box. This is problematic because redistribution slows the very economic growth required to lift the poorest out of poverty, and creates a cycle of unintended consequences. But it is also problematic because redistribution leads to an idea trap: bad ideas lead to bad policies; in turn, bad policies lead to bad outcomes; the wrong ideas are blamed, and more bad policies are adopted. Bad ideas, bad policies and bad outcomes thus become mutually reinforcing (Caplan 2003). In this case, the redistributive state blocks growth and favors political activity over economic activity, thus concentrating income at the top. Voters blame markets and demand more redistribution (and thus more government control of the productive process); redistribution thwarts growth and increases inequality, but voters blame markets and demand even more intervention. The cycle continues – and the only way to break it is to scale back government impediments to wealth creation and access to jobs.

Second, there are concerns about the health of the polity, and social cohesion within a democracy that exhibits high levels of inequality.<sup>16</sup> It is certainly true that high income disparities have historically been associated with concentrations of power at the top and suffering at the bottom. Most of the great revolutions of the 18<sup>th</sup>, 19<sup>th</sup> and 20<sup>th</sup> centuries either originated in, or were fed by, income inequality. The problem is that these revolutions typically replaced one form of interventionism (feudalism or mercantilism) with another (socialism or communism); the lot of the poor was not enhanced by these revolutions (which typically expanded the power of the state, but changed the groups in power) – but by capitalism and rule of law (when they were finally adopted). Indeed, commercial power can temper absolutism in political power. The great communist countries of the 20<sup>th</sup> century engaged in widespread and persistent democide. As Friedman (1967) explains that political power has a natural tendency to centralize, whereas commercial power has a natural tendency to decentralize:

Economic power can be widely dispersed. There is no law of conservation which forces the growth of new centers of economic strength to be at the expense of

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<sup>16</sup> Parenthetically, this makes the roots of modern democracy in ancient Athens quite odd. Indeed, discussions of income equality among the writers of the era are scarce and the consensus of historians is that social and economic inequality was wide (de Ste. Croix, 1981; Arabaster, 2002; Cavanaugh, 2009; Liddel, 2009).

existing centers. Political power, on the other hand, is more difficult to decentralize. There can be numerous and small independent governments. But it is far more difficult to maintain numerous equipotent small centers of political power in a single large government than it is to have numerous centers of economic strength in a single large economy. There can be many millionaires in one large economy. But can there be more than one really outstanding leader, one person on whom the energies and enthusiasms of his countrymen are centered?

Where commercial power joins hands with political power – today’s cronyism<sup>17</sup> – political power enables and exacerbates these problems. We also argue that political capture is a primary consequence of government expansion, not of income inequality – and income inequality is primarily a consequence of government inequality, as political activity comes to be favored over economic activity. As we explain below, state efforts to redistribute wealth contribute to absolute poverty. A powerful state is more likely to engage in cronyism of all types, relative to a weak one, thus increasing income inequality – even if the stated purpose was the reduction of income inequality.

Third, we acknowledge a vast literature that finds a relationship between inequality and lower growth, lower mobility, lower financial stability, and a host of social ills.<sup>18</sup> We argue, however, (a) that the real problem is poverty and reduced opportunity to produce; and (b) that efforts to reduce inequality will inevitably backfire.

### **A Thought Exercise: The Cost of Redistribution**

To illustrate the unintended consequences of redistribution, let us assume that lower income variation is a national priority – to be pursued with eyes wide open and a sober recognition of tradeoffs. Assuming the redistribution is successful (a benefit, according to our assumed national priority), there will also be costs. First, there will be a bureaucracy assigned to collecting and redistributing the income, and there will necessarily be some expense in establishing and maintaining such an agency. Second, a redistribution of income from top earners will create disincentives to activities that build earnings. This is likely to occur through both investment and labor channels (how much will depend on the details of the redistribution scheme). Top earners will earn less because of the redistributive taxation itself; but they will also reduce their labor and entrepreneurial efforts in response to the lower marginal returns from those efforts.

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17 We prefer „cronyism,” „democratically-enabled cronyism,” or „government-granted privilege” as more accurate wording than „crony capitalism” (which isn’t really capitalism). The protection of economic privilege is enabled by political power.

18 For a summary, see <https://www.brookings.edu/wp-content/uploads/2016/06/overstating-inequality-costs-winsip.pdf>

Likewise, top earners will tend to invest marginal income at a higher rate than lower earners, who will tend to spend more (or all) of their marginal dollars.<sup>19</sup> Government redistribution of income from higher earners to lower earners may temporarily help the lower earners, but this will decrease investment, and thus capital growth, productivity, and overall growth. As we explained above, overall growth is required for poverty alleviation, and benefits the poorest the most.

The cumulative effect will be less growth in countries that forcibly redistribute wealth. Results and details vary and are subject, of course, to empirical study, but the principle remains that every action, no matter how desirable, involves both benefits and costs.<sup>20</sup>

We now turn to table 5 (adapted from Tomasi 2012, 235). In this hypothetical example, assume a society with a 4% annual growth rate (“Growth Society”). In a parallel “Redistribution Society,” government redistribution of income will cause growth to fall to 2% per year – for the reasons cited above, income redistribution will reduce the overall levels of economic activity and growth. In some base year (1910), the richest third in Growth Society earn \$4,000, the middle third \$2,000, and the poorest \$1,000. After a century of growth at 4%, the poorest will earn about \$50,000 per year, about one quarter of the \$200,000 earned by the most productive third.

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19 In more technical language, the MPC (marginal propensity to consume) varies with income levels – and with distribution of income (see Carroll, Slacalek and Tukuoka 2014).

20 Mitchell (2005) goes into greater detail, listing the following costs of government intervention: the extraction cost, the displacement cost (as private-sector activity is crowded out), the negative multiplier cost (as regulations impose higher costs than just the enforcement of the regulations), the behavioral subsidy cost (as government creates perverse incentives), the behavioral penalty cost (as government discourages good behavior), the market distortion cost, the inefficiency cost, and the stagnation cost (as government thwarts innovation and growth). We have intentionally not gone into this level of detail.

		GROWTH			REDISTRIBUTION		
		4% growth			2% growth		
Year	Years Elapsed	Poor	Middle	Rich	Poor	Middle	Rich
1910		1,000	2,000	4,000	1,500	2,000	3,500
1920	10	1,480	2,960	5,921	1,828	2,438	4,266
1930	20	2,191	4,382	8,764	2,229	2,972	5,201
1940	30	3,243	6,487	12,974	2,717	3,623	6,340
1950	40	4,801	9,602	19,204	3,312	4,416	7,728
1960	50	7,107	14,213	28,427	4,037	5,383	9,421
1970	60	10,520	21,039	42,079	4,922	6,562	11,484
1980	70	15,572	31,143	62,286	5,999	7,999	13,998
1990	80	23,050	46,100	92,199	7,313	9,751	17,064
2000	90	34,119	68,239	136,477	8,915	11,886	20,801
<b>2010</b>	100	<b>50,505</b>	101,010	202,020	<b>10,867</b>	14,489	25,356

**Table 5. A Tale of Two Countries: Redistribution and Growth**

Redistribution Society successfully diminishes income inequality, by redistributing \$500 from the richest third to the poorest third. Thus, we see incomes of \$3,500 for the most productive third, \$2,000 for the middle, and \$1,500 for the least productive. Redistribution Society grows at 2% per year. At the end of the century, the lowest third is earning about \$11,000, just slightly less than half of the \$25,000 earned by the richest third.

Which society is more desirable? Clearly, Redistribution Society has less income inequality. However, the poorest in Growth Society have an income that is *five times* higher than the poorest in redistribution society. To put this in contemporary context, 2015 GDP per capita for the US was roughly \$50,000, while \$11,000 approximates the GDP per capita of Egypt. *Ceteris paribus*, who is better off? Somebody earning the GDP per capita of contemporary Americans in a less equal society? Or somebody earning the GDP per capita of Egyptians, in a more egalitarian society. In fact, the US has a higher income inequality than Egypt, so the example does mirror reality.<sup>21</sup>

21 <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html>

Of course, this example is simplified, and is primarily meant as a thought exercise. We have simply assumed a cost of redistribution (which will vary in reality, depending on circumstances and policy details).. We intentionally sidestep questions of inflation and purchasing power (there will presumably be upward pressure on prices in Growth Society) – but these are compensated by questions of productivity gains and higher capital accumulation (leading to downward pressure on prices in Growth Society). Some citizens may derive psychic utility from a more equal distribution of income – but that more equal distribution will come at a cost for the poor (are the happy citizens aware of this? Are they willing to accept this cost?). The point, for now, is simply to ask whether the reduction of income inequality is a desirable policy, once we have accepted the reality of the costs of that redistribution – and the absolute lot of the poorest.

### **3.3 The Knowledge Problem: Planned Chaos in a World of Good Intentions<sup>22</sup>**

Hayek (1945) explained that policymakers largely lack the information to understand – let alone fix – the workings of a complex market economy. In a market, entrepreneurs require information about which goods and services consumers wish them to produce. This information is generated and transmitted through the price mechanism (Read 1958). Thus, even if policymakers have good intentions – which may, or may not actually be the case<sup>23</sup> – we must be wary of the dynamics of intervention: intervention in one market distorts the epistemic function of prices (Horwitz 2015) and blocks the knowledge-generating functions of the market (Mises 2007[1955]). This leads to a distortion in related markets... followed by calls for intervention to fix the newly-affected market... and the cycle continues. As we will see, interventionism – even with the noble aspiration of reducing inequality – has a direct and visible cost, especially on the poorest.

### **3.4 The Welfare State and Poverty: Lessons for Income Inequality**

We have already seen that redistribution and the rise of the regulatory state impede growth and thus hurt the poorest (who need growth the most). The next problem is government attempts to reduce poverty.

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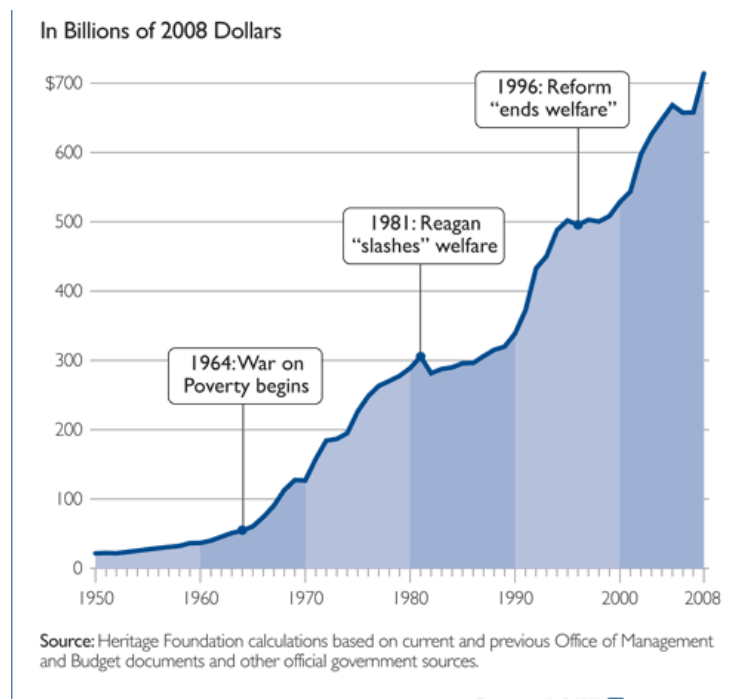
22 See Mises 2007[1947]

23 See Buchanan and Tullock 1962 or Bastiat 2012[1850].



**Sources:** Figures for 1947-1958: Gordon Fisher, "Estimates of the Poverty Population Under the Current Official Definition for Years Before 1959," U.S. Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluation, 1986. Figures for 1959-2012: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements, "Historical Poverty Tables—People," Table 2, <https://www.census.gov/hhes/www/poverty/data/historical/people.html> (accessed September 10, 2014).

**Figure 1. US Poverty Rates, 1947-2012<sup>24</sup>**



**Source:** Heritage Foundation calculations based on current and previous Office of Management and Budget documents and other official government sources.

**Figure 2. Welfare Spending (1950-2008)<sup>25</sup>**

24 <http://www.heritage.org/multimedia/infographic/2014/09/poverty-rate-1947-2012>

25 <http://www.heritage.org/research/reports/2010/06/confronting-the-unsustainable-growth-of-welfare-entitlements-principles-of-reform-and-the-next-steps>

Figure 1 shows US poverty rates since 1959. Note that the rate of poverty, was falling – *significantly* – before the US government took aim at poverty in 1964. By the mid-1960s, when President Johnson’s Great Society was launched, the poverty rate in the U.S. had already fallen below 15%, thanks to the post-war recovery and prosperity. Despite 50 years of federal government involvement, the rate of poverty remains right about at 15% today, the point to which it had already fallen *before* the Great Society efforts. The ineffectiveness of the federal war on poverty is also highlighted by figure 2, which shows total welfare spending since 1950. Over the half century in which the federal government has been actively fighting poverty, to the tune of more than \$1 trillion in 2015,<sup>26</sup> national poverty rates have not changed.<sup>27</sup> While federal welfare programs may not be solely responsible, there is certainly a compelling parallel pattern of government growth, lingering poverty, and increasing income disparity.

Why would government efforts at fighting poverty be unsuccessful (or even detrimental)?

Take the example of wage controls. Minimum wage laws cause unemployment, but the problem is especially prevalent among uneducated and unskilled workers who are priced out of the market. The primary role of an entry-level job is to acculturate neophyte workers to the norms and expectations of the workplace; entry-level workers almost never provide as much value to employers as they are paid. Wage controls affect both the processes and likelihood of entry-level positions in the work force. These are crucial to further human capital developments – a lack of opportunity in these jobs can have long-lasting, pernicious effects on work force participation over a lifetime. Indeed, most households in the bottom quintile have nobody working (Sowell 2015, 168). From an employer’s perspective, as Hazlitt (1973, 147) explains, “we cannot make a man worth a given amount by making it illegal for anyone to offer him less. We merely deprive him of the right to earn the amount that his abilities and opportunities would permit him to earn, while we deprive the community of the moderate services he is capable of rendering.”

More generally, the welfare state provides disincentives to work, and increases income inequality: “to the extent that the expanding welfare state allows more people to live without working – and therefore without earning income or developing their own human capital – supporters of the welfare state are contributing to the very income disparities they so much decry” (Sowell

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26 This includes federal, state and local spending. This does not include indirect welfare spending like education, Social Security and Medicaid. [http://www.usgovernmentspending.com/entitlement\\_spending](http://www.usgovernmentspending.com/entitlement_spending)

27 Of course, one might argue the counter-factual, that poverty rates would have been higher than 15% today, there but for government involvement. But why assume a sudden reversal of the pre-1965 trends, especially considering that the economy has grown by a factor of almost four?

2015, 168; see Hazlitt 1973, 230-231). Tanner and Hughes (2013) share an apocryphal quip about “cliff points” (when workers lose net income by earning more, because they lose welfare benefits): the “highest marginal tax rate for anyone in the US [is] for a person leaving welfare for work.” Consider the following facts from Tanner and Hughes (2013):

- Welfare pays more than minimum wage in 35 states
- In 13 states, welfare pays more than \$15/hour
- In 8 states, welfare pays more than the median income; and in 40 states, welfare pays 80% or more of the median income
- Only 2.6% of full-time workers in the US are poor; but 15% of part-time workers and 24% of non-working adults are poor
- Less than 42% of adult welfare recipients are actually working (despite the 1996 welfare reforms)
- There are currently 126 federal anti-poverty programs in place in the US

These figures simply reflect the moral hazard problems associated with significant wealth redistribution by the government. The creation of dependency among able-bodied adults (and the political spoils associated with the process) has been a problem long recognized by several thinkers (Tocqueville 2015[1835], 23-25 and 35; Hazlitt 1973, 71 and 185-186; Sowell 2015). Yet it persists.

Moving from the micro- to the macro-level, government spending crowds out private enterprise and investment, and thus capital accumulation and growth. In the years “1995-2012, OECD member countries that increased government expenditures as a percentage of GDP grew 30% slower than member countries that trimmed government expenditures as a percentage of the economy over that span – average annual growth of 1.9% compared with 2.5%.”<sup>28</sup> As we have seen above, it is precisely the poorest who benefit the most from economic growth.

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28 „The Mythical Link between Income Inequality and Slow Growth,” Matthew Schoenfeld, *The Wall Street Journal*, October 12, 2015, <http://www.wsj.com/articles/the-mythical-link-between-income-inequality-and-slow-growth-1434319942>



While welfare policies in the U.S. may arguably have some short-term palliative effect, they also do not encourage investment in human capital, and have done little for income mobility (see Hazlitt 1973, 56 and chapter 10).

In closing, we add a brief commentary on regulation that is officially for the public good. The cost for Americans to comply with federal regulations has reached about 10% of GDP. This represents resources that are diverted away from productive investments, job creation, and productivity gains, with a regressive impact (Thomas 2019). In the specific case of employment regulation, approximately 1/3 of Americans today require occupational licenses, up from 5% in the 1950s. The Institute for Justice reports that “on average, these licenses force aspiring workers to spend nine months in education or training, pass one exam and pay more than \$200 in fees. One third of the licenses take more than a year to earn.” This kind of job licensing will typically be regressive, as those with higher incomes are more able to pay for the required courses, exams, and other licensing fees than will be those at the bottom end of income, and especially those who were attempting to enter the job market.

Having examined what does not work, we discuss alternative solutions to poverty in the conclusion.

### **Crushing Innovation: From Luxury to Banality**

At best, the government is ineffective in its anti-poverty efforts. At worst, these efforts have caused the poorest of Americans to be partially excluded from national productivity gains. If government efforts at fighting *poverty* have been counter-productive, we would expect the same from government efforts to fight inequality. Indeed, Hazlitt (1973, 49) notes that income inequality was already falling in the two decades before grand government action in the 1960s, and has been rising since. This is the crux of the problem.

Hazlitt (1973, 123) explains that the progressive taxation used to fight inequality disproportionately seizes funds that were destined for investment, rather than consumption – thus ultimately hurting the poor more than the rich. Lower investment means diminishing growth in productivity, capital accumulation, job creation, and innovation – all of which also dampen decreases in real consumer prices. In sum, investment is the greatest form of charity (Hazlitt 1973, 2).

Redistribution has consequences for investment – and thus (as we have seen) consumption by the poorest. Because top earners have more disposable income, they purchase the luxury goods of today that become the standard features for the rest of us tomorrow. Luxury purchases

by the rich help to drive innovation, allowing entrepreneurs to invest in production and bring those goods to the market at lower prices, thus making them accessible to the middle class, and eventually to all. Hayek (1960, 43-44) summarizes the point nicely: "A large part of the expenditure of the rich, though not intended for that end, thus serves to defray the cost of the experimentation with the new things that, as a result, can later be made available to the poor... Even the poorest today owe their relative material well-being to the results of past inequality" (see also Mises 1985[1929], I.5; more generally, see Bastiat 1995[1848]).

Take the example of automobiles in the early 20<sup>th</sup> century, or mobile phones in the 1990s, or smart phones and car rearview cameras in the early 2010s – all of these started as luxuries, and eventually become commonplace. Imagine the consequences of attempting to level income disparity by imposing a progressive consumption tax – as has been suggested by economist Robert Frank.<sup>29</sup> Taxing cell phones as a luxury in the early 1990s would have discouraged many of the few consumers from purchasing them and would have thwarted the investments that lowered their prices. For those who remember the "bricks" of the 1990s and the "flip phones" of the early 2000s, the transformation has been nothing short of miraculous. Today's smart phone penetration rate approaches 80%<sup>30</sup> – that's not just 80% of Americans who can now peruse pictures of family, friends, and pets on Facebook, instantly chat with their Instagram friends, or enjoy other entertaining frivolities. More significantly, it also represents cheap and easy access to the internet for school research, job searches, or online non-traditional banking. The last is an especially pertinent point. High banking costs – largely driven by federal regulations in the wake of the 2008 financial crisis – keep an estimated 10 million Americans unbanked, and 20% of American households underbanked.<sup>31</sup> Fortunately, non-traditional banking (on smartphones) presents an alternative.

Horwitz (2015) explained (above) that the consumption gap has been falling steadily over the past 40 years; but that gap would be increased by redistributive efforts. Schumpeter (1942, 67-68) elegantly summarizes the issue:

The capitalist engine is first and last an engine of mass production which unavoidably also means production for the masses. . . . It is the cheap cloth, the

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29 „The Progressive Consumption Tax: A Win-Win Solution for Reducing American Income Inequality.“ December 7, 2011. [http://www.slate.com/articles/business/moneybox/2011/12/the\\_progressive\\_consumption\\_tax\\_a\\_win\\_win\\_solution\\_for\\_reducing\\_american\\_economic\\_inequality\\_.html](http://www.slate.com/articles/business/moneybox/2011/12/the_progressive_consumption_tax_a_win_win_solution_for_reducing_american_economic_inequality_.html)

30 <http://www.marketingcharts.com/online/smartphone-penetration-nears-80-of-the-us-mobile-market-65214/>

31 <https://www.forbes.com/sites/realspin/2014/08/04/how-to-help-the-unbanked-repeal-the-durbin-amendment/#5afbea5b71ad>

cheap cotton and rayon fabric, boots, motorcars and so on that are the typical achievements of capitalist production, and not as a rule improvements that would mean much to the rich man. Queen Elizabeth owned silk stockings. The capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within reach of factory girls.

## **Conclusion**

Income inequality exists in the US, and it has clearly been increasing in the past 40 years. However, it would be incomplete to look only at income inequality. The poorest of Americans are better off in the US than they were 40 years ago – but they would also be much higher, had government expansion not crowded out economic growth (Mitchell 2005).

Too much poverty still remains, with no good reason (but plenty of bad reasons, from cronyism to failed government redistribution). Indeed, Hazlitt (1973, 232) bluntly reminds us that “capitalism has already eliminated mass poverty” (see also Mises 2007[1955] and 1985[1929]). Lingering poverty is thus doubly frustrating, because it is avoidable (if only we would let markets work and stop preventing the poor from earning). As Posner (1986) opines, “in a world of scarce resources waste should be regarded as immoral” (see also DeBow 1992).

The purpose of this paper has not been to dismiss income inequality entirely – but to question whether inequality is the real problem and outline the costs of changing it, including the distraction from the real issues: absolute poverty and barriers to productivity for the poor. Income redistribution, which stifles growth, is not a solution, as we have seen from the abysmal U.S. war on poverty. Any real solution to poverty must address the ability to earn. Hazlitt (1973, 209) reminds us, once again, that the real solution is not government relief, but an increase in productivity; “one is ashamed to keep repeating anything so obvious, but the only real cure for poverty is the production of wealth.”

For the sake of the poorest of Americans, it is of vital importance that policymakers not make the same mistakes in addressing income inequality as they have made in attempting to address poverty over the past half century. As Hazlitt (1973, 125) foresaw, “any attempt to equalize wealth or income by forced redistribution must only tend to destroy wealth and income.” In sum, “the promotion of economic equality and the alleviation of poverty are distinct and often conflicting” (Bauer 1981, 23).

The point here is not to abandon the poor – quite the contrary. But, rather than engaging in redistributive programs with unintended consequences, governments can do two things: first, get out of the way, and stop thwarting the market’s wonderful process of growth; and second, let civil society handle those who fall through the cracks of the market.<sup>32</sup> In sum, markets create more wealth, and they do so more effectively and more evenly than government intervention.

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<sup>32</sup> See Beito 2000 on a century of voluntary, fraternal mutual aid efforts – efforts that were effectively killed by the rise of the welfare state

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## **Bio**

### **Bradley K. Hobbs**

Clinical Professor of Economics  
Clemson University

### **Nikolai G. Wenzel**

L.V. Hackley Chair for the Study of Capitalism and Free Enterprise  
Distinguished Professor of Economics  
Fayetteville State University

Corresponding author: [nikolaiwenzel@gmail.com](mailto:nikolaiwenzel@gmail.com); +1.703.609.4000



# **Austrian Economics as a Paradigm of Golden Mean Thinking**

**Jakub Bożydar Wiśniewski, University of Wrocław**

**T**he main contention of the present paper is that the tradition of the Austrian School is a paradigmatic example of the application of the Aristotelian golden mean to the realm of economic theorizing. Consequently, it argues that the Austrian tradition allows for uniquely clear and perceptive interpretation of the workings of the catallactic order and it is uniquely placed to develop economics as a methodologically and substantively distinct scholarly discipline, which does not have to borrow the tools or subject matter of any other field of inquiry.

## **Introduction**

The Aristotelian concept of the golden mean indicates that achieving virtues requires the avoidance of normative polar excesses. This precept applies to moral and intellectual virtues alike, thus providing solid guidance for both socio-relational and scholarly endeavors. In the context of the latter, it points in particular to the necessity of using the right sources of knowledge in the right areas of inquiry and in the right proportions, so that our understanding of reality may grow along a realistic path, free of epistemic distortions and lopsided exaggerations.

My main contention in the present paper is that the tradition of the Austrian School is a paradigmatic example of the application of the Aristotelian golden mean to the realm of economic theorizing. In the next section, I shall comment on the methodological subtlety of Austrian economics as involving a balanced use of complementary analytical tools, thereby allowing its practitioners to arrive at a carefully realistic vision of the logical structure of human action. Then, in the succeeding sections, I shall point to several substantive contributions of the Austrian school that are characteristically nuanced in their conceptual elaborations and their practical relevance. More specifically, I shall comment on the Austrian value theory and the corresponding theory of the entrepreneurial market process understood as scholarly

achievements that assiduously avoid various one-sided overstatements present in their counterparts developed by other traditions.

In sum, I shall suggest that, on account of its deep philosophical self-awareness and the resulting golden mean orientation, the Austrian school allows for uniquely clear and perceptive interpretation of the workings of the catallactic order. I shall also imply that for the same reason it is uniquely placed to develop economics as a methodologically and substantively distinct scholarly discipline, which does not have to borrow the tools or subject matter of any other field of inquiry.

Let me finish this section with a few additional methodological remarks aimed at countering potential criticism of the approach adopted in this paper. One might suggest that, if invoking the golden mean in this context is to serve as something more than merely drawing an interesting parallel to a specific philosophical tradition, then it should be demonstrated that the same line of thinking ought to be applied in most, if not all, fields of scholarly inquiry.

I consider such a suggestion to be misplaced on at least two accounts. First, I believe that economics can be rightly regarded as unique among the social sciences insofar as it emerges from introspectively self-evident propositions and culminates in exceptionless qualitative laws. As such, it bridges the realm of logical deduction and that of empirical interpretation, just as human action – the cornerstone of economic analysis – bridges the realm of human mind and that of the surrounding reality. Thus, conducting cogent economic investigations requires a substantial degree of methodological awareness, knowing when to deploy which source of knowledge and how to ensure the harmonious cooperation of all such sources. In this, I would argue, economics differs both from other social sciences – which are purely empirical in virtue of focusing on the contents of specific human actions and contingent regularities that subsume them – and from abstract philosophical speculation on the nature of one's internal mental life, which can be purely deductive.

In other words, it might be argued that among social scientists the practitioners of economics are particularly exposed to the danger of falling into various methodological excesses, which makes adopting the golden mean orientation a particularly advisable move on their part.

Second, one should notice that even the original Aristotelian formulation of the notion under consideration suggests that it is more of a highly reliable heuristic than a truly exceptionless principle. For instance, with respect to theoretical wisdom, which Aristotle deems the highest of all human virtues, there does not seem to be any cutoff point beyond which excess begins. And



with respect to certain other virtues, such as courage, some excesses are regarded as worse than others – rashness, for example, for all its defects, is considered by Aristotle to be closer to courage than cowardice.

We may employ the same observation in the realm of scholarly endeavors. Thus, instead of conceding that the application of the golden mean in this general area would require using all sources of knowledge in well-balanced proportions in every separate intellectual discipline, it might be argued that, to follow the Aristotelian precept in question, it suffices to realize that each available source of knowledge has its distinct epistemic value, which turns into a disvalue when utilized outside of its proper domain. That is to say, it is perfectly justifiable to use only deduction when doing pure mathematics and to use only experimentation when doing biology or chemistry, but neither experimental mathematics nor aprioristic biology or chemistry would take us very far.

In other words, what the golden mean orientation teaches us in this context is that the general quest for epistemic success – especially among professional truth-seekers – requires building a capital structure of production composed of heterogeneous and precisely interlocking forms of intellectual capital. Furthermore, economics, on account of its aforementioned methodological complexity, is by itself a microcosmic representation of this general approach, since, even as an individual discipline, it requires combining insights derived from distinct yet complementary sources of knowledge.<sup>1</sup> My contention in this paper is that the Austrian tradition is most fully cognizant of the above points and follows their implications most closely, thereby offering a particularly nuanced and perceptive analysis of economic phenomena and the broader realm of cooperative processes.

Having hopefully made my overall position clear enough, let me now demonstrate how it plays itself out in a number of specific areas of economic research.

## **Method, action, and rationality**

Austrian economics is alternatively known as the causal-realist tradition (Salerno 2010), which unambiguously indicates that it is grounded in the causal analysis of the structure of real-world economic phenomena. More specifically, since Austrian theorists identify human action

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<sup>1</sup> Other possible examples of such methodologically complex disciplines might be psychology, which combines introspective and experimental insights, and philosophy, which can utilize practically every source of knowledge, including introspection, intuition, perception, deduction, and induction.

as the keystone of all economic activity, their mode of investigation consists in rendering the phenomena in question intelligible in terms of the categories of human action and their logically necessary causal interrelations (Lachmann 1977).

This methodological approach clearly testifies to careful philosophical self-reflection undertaken by the Austrian school, which resulted in its representatives' clear understanding of the material and formal distinctness of economics as compared with other social sciences (Gordon 1996). Consequently, Austrian economics steers a middle course between apriorism and empiricism, refusing to imitate the methods of any discipline that relies exclusively on one or the other of these epistemological orientations.

Thus, on the one hand, it rejects the highly formalized abstractions and stylized mathematical models of Walrasianism, since it regards them as paradigmatic instances of sterile apriorism that fails to capture the essence of the dynamic market process (Kirzner 2017). However, it should be borne in mind that this is by no means a rejection of a priori reasoning as such, but only a rejection of the kind of a priori reasoning that is in manifest conflict with the broadly empirical, immediately graspable laws of reality (Rothbard 1957). In other words, it is not an admission that logic can be invalidated by experience, but a recognition that logic – in order to advance from validity to soundness – needs to be grounded in the fundamental facts of experience. Such a recognition is particularly important given the fact that the analytical error of describing the workings of the economy in terms of unrealistic, highly mathematized models is oftentimes compounded by the normative error of trying to make the real-world economy conform to the models in question in order to supposedly bring it closer to the state of optimal efficiency (Demsetz 1969).

On the other hand, the Austrian tradition also rejects the approach of those who claim that even the most unrealistic hypotheses can be vindicated by means of experiential confirmation understood in terms not of immediate apprehension, but of quasi-experimental testing. This rejection stems from the realization that in the process of discovering economic laws one cannot rely on empirical facts to speak for themselves – any sufficiently complex set of such facts can illustrate a potentially infinite number of hypotheses, including some that contradict each other. Thus, a priori logical deduction is needed to arrive at a sound interpretation of the empirical data at hand (Long 2006) – one that makes sense in view of the logical structure of human action, together with its feasible potentialities and inevitable limitations.

In sum, Austrian economics is logical-deductive on the level of theory formation and causal-realistic on the level of theory application. Consequently, it embodies the golden mean thinking of the methodological variety, consistently avoiding the twin pitfalls of unrealistic apriorism (as exhibited by Walrasianism) and blind empiricism (as exhibited by neoclassical positivism).

Such an approach is not only uniquely fruitful when it comes to developing substantive economic insights, but it may also be indispensable in the context of filtering such insights through the philosophical lens of soundly understood human action. In other words, it allows for grounding economic phenomena in the pure logic of choice, unadulterated with ad hoc psychological assumptions or idealizations. This, in turn, allows the economic theorist to arrive at a lucid understanding of such crucial praxeological concepts as rationality, and, more importantly, at a clear assessment of how they bear on such crucial catallactic issues as the self-regulatory potential of large-scale social cooperation.

Here, again, the golden mean orientation of the Austrian school is eminently visible. On the one hand, Austrian theorists do not rely on overly demanding, highly-laden concepts of rationality, which require of economic agents that they be fully informed, constant in their preferences, and always capable of keeping their unreflective impulses at bay. Nor do they assume that the informational features of any institutional environment can make economic agents act as if they were rational in the above sense (Gertchev 2007). Thus, they reject the conclusion that a sufficiently “efficient” market needs to be impervious to systemic breakdowns (Fama 1970).

On the other hand, however, Austrian economists are equally resistant to the suggestion that market participants are naturally irrational and prone to acting on uninformed whims, thereby periodically thrusting the market into general disarray (Akerlof and Shiller 2009). This is because such a suggestion is at best based on contingent psychological observations, which cannot be elevated to the rank of universally applicable insights into the nature of the catallactic order. Furthermore, such a claim cannot account for the emergence of complex market environments in the first place, as well as for their continuing existence in the face of various temporary upheavals and downturns.

The Austrian vision of rationality carefully avoids both of the abovementioned extremes. Rational action, as viewed through the lens of causal-realist analysis, is tantamount to purposive action – that is, behavior grounded in an underlying consciously conceived means-ends relationship (Wiśniewski 2009). The fact that such mental representations may not conform to the structure of external reality in no way impugns the rationality of the corresponding actions – what matters

in this context is that they are purpose-driven and goal-oriented. Nor does this fact in any way undermine the self-regulatory potential of large-scale social cooperation. After all, no matter how impulsive and uninformed some of the participants of a given market may be, the profit and loss system inherent in every genuine market is bound to promote the relatively more thoughtful and knowledgeable of its participants and penalize those who are relatively less so (Mises 1996, chap. 15). At the same time, it should be noticed that the selection system in question does not need to endow its users with perfect or “full” knowledge in order to allow for market self-regulation – it is enough if it continually generates a discovery procedure whereby various economic agents can intersubjectively compare the relative efficiency of their respective plans (Hayek 2002).

In sum, the Austrian concept of rationality strays neither in the direction of New Classical overestimation nor in the direction of behavioral economic underestimation, once again charting a middle course between analytically dubious extremes.

## **Value, scarcity, and subjectivism**

Carl Menger, the founding father of the Austrian school, is widely known as one of the pioneers of the marginalist revolution, which has fundamentally transformed the discipline of economics by grounding it in a new value theory, capable of decisively solving the age-old paradox of water and diamonds. This theory, when reflected upon from a philosophical point of view, can be seen as yet another instance of golden mean thinking, which, in virtue of identifying scarcity and utility as the twin pillars of economic value, navigates between the twin pitfalls of objectivism and hypersubjectivism.

On the one hand, the marginalist revolution delivered a deadly blow to classical economics and its labor theory of value, thereby undermining in particular the economic foundations of Marxism (Böhm-Bawerk 1898). Furthermore, the Mengerian branch of marginalist thinkers mounted serious criticism of the fledgling neoclassical tradition, seeing its adherence to value subjectivism as half-hearted and unjustifiably concessive to the idea of objective costs (Böhm-Bawerk 1894/5).

On the other hand, however, Austrian economists have always been particularly insistent in emphasizing the physically scarce nature of genuine economic goods. This allowed them to identify those instances in which the representatives of the dominant neoclassical synthesis tried to perform the conceptual trick of turning stones into bread by seemingly conjuring away

the scarcity of capital. For example, such a trick appears to be embedded in the Keynesian suggestion that, under recessionary conditions, stimulating “idle resources” through deficit spending is capable of generating positive “multiplier effects”. The crucial issue overlooked in this suggestion, which the Austrians never tire of pointing out, is that “idleness” of resources in no way eliminates their scarcity and the corresponding opportunity costs (Boyes 2014). In other words, if at a given moment no entrepreneur is willing to employ a particular resource, then this resource either possesses no utility in the eyes of current market participants, or they consider all of its conceivable present uses to be suboptimal as compared with anticipated future opportunities. Thus, stimulating it through the use of funds coercively siphoned away from the private sector is not only incapable of conjuring additional economic value into existence, but is bound to exacerbate resource misallocation, making the ineradicable condition of scarcity all the more painful.<sup>2</sup>

A similar conceptual ploy seems to be involved in the neoclassical theory of public goods. Among other things, the theory in question postulates that one of the essential characteristics of public goods is their non-rivalness – that is, the feature of being consumable by a given agent without losing use value for other agents. In view of this, it is then claimed that producing non-rival goods on a for-profit basis is economically suboptimal. The phenomenon of non-rivalness, however, is bound to be at best temporary – more specifically, it can persist only until the full carrying capacity of a particular capital structure of production is reached and the crowding effect kicks in. In other words, the supposed non-rivalness of certain consumer goods turns out to be economically insignificant in view of the inescapable scarcity of the underlying capital goods and the necessity of subjecting the latter to the entrepreneurial calculation of opportunity costs (Wiśniewski 2013). Hence, once again, trying to divorce utility from scarcity even in apparently exceptional circumstances results in a defective understanding of catallactic phenomena.

Finally, the Austrian school is clear and consistent in emphasizing that goods that are useful, but genuinely non-scarce, are not economic goods but free goods, and as such are not subject to

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<sup>2</sup> One might argue that the Keynesian error in question stems from a rudimentary misunderstanding of the nature of employment rather than from any specifically methodological confusion. This, however, seems to be a false alternative. More specifically, while it is true that the said error is not methodological in a direct sense, it may be ultimately traced to a rejection of the strictly nomothetic character of economics. In this particular case, the rejection involved consists in suggesting that economic goods may display different characteristics in different circumstances, sometimes ceasing to be scarce. The causal-realist tradition, on the other hand, sees economics as a fully integrated science, capable of interpreting both micro- and macro-level phenomena through the lens of universal laws derived from the action axiom. Consequently, it admits of no exceptions to the law of scarcity and regards temporary idleness of resources as an important element of intertemporal plan coordination on the part of entrepreneurs.

the principles of economizing. Thus, any attempt to make them artificially scarce by restricting their replication inevitably leads to utility losses. A paradigmatic example of such a procedure is that of obtaining copyrights and patents, whereby one forcibly constrains the dissemination and utilization of productive ideas and innovations, which become naturally superabundant as soon as they are initially brought into existence (Kinsella 2008).

In sum, contrary to common opinion, it is not only classical economics that is at odds with the insights of marginalism. As indicated above, it is also neoclassical economics that occasionally allows itself to apply those insights in an inconsistent manner, sometimes regarding scarce goods as free goods (as in the context of the theory of public goods), and sometimes regarding free goods as scarce goods (as in the context of utilitarian analyses of intellectual property laws (Posner 2005)). In contrast, the Austrian school – that is, the Mengerian branch of marginalism – is steady in its adherence to causal-realist value theory, thereby avoiding the mistakes of both classicism and neoclassicism.

That is to say, it succumbs neither to wholesale methodological materialism nor to excessive methodological subjectivism. Thus, on the one hand, it dispels the notion that economic values inhere objectively in physical goods or in the physical processes leading to their creation, while on the other hand it rejects the claim that economic goods can be created outside the ambit of physical scarcity. As shown above, taking such a middle course allows it to develop a nuanced theory of value and utility capable of generating logically consistent and universally applicable recommendations for those eager to preserve the essential conditions of extended social cooperation, even under supposedly atypical circumstances.

## **Uncertainty, entrepreneurship, and the market process**

The final area in which I would like to illustrate the golden mean orientation of the Austrian school is its theory of entrepreneurship and the market process.

Those economists who are clearly cognizant of the processual nature of market activity have long debated the issue of whether the influence of entrepreneurship on the direction of the economy is predominantly equilibrating or disequilibrating. According to the Schumpeterian perspective (Schumpeter 1975, p. 42-5), it is primarily disequilibrating. According to some interpretations of the Kirznerian perspective (Kirzner 1973) – particularly those that tend to analyze the work of Kirzner through the neoclassical rather than the characteristically Austrian lens – it is primarily equilibrating. By comparison, what might be regarded as the purely Austrian approach to the subject suggests that the whole question is misplaced, since the goal of entrepreneurship is

not to push the economy towards or away from some hypothetical long-run equilibrium, but to carry out the function of capital ownership in the face of an uncertain future (Salerno 2008). Thus, performing the entrepreneurial role may include both introducing disruptive innovations and exploiting arbitrage opportunities, the latter being a natural market response to the former or vice versa, the two being complementary rather than mutually exclusive (Holcombe 1998).

In other words, according to the Austrian view the defining feature of the entrepreneur is neither creativity, nor alertness, nor any other psychological characteristic, but the ability to exercise business judgment under conditions of uncertainty, which is the functional essence of harmonizing supply and demand in the necessarily dynamic world of human action (Foss and Klein 2012). This perspective allows the economic theorist to realize that what is particularly important in the context of understanding the economically essential role of entrepreneurship is not whether its influence is ultimately equilibrating or disequilibrating, but what is the institutional environment in which the exercise of entrepreneurial judgment can operate unimpeded (Henrekson and Sanandaji 2011). It also allows for deducing some of the indispensable features that any such environment needs to exhibit, including robust protection of property rights, legal transparency, monetary stability, and respect for peaceful competition. In sum, by following the golden mean approach, the Austrian tradition refuses to narrow down the definition of the entrepreneur to any particular ideal type, instead investigating the praxeological preconditions of performing the core function of entrepreneurial activity in all of its varieties.

Furthermore, the Austrian emphasis on the uncertain character of business decisions and the necessity of harmonizing them with the anticipated will of sovereign consumers sheds light on the nature of entrepreneurial opportunities. In contrast to the objectivizing view that treats such opportunities as discovered and the hypersubjectivizing view that treats them as created, the causal-realist perspective treats them as imagined (Klein 2008). In other words, it neither underplays the importance of unforeseen contingencies in the execution of business plans nor overplays the ability of the entrepreneur to shape the tastes and preferences of his clients. In this context, the middle ground charted by the Austrians allows for an economically robust understanding of the goal of entrepreneurial efforts, which is not colored by psychologically appealing yet logically unsound metaphors.

Finally, the Austrian reflection on the nature of the firm articulates a subtle compromise between the respective roles played by spontaneous and planned orders in the area of business organization. On the one hand, the Misesian theorem of the impossibility of economic calculation under socialism clearly demonstrates that no single firm could conceivably take over

the whole market, since, as the sole user of various non-specific factors of production, such a firm would face insurmountable economic challenges similar to those confronting a socialist central planner (Klein 1996). On the other hand, however, consistent application of the Ricardian law of association and the attention paid to the entrepreneurial aspects of the managerial role make causal-realist scholars realize that even in a decentralized, knowledge-intensive economy creating and maintaining a well-functioning system of corporate governance requires a substantial amount of top-down planning (Foss and Klein 2014). Thus, while obviously alert to the inherent inefficiency of socialism, the Austrian tradition is perfectly willing to acknowledge certain important advantages of planned orders as long as they are grounded in voluntary contracts and embedded in a broader competitive environment.

In sum, on account of its focus on the logical essence of the market process, the causal-realist approach is singularly capable of providing a cogent and balanced account of entrepreneurship and the firm, which neither romanticizes the entrepreneur nor reduces him to a quasi-automatic coordinating device. More specifically, the approach in question avoids the excesses of both the mechanical neoclassical outlook, where entrepreneurs are at best conceptualized as Walrasian auctioneers capable of robotically keeping the economy in the state of near-equilibrium, and the grandiose quasi-historicist outlook, where the entrepreneur is seen as a revolutionary figure capable of single-handedly shaping market reality according to his will. That is to say, the Austrians see the domain of business and entrepreneurship as it is, with both its great potential and its unavoidable limitations, which nonetheless cannot be improved upon by any constructivist extra-market schemes.

## **Conclusion**

As demonstrated in the numerous examples above, the Austrian school, as compared with other economic traditions, is uniquely justified in regarding itself as an embodiment of golden mean thinking. As such, it offers a distinct, internally integrated and analytically self-sufficient vision of the extended social order, which is properly economic, meaning that it does not have to borrow the methodological precepts or substantive concerns of any other science, be it social or natural. By the same token, it avoids the categorical mistakes and interpretive excesses typically associated with extending the application of any given discipline into areas where it does not belong. Furthermore, in the context of specific, substantive economic issues, it consistently traces them all the way back to the self-evident action axiom, thus insisting both on their strictly deductive interpretability and on their rootedness in the domain of empirical



events, without allowing either of these methodological characteristics to dominate the other. Hence, it promises to be a particularly fruitful approach in providing a logically clear and realistic perspective on various economic phenomena that are to appear in the future, especially insofar as they embody increasing technological ingenuity, organizational complexity, and entrepreneurial emancipation.

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### **Bio**

Jakub Bożydar Wiśniewski (jakub@cantab.net) is an assistant professor in the Faculty of Law, Administration, and Economics at the University of Wrocław and an affiliated scholar and a member of the Board of Trustees of the Ludwig von Mises Institute Poland.

# COVID-19 and Rent-Seeking Competition

Frank Daumann, Friedrich Schiller University Jena  
Florian Follert, Seeburg Castle University

**T**he COVID-19 pandemic affects the everyday and working life of several parts of the population. Politicians, scientists and entrepreneurs face new challenges, decisions are made under enormous uncertainty. Under the primacy of infection control, restrictive political measures have been implemented worldwide with economic, social and mental-health consequences which can hardly be assessed at present. Not at least, the pandemic has eroded bastions of freedom whose existence would have been considered unshakeable in many countries just a year ago. The present paper does not aim at a (final) evaluation of these measures. Rather, the theory of rent-seeking will be used to sketch a mechanism that will be stimulated by the current crisis and that will promote rent-seeking competition that could finally result in non-efficient resource allocations. Given a high degree of uncertainty and incomplete information on both sides of the political market, interest groups try to take advantage from this situation by putting the political actors under pressure. At the end of this chain of effects occurs the problem of restaurant bills and the question: “Who is going to pay for this?”

## **Acknowledgment:**

*The authors would like to thank two anonymous reviewers for helpful comments on a previous version of the paper.*

## **Introduction**

The COVID-19 pandemic is a global crisis phenomenon that challenges business, politics and science. While in the first months of the crisis the main focus was on virological and epidemiological considerations (e.g., Christian Drosten, Hendrik Streeck, or Alexander Kekulé in Germany), other disciplines, esp. from the social sciences, are now also participating in the scientific discussion (e.g., Armbruster and Klotzbücher, 2020; Bickley *et al.*, 2020; Chan *et al.*, 2020; Drewes *et al.*, 2020; Eichenberger *et al.*, 2020). The present paper aims to contribute to this discussion by transferring the phenomenon of rent-seeking well-known from Public Choice literature (e.g., Tullock, 1967; Krueger, 1974; Buchanan, 1980; Tollison, 1982; Nitzan, 1994; Ekelund

and Thornton, 2020) to the current situation. We therefore discuss a chain of potential effects at the end of which there is an unleashing of rent-seeking competition. In our analysis we follow Olson (2002) and assume that individuals form interest groups to better achieve their goals, which will be the case if the benefits in terms of the target function of the individual member exceed its costs. We further assume with respect to the Public Choice literature that interest groups try to influence legislation in the interests of their members through targeted lobbying and thus seek rents. The fact that this rent-seeking competition can lead to misallocations and welfare losses from a perspective of a society as a whole has already been discussed in detail in the literature (Olson, 1982; Acemoglu and Robinson, 2012; another opinion is provided by Becker, 1983). We take up these findings and discuss, on the basis of the current situation in Germany, that the economic policy measures lead to considerable deadweight effects and government becomes a “[p]layball of group interests” (Hayek, 1982 [1973], p. 99). With regard to this metaphor we follow Tollison (1982, p. 578) in his interpretation that “[r]ent seeking is the expenditure of scarce resources to capture an artificially created transfer”.

It cannot be denied that this is a stylized consideration under the typical assumptions of economic theory (e.g., Schumpeter, 1950; Downs, 1957; Niskanen, 1975). However, valuable insights can be derived from this analysis with regard to the assessment of political actions. Although we refer to the political and legal situation in Germany, the implications are transferable to most democratic countries.

The paper is organized as follows: First, in section 2 we present our theoretical framework and highlight the relevant assumptions of Public Choice. After that, we present central mechanisms within the political process in section 3. Then, we focus on COVID-19 in section 4, where we show how COVID-19 stimulates rent-seeking competition between different interest groups that try to take advantage from the uncertainty of the crisis (on the uncertainty of the COVID-19 pandemic see Altig *et al.*, 2020) and the given incomplete information. Section 5 summarizes finally the results of our analysis.

## **Theoretical Framework**

In indirect democracies, competencies for decisions affecting all or parts of the population are delegated to representatives elected by the population in secret elections (in the following Daumann, 2017). If one looks at this manifestation of the democratic constitutional state from an economic perspective, it can be interpreted as a relational contract between the members of the state (the citizens) as principals and their representatives as agents (Richter and Furubotn,

2010, pp. 524–525; on the interpretation as contractual democracy see fundamentally Gersbach, 2012), so that a client-contractor relationship exists in essence (on this, also in the following Follert, 2018, pp. 237–241; Follert, 2020). As it is well-known from new institutional economics, such an agency relationship is accompanied by an asymmetrical distribution of the already incomplete information (Stigler, 1961; Akerlof, 1970; Spence, 1973; as an overview, e.g., Spremann, 1990), from which the typical problems of decision-making and control arise both a priori and after the conclusion of the contract (e.g., Holmström, 1979).

Parliament, as the Assembly of Representatives, acts as a legislative body. Changes to the existing legal system require the approval of a majority of the members of Parliament and must be in accordance with the Constitution. The members of Parliament in turn elect the government. The economic view of the political system in general and of democracy (Downs, 1957) and bureaucracy (Niskanen, 1975) assumes that a self-interested actor is involved. It also postulates that the preferences of citizens are subjective and heterogeneously distributed. According to Arrow (1951), a mere aggregation of individual preferences is therefore problematic; maximizing a social objective function is precisely not compatible with the assumption of democracy (on this point, also Frey, 1977, p. 31). The following can therefore be assumed for government politicians (Downs, 1957; further Daumann, 1999):

Their primary objective is to secure their position as members of the government, with all the comforts, and to keep the current ruling party in government. In this respect, it is a maximization of benefits under the secondary condition of re-election. The less competition there is between the parties, the more likely it is that the political actors will be able to behave differently (e.g., Frey, 1977, pp. 129–130). Furthermore, they have only limited knowledge of the needs of voters or individual groups of voters. Due to the highly differentiated preferences of voters, high costs are incurred in order to gain knowledge of voters' preferences. Finally, politicians have only limited instrumental knowledge to be able to satisfy the voters' preferences in a targeted manner. This instrumental knowledge includes not only knowledge of the appropriate form of the applicable measures but also their effect on the target figure. The politician must therefore know which measures come into question and how they are to be designed in order to be conducive to his objective. With respect to Kirzner (1973) we understand the market process as a dynamic competition, where the chance to take economic rents stimulates entrepreneurial decisions (see also Tollison, 1982). Given the incomplete information which is asymmetrical distributed, we follow the interpretation of Public Choice theory that interest groups engages in lobbying to take advantages from the situation on behalf of their members. In this way, scarce resources

are allocated to specific interest groups by means of a transfer artificially generated by lobbying (Tollison, 1982). While “rents” in a market process have usually productive implications, rents in the context of this paper could lead to economic wastefulness of scarce resources (Krueger, 1974; Buchanan, 1980; Tollison, 1982). The link between the Downsian assumptions on political behavior and the theory of rent-seeking by different interest groups can be pointed out by Hayek (1982 [1973], p. 99):

“The reason is that democratic government, if nominally omnipotent, becomes as a result of unlimited powers exceedingly weak, the playball of all the separate interests it has to satisfy to secure majority support.”

In the following, we will show by the current example of the COVID-19 pandemic, how the uncertain situation stimulates a rent-seeking process at the expense of the economy as a whole.

## **Design of the Political Process**

The following description of the political process is presented with regard to Germany’s parliamentary democracy, which is characterized by a federalism with 16 federal states (*Bundesländer*). Therefore, the Bundestag and the Bundesrat (representing the federal states) act as legislative bodies. To reduce the complexity of our analysis we would like to concentrate only on two actors on the political market: The voter on the demand side and the politician/or government on the supply side.

In general, we can note that the large number and high complexity of the areas of potential state intervention require a considerable amount of professional expertise. It now becomes apparent that a sanction of government politicians is only possible to a limited extent for the following reasons (Knappe, 1980; Daumann, 1999):

1. Thus, the representatives are elected for the entire legislative period (four years in the German Parliament *Bundestag*), so that citizens do not have the possibility to dismiss their representative during the term as a sanction instrument (on this topic see e.g., Gersbach, 2017; Follert, 2018, pp. 242–243; Follert, 2020).
2. The voter can only choose between bundles of planned political decisions (election programs). A differentiation is not possible due to the complexity and existing information asymmetries. Moreover, the possibility of choice is further restricted by the formation of parties that channel opinions in the form of a uniform election program and sanction positions that deviate from it to varying degrees. In addition, the party is not legally bound by “election promises” (Franz

Müntefering at the time of the statement German Vice-Chancellor of Cabinet “Merkel I”: “I maintain that the fact that we are often measured by election campaign statements is not fair”; Schmiese, 2006, translated). Obviously, breaches of trust reduce the reputation of political actors and c.p. the chance of re-election. From a game theoretical perspective, however, this argumentation only applies if further rounds of the game are foreseeable. Since party decisions are also taken by a majority, this argumentation may not necessarily apply at the collective level, but it does confirm at the individual level. If, for example, the opportunity costs of an elected member of Parliament are only high enough and he or she has made an (internal) decision not to stand for re-election, there is discretionary potential and a strong incentive to deviate.

3. Potential competition is made considerably more difficult by institutional barriers to market entry. For example, the “5 percent”-clause effectively prevents certain groups of voters from finding representation in parliament. In addition, there are de facto further hurdles, for example, because new political organizations—regardless of their political color—are viewed with general skepticism very often in media. A further narrowing of voters’ choices is achieved through cartel agreements between the parties. Thus, certain options for action are excluded from the political agenda from the outset by agreements between the parties (e.g. non-introduction of the death penalty in the 1950s, introduction of the euro in the 1990s). It is well known from competition economics that such agreements prevent competition. In a democracy, this also limits competition between parties and may be more significant than in the market sector (see Becker, 1958, p. 108).
4. The principle of the unity of action and liability that constitutes a market economy (Eucken, 2004, pp. 279–280) is largely suspended. This means that political decision-makers can only be held accountable for their actions to a very limited extent, if one disregards (ordinary) voting out (in the following Follert, 2018, pp. 245–246, on the liability claim also Gebauer, 2016; 2019; Follert, 2020). The fact that political actors are not liable for their actions to the same extent as members of the management board of a stock corporation if they violate the so-called “business judgment rule” (well-known from US law (e.g., Arsh, 1993) and since more than twenty years in section 93 (1) sentence 2 of the German Stock Corporation Act) is incomprehensible in as much as in the case of stock corporations there is also a separation of ownership and power of disposal and in as much as a client-contractor relationship exists (e.g., Berle and Means, 1968). With respect to this, from an economic perspective, it would only be consistent to implement a liability of the political actors and correspondingly a



liability-free area for responsible decisions made under uncertainty, like a “political judgment rule” (Follert, 2018, pp. 245–246; Foller, 2020).

This situation on the supply side meets further deficits on the demand side:

1. Content-related limitations: The state takes action in so many areas of life and so obsessed with detail that the voter can no longer gain a complete overview of it. Therefore, many voters will limit the procurement of information relevant for the election to those areas that they consider to be their most important areas of life. This information will also be incomplete and therefore very selective (rational ignorance).
2. Time-limited horizon of memory: The horizon of perception of most voters is also time-limited and shorter than a legislative period.

As a result, voters will only use the sanction potential available to them to a very limited extent and some government decisions that are negative for them will not be sanctioned at all. For the government, this results in a considerable discretionary potential. This is limited by the constitution, the available budget and the opposition: The German constitution provides a framework for state action; originally—and this is often misunderstood—the constitution regulates the relationship between citizen and the state: The Grundgesetz (German constitution) is supposed to guarantee the citizen certain civil rights as well as equality and basic procedural rights. Laws and thus state action must not, in principle, violate individual fundamental rights. Restrictions are subject to the proportionality principle of public law. Nevertheless, the Basic Law and the Federal Constitutional Court allow the legislature to formulate state objectives and to implement them.

Goods and services provided by the state (e.g. in the form of monetary transfers or subsidies) are financed from the state budget. The government’s scope for action is therefore limited by the size of the available state budget. This amount depends on tax revenues and the possibilities for borrowing. The latter is limited by the debt brake. In principle, however, there can be no doubt that democratic governments, which can be interpreted as administrators for a legislative period tend to incur debt due to their time preference (e.g., Hoppe, 2007) and to uses political business cycles to maximize their utility (e.g., Frey and Lau, 1968; Nordhaus, 1975, Rogoff, 1990).

The opposition’s options for action consist of showing alternatives to the government’s actions and making the negative consequences of the government’s actions transparent to the voters.

The limited knowledge of government politicians about the preferences of voters or individual groups of voters and about the corresponding instrumental knowledge can be remedied by the interest groups as lobbyists: The interest groups possess extensive information about their members, which they collect primarily in the context of fulfilling domestic private sector functions such as market observation and the ongoing information of members about sector-relevant facts (Daumann, 1999, pp. 121–122). This information relates to the framework conditions relevant to the actions of the members (relevant legal regulations, characteristics of the upstream and downstream markets, relevant technological knowledge), the economic potential of the members (information on income and expenditure structure, structure of the workforce etc.) and the market behavior of the members (knowledge of different business strategies and of the use of the different action parameters) (Daumann, 1999, pp. 121–122).

This makes it clear how government politicians will use the discretionary potential: They will use the necessarily selective information offered by interest groups to obtain information about the preferences of important voter groups and the necessary instrumental knowledge at low cost. The influence of interest groups, e.g. the banking industry, is evident from a large number of published position papers and intensive advice to the government on legislative amendments. Government politicians will favor measures that ensure re-election by increasing the benefits for large constituencies in areas that are important to these voters. Such measures must be compatible with the law and should place only a minimal burden on the state budget. Admittedly, disadvantaged minorities must not be allowed to aggregate into a majority. This can be achieved by keeping the extent of disadvantage to individual groups of voters and the transparency of the effects of disadvantage as small as possible.

Even before the COVID-19 pandemic, rent-seeking by numerous interest groups was already apparent in Germany, which were able to take advantage in particular of phases of greater uncertainty. Examples include the long-standing protests against nuclear energy in Germany and the more recent demonstrations concerning human-made climate change (*Fridays for Future*). In this context, enormous pressure was exerted on the government. In particular, the younger past shows that political decisions can often be driven by public pressure and the anticipation of future votes. A prominent example of this is the sudden exit from nuclear energy by the German government after the terrible accident in Fukushima, Japan, in March 2011. Follert and Daumann (2020) assume that this decision could be the result of a change in the population's subjective perception of danger, which was anticipated by the Merkel-government. The geographical conditions and thus the uncertainty regarding the dangers have not changed

as a result of the accident in Japan, so that the explanation of the political action may have to be sought using public choice theory. With respect to the massive funding of renewable energies by wind or solar power (e.g., Federal Office for Economic Affairs and Export Control 2020),<sup>1</sup> it is reasonable to assume that especially those interest groups that positioned themselves against conventional power generation at an early stage have been able to generate rents.

## **COVID-19 as a Stimulator of the Rent-Seeking Competition**

Covid-19 is a viral infection that is apparently highly contagious and probably poses a considerable risk to life and limb (on the COVID-19 mortality see e.g., Promislow, 2020; Ruan *et al.*, 2020). The fact of the matter is that the knowledge about this disease is rather limited, as there are hardly any comparable data concerning the spread of the novel coronavirus, that is a member of a group that we already know as zoonotic pathogens (e.g., Millán-Oñate *et al.*, 2020). Consequently, on both sides of the political market there is incomplete information on the medical risks of the spread of the virus. Moreover, it is difficult to predict the social, economic and psychological consequences of the pandemic. In particular, phases of lockdown as we have seen in Germany in March and April 2020, which for many people go hand in hand with isolation, appear to pose different dangers (e.g., Armbruster and Klotzbücher, 2020). However, since the government has the opportunity to obtain the necessary information through scientific expertise (in Germany especially by the advice of Christian Drosten and Hendrick Streeck), the supply side tends to have an information advantage over the voters. Nevertheless, there is also an information gap on the government side as well, since forecasts are also associated with uncertainty for scientists and every scientist interprets the implications derived from the data differently (on the role of science in this context see Follert *et al.*, 2020). Furthermore, there is a considerable degree of uncertainty for the electorate concerning the future developments of the pandemic and the effects on individual life. In particular, the uncertainty cannot be sufficiently mitigated by approximate estimates of future environmental conditions based on past indicators. The negative scenario is reinforced by media reports and, in particular, social media, which of course focus primarily on the threats posed by the disease to the individual, the health care system and the economy (on risk perception and its influence on political decisions, recently Follert and Daumann, 2020). There is at least anecdotal evidence that the dreadful images from northern Italy showing the removal of corpses by military trucks increased the perception of danger in Germany and influenced politicians to take more stringent governmental measures. For most of the voters, the pandemic has

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<sup>1</sup> On the expansion of renewable energies in Germany after the accident in Fukushima see Rave (2016).

created a completely new and unknown threat to both their own health and their economic resources. In this respect, the threat potential of the pandemic goes beyond the financial and economic crisis of 2008. A prevention of a bank run in the situation at that time was also achieved by the fact that Chancellor, Angela Merkel, and Federal Minister of Finance, Peer Steinbrück, had a strategy for reducing the subjective perception of danger by announcing the apparent safety of all savings deposits (on the importance of trust in this context e.g., Butzbach, 2016; Waschbusch, Schuster, and Berg, 2018, pp. 62–64). More than a decade later, such a measure probably no longer would have the desired effect on the financial sector either. One reason could be seen in the fact that, although the information on the effects of the pandemic is incomplete, this vacuum has led to the circulation of numerous untruths and absurdities in addition to serious and scientific criticism. The average man faces a problem of selection. Confidence-building measures can hardly be implemented by the political side.

In this uncertainty, parts of the population are understandably looking for reliability and a “strong” state of some kind. Since the threats in the current period are perceived as more dangerous than any threats in future periods, the pandemic raises the threshold of tangibility and improves the acceptance of government measures among voters. In other words, the majority of voters would have refused to favor individual groups of voters, for example in the form of direct transfers, before the pandemic, but the pandemic has brought about a greater degree of acceptance.

Like every government, the German government is fighting on two fronts against COVID-19. On the one hand, it is trying to keep the number of infections as low as possible and, on the other, it tries to contain the economic consequences. In the context of COVID-19 crisis-decisions, the government is basically confronted with three information problems:

- (1) The effectiveness of infection control measures.
- (2) The reaction of the population to the measures.
- (3) The effectiveness of the measures for economic stabilization.

While the measures to combat a pandemic (1) are largely known through epidemiological research with regard to their effectiveness in achieving the goal of “protection against infection”, especially (2) and (3) are characterized by a high degree of uncertainty. Particularly the reaction of the population is relevant for politicians to reach their overall political goal. The fact that this situation can lead in a political competition is demonstrated by the Minister Presidents,

Armin Laschet (North Rhine-Westphalia) and Markus Söder (Bavaria). While Söder pursues a particularly strict policy, Laschet tried to implement less restrictive measures in his state.

This information problem mentioned in (3) turn also favors the interest groups, which point to a particularly difficult situation of their clientele and demand state support services. In Germany governmental aid began with "Immediate Federal Economic Assistance [*Corona Soforthilfen*]". Federal Ministers Peter Altmaier and Olaf Scholz emphasizes on 03/29/20:

"The Federation and the Länder have jointly put in place the necessary requirements for quick applications for the coronavirus Immediate Assistance Programme and for quick payments, and have done so in record time. We are acting in response to the hardship faced by many small businesses, own-account workers, members of the free professions, and farmers who are in urgent need of this assistance. The application and payment process is to be swift and free from red tape. Up to €50 billion of federal budgetary funding can be accessed by the Länder for this purpose as of this Monday" (Altmaier, 2020).

"The Federation and the Länder have acted very swiftly so as to be able to deploy the coronavirus Immediate Assistance Programme immediately. Own-account workers and businesses employing up to ten people can claim grants for their operational costs – a total of €50 billion has been set aside for this. The Länder can begin to access these funds as of tomorrow (Monday), so that the grants can be paid out quickly and without red tape. It is good that the Federation and the Länder are working so closely together to ensure that the assistance will quickly be available to those who need it" (Scholz, 2020).

To point out his determination to fight against the economic consequences of the COVID-19 pandemic, Federal Minister of Finance, Olaf Scholz, uses the image of "bazooka" (e.g., Chazan and Fleming, 2020), which shows clearly that the governmental expanses are no longer limited. If, despite the almost unlimited possibilities of today's (paper) monetary system (fundamental insights on the monetary system by Huerta de Soto, 2012), one assumes that financial resources are a scarce resource, competition between the various interest groups will develop. The German economic newspaper *Handelsblatt* (2020, translated by the authors) emphasizes the problem of rent-seeking competition:

"Whether in the automotive industry, tourism, transport, pharmaceuticals or retail: everyone wants to secure as much of the package as possible. [...] Olaf Scholz must feel like Santa Claus. The Federal Minister of Finance is literally showered with wish lists. Since it became known that the federal government wants to

put together an economic stimulus package worth billions, [Scholz] has received approximately 350 letters of request from all over the country.”

The demands of individual interest groups thus trigger the phenomenon of the “rat race”, which is well known from sports economics (Akerlof, 1976; further Daumann, 2019, pp. 177–178): Several rats try to reach a piece of cheese. Since only the first rat can eat the piece of cheese, all rats make an increased effort to reach the cheese first. Due to these basic conditions, overinvestment occurs. This is the situation in which the interest groups believe they find themselves: Other associations try to counter the advance of individual associations; they do not want to stand back and also want to achieve advantages for their members. If they are too reluctant to do so, they run the risk, in their opinion, of coming too late in gaining state support for their members. Failure to do so could lead to the association being delegitimized by its members, since its original purpose is to represent particular interests, which would then not be provided (Olson, 2002). Large interest groups tend to start lobbying, while in the following further stakeholder groups appear on the scene. Especially those organizations which prima facie do not act as lobbyists but as so-called “activists” should not be underestimated in their influence on the political actors of modernity, which can be seen in the effects of *Fridays for Future* on political behavior. Benson (1984, p. 388) describes this mechanism as a

“spiraling process of government growth since successful rent seeking by one interest group generally requires expansion of bureaucratic powers, while at the same time creating incentives for the formation of additional rent-seeking interest groups. Legislative responses to these new groups requires further expansion of the bureaucracy and creates incentives for more rent seeking, so the growth process continue.”

In the final step, the government also becomes aware of the scarcity of its resources, which is due not least to the debt brake. Due to the limited term of office, the assumption of new liabilities at the expense of later generations does not tend to be a particular obstacle, so that finally it is to be feared that the pandemic will override the budget constraint: The debt brake is simply tilted and the “restaurant bill problem” arises (Koslowski, 1994, p. 306): if a larger group decides to go out for dinner in the evening and simply divide the total expenditure according to the number of heads, then much more is eaten than if everyone has to pay for himself. In other words, all groups of voters now try to get state benefits because the cornucopia has been opened.

The result could be considerable deadweight effects and a misallocation of scarce resources. Since transfer payments in acute crisis situations must necessarily be carried out quickly and

unbureaucratically without a careful examination of the economic conditions, the state cannot distinguish between “good” and “bad” companies. Subsidies are distributed by watering can, so that business models are kept alive which would actually have already gone bankrupt without the crisis. In addition, support is also given to companies that do not need it. Incidentally, the same would also be expected with a flat-rate “child premium” if it were not possible to differentiate between the economic and social conditions of households. In extreme cases, there is also discretionary potential for fraud. Only a short time after the start of aid payments, several fraud cases in Germany become known, especially in Berlin, cases of suspected subsidy fraud are increasing (e.g., Stehle, 2020).

## **Concluding Remarks**

The aim of this paper is to transfer the mechanism of rent-seeking competition that is known from Public Choice theory to the COVID 19 pandemic. We emphasize that the current crisis is characterized by a high degree of uncertainty, because the phenomenon is mostly new and difficult to compare with other health crises in the past. Especially the incomplete and asymmetrically distributed information leads to a political vacuum that offers rent-seeking potential. The uncertain and complex situation could be used by various interest groups to seek for rents for their members. It is typical for such a situation that politicians are receptive to this lobbying, which is already derived from the goal of the maximization of votes to stay in the office. This leads to increased spending in the COVID-19 crisis, which burdens future generations of tax payers. In the end there is the typical “restaurant bill problem”, where the expenses are divided among all parties involved, which tends to lead to increased expenses.

With this analysis we would like to sensitize the reader to the political-economic dimension of the COVID-19 pandemic and show that—apart from the known health-related risks—, there may also be considerable economic consequences that have to be discussed. Future research, particularly from an ex post perspective, should attempt to examine, on the basis of empirical evidence, the extent to which state measures were favored by lobbying activities, although a causal connection can hardly be established.

At the end of our analysis, it should be pointed out that we are building on some assumptions, especially those of Public Choice theory. It is obvious, that these do not necessarily apply to every individual. However, we broaden the perspective of neoclassical Public Choice theory to the extent that a central point of our essay is the incomplete and asymmetrical distributed information that favors certain mechanisms within the COVID-19 pandemic.

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## Bio

### **Prof. Dr. Frank Daumann**

Faculty of Social and Behavioral Sciences, Friedrich Schiller University Jena, Germany.

### **Ass.-Prof. Dr. Florian Follert**

Faculty of Management, Seeburg Castle University, Seekirchen am Wallersee, Austria.

Corresponding Author: [florian.follert@uni-seeburg.at](mailto:florian.follert@uni-seeburg.at)