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ECONOMIC CALCULATION, MATURITY MISMATCHING AND THE CREDIT CYCLE

IVAN JANKOVIC†

ABSTRACT

This paper is an attempt to synthesize the classical Misesian argument for the impossibility of economic calculation in socialism with the Mises-Hayek credit cycle theory. The key concepts of the ABCT such as "interest rate" and "natural interest rate" have been traditionally defined for a barter economy, which made it very difficult to integrate them with the monetary theory of economic calculation. The focal point of the synthesis proposed here is Mises's regression theorem in which he showed that money can be understood only as a commodity that has to be independently demanded for industrial and consumption purposes prior to establishing itself as a medium of exchange. It is shown that abandoning of the pure gold standard is just a special and limited case of the general problem Mises originally explored in the context of the debate on socialism – abolishing of the private property rights that leads to "incalculability" in the economic system. The main finding of the paper is that maturity mismatching and fractional reserve banking in a similar way bring about the inconsistent time structure of private property rights in money, and distort the economic calculation that way. Hence, the necessary condition for both the rational economic calculation and the avoidance of business cycle is the presence of a 100% reserve commodity money that is privately owned, the full-banking reserve as well as the private property in the means of production and the absence of maturity mismatching.

KEY WORDS: business cycle, gold standard, economic calculation

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I. INTRODUCTION

When an economist of the Austrian school is asked what causes the business cycle, the usual answer is “the artificially low interest rates”. On the follow-up question: “how do you know that any particular interest rate was artificially low”, the predictable answer is: “because it was lower than the natural interest rate that would have otherwise prevailed on the free market”. When the next question comes “what is the natural interest rate and by how much should it be higher than the actual interest rate”, the real problem begins to loom; an Austrian looks into the main texts of Mises and Hayek and comes up with approximately the following definition: “the natural interest rate is the one that would prevail in a barter economy”.[1] Obviously, this is a problem, since it is not immediately clear how can one claim any precise relationship between the magnitude A (an actual interest rate) and the magnitude B (a natural interest rate) when the magnitude B is not only unobservable, but conceptually of a very different kind. It is really problematic to claim that the monetary policy of the Fed under Alan Greenspan was too easy, because in a primitive barter economy the interest rate would have been higher than it was under his chairmanship![2] How can anyone know that? And what kind of change should be made in the existing monetary arrangements in order to make the interest rate as closely as possible approximate the natural rate? Of course, this does not mean that the general concept of an artificially lowered interest rate is wrong, but only that this concept is not sufficiently developed or clarified, because it is typically not analyzed in the context of private property rights in money.

The purpose of this paper is to try to deal with this problem – to show that all disagreements about whether fractional reserve banking and maturity mismatching were consistent with the ABCT stem from the failure to put the discussion in the context of private property rights and economic calculation. Once this is done, it becomes clear why so much confusion exists in this area. Inconsistency between the monetary explanation of the business cycle and a non-monetary definition of the key analytical terms of that theory is much more peculiar and ironic as we bear in mind that the same intellectual tradition provided a theory of impossibility of socialism based on its incapability to calculate the monetary prices of the factors of production, and hence to provide a basis for the cost-accounting and hence rational economic planning (Mises, 1990). Now, it turns out that the Crown Jewel of the same tradition, a purportedly “monetary” theory of the credit cycle is based on the non-monetary categories of a barter economy. Ironically, maybe the two most important paradigms in the economic theory of the Austrian School, Mises’s theorem of impossibility

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1 See Hayek, 2009, Mises, 1949.

2 A reviewer objected to this statement of mine by arguing that every change in the money supply always artificially pushes the interest rate downward, so there was no problem with the Austrian definition. However, although this is quite correct as far as qualitative law goes, it still does not provide us with a systematic and rigorous explanation as to how much the interest rate was depressed under the Greenspan’s chairmanship, and what has to be done in order to avoid the same thing in the future.

of the economic calculation in socialism, and the Mises-Hayek theory of the credit cycle remained disintegrated. The basic arguments that underlie both of these paradigms seem to be well understood, and it could be even said that in some sense there is a "consensus" among the majority of "Austrian" economists about the meaning of those two theoretical paradigms, and yet none has come up with an idea how to unify them in a comprehensive theoretical whole.

However, this is less surprising when we take into account that Mises and Hayek themselves in their classic texts were vague and often inconsistent in explaining what they meant by the "sound money" or a free market monetary regime. Mises was generally close to the 100 % gold standard, but considered free banking as a second best, and even occasionally accepted the legitimacy of the fiduciary media (Mises, 1978), contrary to his general theoretical assumptions. Hayek was even less consistent, for he accepted at various points of his career everything: 100 % gold standard, fractional reserve free banking, competition in issuing the private currency all the way to the central banking which he considered a given framework in his best works from 1930s (Hayek, 2009).

It is then even less of a surprise that among the followers there is an even bigger confusion on this issue. Today, at least two distinct Austrian traditions or schools of thought exist, which tend to offer fundamentally different accounts of the basic categories of monetary economics, and therefore completely different analysis and policy prescriptions for business cycle, due to the different understandings of this critical issue. What distinguishes those two traditions is exactly how they understand money – its origins, its place in economic life, and the ways how it affects production. The one tradition that follows Menger and the classical economists sees money as a scarce commodity which is used as a medium of exchange (such as gold or silver).[3] The economic calculation only makes sense in terms of units of that commodity. Banks and other financial institutions cannot create additional money out of "thin air" that is not backed by 100% commodity reserves, without hampering and distorting the very process of economic calculation. The second "Austrian" tradition, on the contrary, considers the Misesian economic analysis (praxeology) to be compatible with the emission of fiduciary media, i.e. credit money in the fractional reserve banking system which does not have a 100 % backing in money proper, or specie, such as gold (Selgin 1988, White 1990, Garrison, 2002). It is widely believed within this tradition that the Austrian theories of monetary calculation and credit cycle (with all their indispensable ana-

3 But even this tradition, the main representative of which is Murray Rothbard, and contemporary heirs Hoppe, Block, Huerta de Soto, Huelsman, Salerno etc, does not offer an unified theory of monetary calculation which would put Mises's impossibility hypothesis together with the credit cycle theory, as analogous consequences of the interference in private property rights, which distorted and took into question the very possibility of rational economic planning. De Soto (1998) came closest to that perspective by insisting that central banking management of the money must fail for the same reason as attempts to centrally plan a whole economy, but even he did not offer a complete theory of the demand-side incalculability stemming from hampering private property rights in the money commodity. Others, such as Hoppe (1994) and Huelsman (1996) emphasized the ethical and economic consequences of abandoning 100% gold standard, but did not offer an integrative theory of calculational effects of commodity money either.

lytical tools) hold true even when we abandon the commodity standard and accept some form of fiat or fiduciary money; the Austrian theory is "institutionally elastic", i.e. equally applicable both in the pure gold standard and in the various forms of mixed-systems, including the fiat money and central bank regimes.

Moreover, the things are even worse than that: not only is there not an agreement about what the proper monetary framework is, but the very disagreements are based on personal opinions or philosophical and ethical differences rather than on rigorous economic theorizing. The economists who argue for 100 % standard do that irrespective of the theory of monetary calculation: as we shall see, all the praxeological deductions concerning the natural interest rate, malinvestment, voluntary saving etc. apply only to the barter economy. None has any idea what these categories would mean in a monetary economy (i.e. in different types of monetary regimes). The "Rothbardian wing" of the Austrian school has a praxeological theory which explains the properties of Crusoe economy or barter, including the pure time preference theory, definitions of interest rate, profit and loss and so on, on the one hand, and a theory of 100% gold reserve system, on the other hand, based largely on the ethical and philosophical interpretations of what the libertarian or "free market" monetary system would require. No attempt at their synthesis or unification by economic analysis has been undertaken. The members of the "Kirznerian" wing, from their part, accept a general Mises-Hayek framework in explaining the credit cycle, but when it comes to money they adopt the mainstream Keyensian-monetarist doctrines (macroeconomic equations, monetary policy, anti-deflationist measures etc). Unlike the Rothbardians who at least emphasize the regression theorem (although they do not incorporate it into their pure theory and the credit cycle theory), Kirznerians reject it completely and explicitly.

The main thesis I would like to defend and elaborate more in detail in the remainder of the paper is that the Austrian concepts related to the credit cycle, such as voluntary and "forced" saving, time preference, natural rate of interest, monetary calculation, credit-induced production cycle etc., make sense ***only*** in the pure 100 % commodity money system. And consequently, that all forms of interference with the 100 % commodity money system hamper economic calculation and distort the price system and production structure. Furthermore, I will argue that even in the 100 % reserve system, miscalculation is possible, with the same consequences as in the FRB, if so called maturity mismatching is allowed. Both the fractional reserve banking and maturity mismatching create the inconsistent structure of property rights in money and inflict the distortions in the price mechanism, making rational economic planning impossible. Both of these "special impossibility theorems" (FRB and MT) are derived directly from the Mises's general impossibility theorem of socialism: private property rights = market prices = rational economic calculation. In this case, this algorithm is applied not only to the consumers' or producers' goods (as it was usually the case from Mises onwards), but to money as well.

II. THE REGRESSION THEOREM AND ECONOMIC CALCULATION

The Austrian credit cycle theory originally proposed by Mises (1978, 1998), and developed in its state-of-the-art form in Hayek (2009), was adopted and reinforced by their subsequent students and followers. It is a theory of monetary-induced over-investment in the capital intensive production processes that causes the inter-temporal misallocation of resources and distortions in the pattern of production that leads to the economic crises. By artificial lowering of the interest rate below the free market rate (the "natural" interest rate), banks create 'forced savings' and induce the entrepreneurs to invest in the capital-intensive production processes that are unsustainable in the long run and will be liquidated in the future (Rothbard, 2004, Huerta de Soto, 1998). As it was mentioned, none of the economists writing in the Mises/Hayek tradition would question this basic framework for the explanation of the business cycle. However, the problem shows up when we try to define more precisely and stringently the key analytical categories of the theory, money being the most important among them. Depending on how we define money the theory itself could be interpreted in completely different ways.

What this practically means is that unless the relationship between Mises's "impossibility theorem" and the credit cycle theory is explained, the latter remains in a vacuum. What does it mean to say, for example, that some interest rate is "natural" and some other is not, and what is the "genuine free market" on which a natural rate would manifest itself? Mises follows Wicksell in understanding the natural rate of interest as one that would prevail if no money would exist and the exchange of productive factors would have been carried out through a series of barter arrangements (Mises, 1978). However, since in the market economy we never face that situation of barter, of what analytical use is the concept of natural rate which cannot be approximated by anything observable in a real market economy? We have the two interest rates, "a" and "b" (say, prior to, and after the central bank's intervention) on the real market. Which one of them is closer to the "natural" rate and why?

As we have already shown, in the pure Austrian theory there is only a metaphorical theory of interest, pertaining to the artificial constructs of the moneyless Crusoe economy. However, our main task here is exactly to look at how the interest rate is forming in a real *monetary* economy.[4] Of little help in that endeavour would be either to say, again in Wicksell's footsteps, as all Austrians have been doing for a century, that the natural rate is the one that "equates the demand for and supply of capital" (Hayek, 1967:23). For, immediately the question arises – what is the legitimate "supply of capital" and what is the legitimate "demand" for capital in this context? As the Austrians warn us, money is not and cannot be "neutral" to prices and production, and hence nor to the volume of available capital. So, the Wicksellian definition accepted by Hayek again begs the question. It is a petitio principii:

4 An additional irony of the situation is that the branch of the Austrian school insisting the most on the credit cycle theory is called a causal-realistic school, meaning a school concerned not with the artificial equilibrium prices, but with the mechanisms of the formation of the real, everyday, market prices.

the natural interest rate equates the demand for and supply of capital, and demand and supply are equal when there is a natural interest rate.

Let us look at an example: the rate lowered by a central bank using its "discount window" appears to provide a higher level of the "supply" of capital than otherwise would have been the case. But, the entire point of the ABCT is that this "inflated" supply of capital is not real, ie. that it provides for an artificial increase of long-term investment which is not justified by the change in the underlying rate of time preference of the public. In other words – it is not clear what all this supply-demand rhetoric means (if anything) in the fractional reserve system (with or without the central bank) where the "supply of capital" can be increased by emitting fiduciary credit, without any changes in the underlying gold base, and without any change in the social rate of time preference.[5] How would we recognize the "natural" rate when we see one? Further, what is "voluntary saving" as opposed to "forced saving" in each of these different systems, and how can we distinguish praxeologically between the two? And does it make any sense to talk about such analytical differences in the context of the central banking regime at all?

The problem we face here is not just a matter of some theoretical splitting of hairs. If we cannot establish the mentioned distinctions in a praxeologically relevant way, by explaining the central concepts of monetary theory within the sensible theory of individual human action, the explanatory power of both the ABCT and impossibility theorem would have been greatly diminished. If we have no sensible way of defining the natural rate of interest, the theory of the credit cycle as stemming from the "artificial lowering of the interest rate" becomes a little more than game playing, just as the impossibility of monetary calculation becomes a murky speculation, once we are not able to define the "sound money" clause (Mises, 1990) upon which the very calculation is supposed to be based.[6] In his seminal paper "Economic Calculation in the Socialist Commonwealth" Mises lists the three conditions for a successful economic calculation and rational planning: consumer goods must be privately owned, producer goods also have to be privately owned and there must be a "universally accepted medium of exchange", ie. money. That is pretty much everything Mises has to say about the role of money in economic calculation. He does not specify anything further, neither about the nature of this medium of exchange nor about the "right" monetary regime. He merely emphasizes that the fluctuation in purchasing power of money should not be too sudden in order for the system to retain the ability to calculate (ibid.). But, he never addresses the problem of the monetary system consistent with "genuine" monetary calculation.

Mises in "Human Action" clearly concedes that the problems of artificial lowering of the interest rate and malinvestment boil down to the distortions in the mechanism of economic

5 For the explanation of how it is possible for this to happen, see de Soto (1998; 688–700).

6 In "The Economic Calculation in the Socialist Commonwealth" (1990, p.8) Mises lists money as one of three preconditions for rational economic planning, but does not define it stringently. Mises's "sound money" is indifferent toward the distinction commodity money-fiat money.

calculation. At least at the surface, those two paradigms, the credit cycle and the economic (mis)calculus appear to be interrelated: "But now the drop in interest rates falsifies the businessman's calculation. Although the amount of capital goods available did not increase, the calculation employs figures which would be utilizable only if such an increase had taken place. The result of such calculation is therefore misleading. They make some projects appear profitable and realizable which correct calculation, based on an interest rate not manipulated by credit expansion, would have shown unrealizable. Entrepreneurs embark upon the execution of such projects. Business activities are stimulated. A boom begins." (Mises, 1998: 550). Mises's works are full of similar rhetorical snapshots linking the credit cycle with economic (mis)calculation. What is, however, missing in these eloquent descriptions of the "calculational failure" as a cause of the boom is an institutional structure that gives rise to the artificial lowering of the interest rates; or to be more precise, the description of a type of *monetary regime* that brings about that kind of effect, as well as the description of the type of a regime that could prevent the same process from happening. The cluster of unanswered questions we asked recently reappears: is it possible to avoid this kind of wrong calculation in the central banking regime? If not, is that possible in fractional reserve free banking? If not, why? What is a "sound money" which provides a reliable informational basis for the economic calculation? Can it include fiduciary credit and why? Obviously, we cannot rely upon any sort of end-state criterion to answer these questions, but can only define a genuine interest rate as a result of a legitimate process. Which kind of process, and in which type of institutional framework and property rights regime? How could the "free market rate of interest" be brought about?

Mises seems to provide a preliminary hint as to the resolution of these problems in his discussion of the fiduciary media and its influence on artificial stimulation of the credit expansion in "Human Action", where he says: "The notion of "normal" credit expansion is absurd. Issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle. Of course, if the additional amount issued is not large, neither are the inevitable effects of the expansion." (Mises, 1998; 442). What the quoted passage clearly enunciates is that the fractional reserve system *per se* is a cause of the credit cycle; that any amount of fiduciary media emitted sets in motion the forces that lead to the famous "artificial lowering of interest rate", that is to say, to the unwarranted credit expansion and unjustified lengthening of the production structure. From there, it would further follow that only the 100% reserve ratio banking model is consistent with reliable economic calculation, and with the preservation of the genuine time preference of the public.

Curiously enough, although this proposition might have been precious for synthesizing the credit cycle with the monetary calculation argument, Mises has never followed up on this crucial and fundamental insight to develop a more detailed theory of the calculational failure of fractional reserve banking. He was satisfied to point out that the creation of

fiduciary media leads to the insolvency and instability of the banking system, leaving the monetary miscalculation problem in a very rudimentary state (Mises, 1978).[7]

However, although Mises has never elaborated this in depth, I believe that he gave us both the general theoretical framework for understanding the problem, as well as some specific guidelines where to look for the elements that can be utilized for the synthesis of these two paradigms (the calculation argument and the credit cycle theory). In my opinion, the key is the concept of private property rights. What Mises failed to do in his paper on economic calculation in the socialist commonwealth was to emphasize that for a successful calculation to take place it is not enough to have private property in the producers' and consumers' goods; we need private property in money as well. As we shall demonstrate later on, the very existence of fractional reserve banking represents an infringement on the private property rights in money. Mises should have applied his "impossibility theorem", with its famous sequence *private property-prices-calculation* on money as well, and he would have reached the same conclusion.

The absence of this deduction is even more surprising as we take into account that Mises had done all the necessary preparatory steps for it. He gave a complete praxeological deduction of money! In "Theory of Money and Credit" Mises, following Carl Menger, explains the origins of money as a commodity spontaneously emerging from the market transactions as a universal medium of exchange. After the economy surpasses the stage of a primitive barter, and when division of labour allows for a much wider extent of trade than was possible within the isolated group or tribe, the need emerges for an indirect exchange of goods and services. For that purpose, some commodity is needed that everybody will want to own, but not for its potential to directly satisfy certain human needs, but because of its usefulness as a universal medium of exchange. The qualities of that good that functions as a universal medium of exchange should be its relative scarcity, marketability and possibility to be easily divided into smaller homogenous pieces. During history, the free market gradually selected some commodities as more appropriate than others for this purpose: "Whenever a direct exchange seemed out of the question, each of the parties to a transaction would naturally endeavour to exchange his superfluous commodities, not merely for more marketable commodities in general, but for the most marketable commodities; and among these again he would naturally prefer whichever particular commodity was the most marketable of all. The greater the marketability of the goods first acquired in indirect exchange, the greater would be the prospect of being able to reach the ultimate objective without further manoeuvring. Thus there would be an inevitable tendency for the less marketable of the series of goods used as media of exchange to be one by one rejected until at last only a **single commodity remained**, which was universally employed as a medium of exchange: **in a word – money**" (bold ours) (Mises, 1978, 32–33).

7 Moreover, especially in his earlier work, he sowed the seed of confusion by attributing some positive features to the fiduciary media that gave some room to the advocates of fractional reserve banking to claim the "Misesian" mantle (see, Selgin and White, 1994).

So, Mises here explicitly claims that money cannot be established but as *a physical commodity* that has been demanded for industrial and consumption purposes initially, and only gradually transformed into money by emerging demand for it as a medium of exchange. Therefore, in his famous "regression theorem" Mises was quite explicit that money was just another commodity which survived the competition with other goods for the status of the universal medium of exchange.[8] Therefore, the monetary calculation in a praxeologically relevant sense means *expression of the relative value of various goods for the participants in the exchange in terms of one common denominator which is also a scarce physical good, which is privately owned*. For, how otherwise would have the purchasing power of money – the price of money in terms of consumer and producer goods – reflected the real scarcity and opportunity cost of money, had it not been privately owned itself? Money emerges as a private good on the market, with separate demand for industrial purposes, and only after its acceptance as a medium of exchange does it gain an additional element of purely "monetary demand".

However, there is no basis whatsoever to believe that money can cease to be a privately owned commodity and still be used as a medium of exchange and the basis for a reliable economic calculation; nothing more than the producers' good which is not privately owned can be used in the economic calculation. Of course, an economy with a large part of capital goods in government ownership can still survive, but the calculation mechanism would be significantly damaged and tampered with. As Murray Rothbard has pointed out, insofar as the extent of the economy which is not privately owned increases, the "island of incalculability" in the economy increases as well (Rothbard, 2004). The nationalized money, fiat money, or a fractional reserve banking money (fiduciary media) all broaden this island of incalculability in the same way the partial nationalization of various industries broaden it on the side of the "real economy", making the economic calculation less efficient and less precise than it would have been otherwise. There is no qualitative difference at all between money and capital goods in terms of their influence on economic calculation. The only significant difference is that tampering with private property rights in money distorts not only a particular set of prices, but the structure of relative prices of the entire economy. The theory of the trade cycle describes just a special case of calculation failure of the socialist economy. The ABCT is just a special case of Mises's "impossibility theorem".

The prices of goods and services depend upon the conditions of supply of and demand for those goods and services, and upon supply of and demand for the money commodity on the other hand. All prices are thus the consequences of the millions of individual valuations demonstrated by the millions of acts of buying and selling on the market, expressed in some common commodity denominator – money. We should bear in mind that money, being a scarce good itself, also has its own costs of production, and that since money tends

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8 This is quite obvious even from the very title of the German original of the book that came to be known in its (very imprecise) English translation *"Theory of money and credit"*, and that is Theorie des Geldes und der Umlaufsmittel, which means literally *"Theory of Money and Fiduciary Media"*. We see that Mises draws a sharp distinction between money and fiduciary media, and that he does not seem to consider paper credit money to be a money in praxeological sense.

to be a *very* scarce commodity in the same time, the costs of money production are usually very high. Thus, Mises's regression theorem offers a synthesis of the monetary and real economics in a praxeological whole (Salerno, 1994) as well as an implicit explanation how the abandonment of commodity standard distorts the economic calculation. The problem was, and remained, that the Austrian theorists often, especially in the context of the credit cycle theory, tended to forget this critical implication of the regression theorem – the extremely institutionally rigid character of money as a tangible commodity selected by the individual choices of the people on the free market. Economic calculation without the regression theorem is a theoretical impossibility.

Having this in mind, we can now define more stringently many other important categories of "monetary economics" we mentioned earlier, such as voluntary saving, natural interest rate, a genuine free market production structure and so on. For example, "voluntary saving" is a quantity of income of individuals that is withheld from the current consumption and assigned for investing in future consumption either *via* direct personal investment or through lending to other investors with interest. The quantity of the available saving is expressed as a sum of individual savings of all members of a community. In a free market society, quantity of saving would equal the *aggregate quantity of goods as expressed in gold* that all individuals together are willing at any given point of time to *sacrifice* (withhold from consumption), and confine to production/investment. This is the only possible praxeological, Misesian meaning of the term "voluntary saving"; no credit money beyond the gold base.

What is then the "natural interest rate"? If we go further from the circular definition according to which it is a "rate which equates supply and demand of capital" (what is demand? what is supply?), we can define it as an interest rate paid on capital in a society in which all investment is carried out on the basis of voluntary saving (as previously defined), which is to say the natural interest rate is a rate paid on capital in the market with 100 % commodity money. This is the real praxeological definition of the famous rate of interest that "would prevail on the free market", the rate that Austrian economists are always talking about, but very rarely, if ever, define. The production structure on the free market is therefore the one determined by the social rate of time preference expressed in a given ratio consumption/investment, as measured by commodity money prices.

III. BEYOND PRAXEOLOGY, OR THE FRACTIONAL-RESERVE BANKING

The obvious implication of our analysis would be that fractional reserve banking is irreconcilable with rational economic calculation, since it eliminates the assumption of private property in money, i.e. of money as a physical commodity with a rigidly fixed quantity, the price of which is determined by the cost of production and the demand of the public. By fitting together a deposit contract with a loan contract banks are able to "duplicate" in some sense parts of the money supply – by creating the loanable funds beyond their available commodity money reserves (Rothbard, 1991 De Soto, 2006). What in this process happens in terms of

private property rights is the creation of the inconsistent structure of property titles. Let us suppose that there are 1.000 ounces of gold in a country. That means that all producer and consumer goods are priced according to their relative values as calculated numerically using this monetary base. The factors of production are distributed among the various branches of industry in accordance with their relative prices as revealed in the millions of actions of buying and selling with gold used as a medium of exchange. The distribution of gold among the people in that country corresponds to the proportions of the *real goods* and services their incomes can command at the given point of time. The investment and consumption patterns are defined in accordance with the aggregate social rate of time preference which determines the gross market interest rate and thus the distribution or the factors of productions among the various branches and among the different stages of production.

Let us suppose further that 100 ounces of gold are deposited with the commercial banks as demand deposits. Suppose also that the banks are the fractional reserve banks, and that they emit, for every ounce of gold received, an additional claim to an ounce of gold that does not really exist (fiduciary media) which is then channelled into the economy via the credit market. In the meantime, the time preference of the public did not change; the consumption-saving ratio remained the same as before. Hence, what does emerge from this is that for every ounce of deposited gold-cash, we have an equivalent of an additional ounce of credit lent out to the entrepreneurs; that way the same amount of money (100 ounces) was effectively doubled by a stroke of the pen, or out of "thin air", by creating the claims to an additional 100 ounces that did not exist anywhere in the bank's vaults.[9]

Suddenly, we have two sets of people – the depositors with the commercial banks, and the corporate borrowers who have been given the new loans by the same banks – who claim the property rights over the *same* 100 ounces of gold in the same time! No new saving is accumulated, no change in the time preference has occurred; banks just by an administrative stroke of pen transformed the deposits into the loans and 100 ounces of money into 200 ounces of money![10] And all of these people are starting to compete for the limited real resources the quantity and quality of which had not changed at all. As the ABCT explains, the people do not cut their consumer spending, while the investors increase their investment spending, which is the original sin that leads inexorably towards the crash. This is the most critical element in the credit cycle theory; that what we perceive as a distortion in the investment-spending patterns in the fractional reserve system is essentially caused

9 This analysis has nothing to do with the question whether the fractional reserve bank is "solvent" or not, whether it is "inherently bankrupt" or not. The only thing I am interested in here is what happens to the private property rights and the economic calculation in the fractional reserve banking.

10 See Murray Rothbard (2004, pp.115–16): "...a claim – and bank notes or deposits are claims to money – does not involve the creditor's relinquishing any of the present good. On the contrary, the noteholder or deposit-holder still retains his money (the present good) because he has a claim to it, a warehouse receipt, which he can redeemed at any time he desires. This is the nub of problem, and this is why fractional-reserve banking creates new money while other credit agencies do not – for warehouse receipts or claims to money function on the market as equivalent to standard money itself".

by the inconsistent structure of *property rights* in money, and the consequential misinformation about the real quantity of goods people think their money income can command. The duplication of property titles over money units means eventually a duplication of the claims to the real, physical resources. And that means over-investment in the more roundabout productive processes more sensitive to interest rate variations. The phenomenon of the business cycle described in the Austrian theory is just a form of the failure of government to enforce private property rights. One of the authors who probably most forcefully emphasized this was Jorg Guido Hulsman: "The customer receiving interest payments for his money deposited in a demand balance believes he receives a free lunch. In fact, they do not do so for their deposit with a bank makes fiduciary issues possible and thus leads to a decrease of the purchasing power of their money. Additionally, they are erring about the quantity of money they can dispose of. Thus, it is precisely under a regime of fractional reserves that the market participants are systematically misinformed about the quantities of goods they can dispose of." (Huelsman, 1996; p.33)

Of course, entrepreneurs and other market participants do not know about this "misinformation" ahead of time. Since they have no real practical way of differentiating between the genuine increase of savings and an artificial credit creation by the banks (the praxeological properties of money and the fiduciary media are the same in this context),[11] they behave as if the increase in real savings has taken place, i.e. as if the social rate of time preference has decreased. Led by an illusion of a command over the greater amount of real goods, they increase accordingly the investment in the long-term and more capitalistic ways of production.[12] This situation is usually described as an "artificial lowering of interest rate", but we can now more precisely define when some particular interest rate is "artificially" lowered; it is in the case when the banking system emits *any amount* of fiduciary media, which is to say, any amount of credit money that is not covered 100% by gold money proper ("specie"). In that case, the whole process of dis-coordination of economic activity is set in motion, leading to the malinvestment of capital by oversupplying it to the remote parts of the production processes – to the "higher order" goods – and under-supplying it to the stages of production nearer to the consumption.[13] That process must eventually lead to the

11 "Fiduciary media are scarcely different in nature from money: a supply of them affects the market in the same way as a supply of money proper: variations in their quantity influence the objective exchange value of money in just the same way as do variations in the quantity of money proper" (Mises, 1978; 446).

12 For the explanation why it is unavoidable that entrepreneurs treat an artificially lowered interest rate as genuine increase in saving, see Mises (1978), Garrison (1986), Huelsman (1998) or Carilli and Dempster (2001).

13 This does not mean, as some popular misunderstandings of the ABCT claim, that one should expect a depression in the consumer goods industries during the boom. It only means that the higher-order goods expansion would be disproportionately larger than in the consumer goods industries, and that the squeeze in the real resources nearer to the consumption will eventually lead to the under-supply of capital to the higher stages of production, and the entire structure must collapse. But, the entire point of ABCT is that because of an artificially low interest rate the consumer goods industries experience a too high and not too low growth during the boom.

liquidation of the wrong investments and to shrinkage of artificially lengthened production structure. As Ludwig von Mises emphasized time and again, there is no other way to eliminate those cyclical economic miscalculations and misdirections of production on a large scale, except to abolish all fiduciary media altogether: "Fiduciary media are scarcely different in nature from money; a supply of them affects the market in the same way as a supply of money proper; variations in their quantity influence the objective exchange value of money in just the same way as do variations in the quantity of money proper. Hence, they should logically be subjected to the same principles that have been established with regard to money proper; the same attempts should be made in their case as well to eliminate as far as possible human influence on the exchange ratio between money and other economic good. The possibility of causing temporary fluctuations in the exchange ratios between goods of higher and of lower orders by the issue of fiduciary media, and the pernicious consequences connected with a divergence between the natural and money rates of interest, are circumstances leading to the same conclusion. Now it is obvious that the only way of eliminating human influence on the credit system is to suppress all further issue of fiduciary media." (Mises, 1978, pp. 407–408).

This is in complete agreement with Mises's original argument of the impossibility of calculation in socialism and with Hayek's reformulation of that argument. Those arguments rest on a proposition that without private property in the means of production there are no genuine market prices. All attempts of so called market socialists to "play the market", i.e. to devise the various mechanisms for substituting prices with the trial-and-error way of determining value of goods in a centrally planned society, are futile. If this is so, and if money is, on the other hand, a fungible commodity as every other such commodity (as Mises, among others, had established), then the very possibility of economic calculation rests critically on the money being a privately owned good, and also on its having a certain physical quantity, determined by the supply, demand and the production costs. Just as there is no genuine market price for ordinary goods and services in terms of money, if those goods are not privately owned, also there is no a genuine market price for money in terms of other goods without money being a privately owned physical commodity.

The price system with less than 100 % gold backing for all demand deposits continually sends wrong or distorted information to the economic actors about the structure of the relative prices of producer and consumer goods which is optimal from the point of view of a genuine time preference of the public, inducing those actors to invest in the wrong kind of projects.

The problem cannot be resolved by somehow managing the money supply better, either by government fiat, or by "competition" of the private banks in multiplying the money "substitutes"; if there is an increased scarcity of bread, bare issuing of the million fake "certificates" for bread, that cannot be redeemed for bread in the stores, will do nothing to alleviate the scarcity of it. The solution can be only found in increased production and/or increased price of bread. By the same token, the quantity of money commodity cannot be increased simply by issuing paper stickers that have no real backing in the certain quantity of money proper; nothing more than the mere coupons for bread can increase the quantity

of bread, without previous increase in its production. The price of money in terms of other goods must fall, and/or production of that money should increase if both money and other goods have to have a genuine market price, and money to become less scarce at the same time. From the praxeological point of view, the issuance of the fiduciary media is not a production of money, but counterfeiting, because paper is not money, and banks do not engage in mining and refining gold or silver that *are* monies.

IV. MATURITY MISMATCHING AND ECONOMIC CALCULATION

Until now, we have explored the relationship between fractional reserve banking and economic calculation in the Misesian sense, concluding that the very institution of fractional reserve banking is irreconcilable with rational economic planning and calculation, because it leads to an inconsistent structure of property rights in money. The only monetary and banking system that can provide the smooth functioning of the free market, a viable economic calculation and avoid the credit cycle is the 100 % reserve gold standard.

However, an additional complication in this connection is contained in the fact that even the 100 % reserve system is not *per se* a reliable safeguard against the credit cycle and economic mis-coordination and miscalculation. It could be deemed just a *conditio sine qua non* of the successful market system. The usual and widespread practice of modern banks to "borrow short and lend long" would have the same detrimental consequences, as the ones the ordinary fractional reserve banking inflicts upon society, even if carried out in the system of 100 % reserves. The maturity mismatching, in other words – a divorce between the time structure of bank's assets and its liabilities – brings about the situation in which the same quantity of money proper again can create more credit, depending upon the bank's policies, just like in the case of a "normal" fractional reserve system. The reason for the attractiveness and hence for the danger of maturity mismatching is simple: the long-term interest rates tend to be higher than the short term interest rates. The value of utility forgone is higher when one abstains from the consumption for a longer period of time than for a shorter period of time. Technically speaking, the yield curve tends to be steeper overtime, which means that the interest rate grows as the maturity of a loan increases. That further means that the basic reason for the popularity of maturity mismatching is that a bank can increase their profits by practising it. The banking business most often takes a form of the interest rate arbitrage. The final consequence is the same as in the ordinary fractional reserve banking: an oversupply, or inflation of long-term commercial loans that causes the productive processes to become more roundabout by introducing the new intermediate stages of production that would have never come into being otherwise.

The danger of maturity mismatching has not gone unnoticed by the Austrian economists. As early as 1912 in the "Theory of money and credit", Ludwig von Mises warned: "For the activity of the banks as negotiators of credit the golden rule holds, that an organic connection must be created between the credit transactions and the debit transactions. The

credit that the bank grants must correspond quantitatively and qualitatively to the credit that it takes up. More exactly expressed, 'The date on which the bank's obligations fall due must not precede the date on which its corresponding claims can be realized.' Only thus can the danger of insolvency be avoided" (Mises, 1978; 263). Murray Rothbard also stumbled upon a similar problem, and he noted that: "Another way of looking at the essential and inherent unsoundness of fractional reserve banking is to note a crucial rule of sound financial management – one that is observed everywhere except in the banking business. Namely, that the time structure of the firm's assets should be no longer than the time structure of its liabilities". (Rothbard, 2008).

However, neither Mises nor Rothbard went further than noticing the harmful effects of maturity mismatching on the bank's solvency and soundness, and on the integrity of the banking system overall. They did not analyze the systematic effects of the maturity mismatching on economic calculation and cyclical movements of the economy. The problem of detrimental effects of maturity mismatching as such remained by and large ignored in Austrian economics. None moved beyond Mises's and Rothbard's sporadic and isolated objections against this process to systematically analyze them in the context of economic calculation and how they affect the structure of property rights in money. This problem fell into an almost complete oblivion until quite recently.

The main problem that remained unaddressed is which way maturity mismatching interferes with private property rights in money commodity, and distorts the price of money in terms of producer and consumer goods? If we are not able to demonstrate how the process of maturity mismatching inflates property titles, then the objection against this process becomes irrelevant, because we are unable to demonstrate how it creates the miscalculation of economic data. Why would one care at all about the unsoundness or insolvency of the banking system if that "unsound" system does not create any systematic distortion in the price structure of the economy? The "stability" and "solvency" of the banks is not a good thing *per se*, nor is it the task of an economist to deal with these problems. Let the banks take care of themselves in the market process in which the sound ones would out-compete the unsound ones. Maturity mismatching is an economic problem only insofar as it has some systematic ramifications for economic calculation and the credit cycle. The fractional reserve system is a problem not because it creates a "systemic risk" or "liquidity crises" but because it multiples (inflates) the property titles in money by using the portions of the demand deposits to create the loanable funds out of thin air, distorting the relative price of higher and lower order goods that way. Can we found a similar mechanism by which maturity mismatching interferes with genuine private property rights in money and brings about distortion in the mechanism of economic calculation?

The great step forward in closing this theoretical gap in understanding the link between maturity mismatching and private property rights infringement was made by Walter Block and William Barnett II in their article "Time Deposits, Dimensions and Fraud" (Barnett and Block, 2008). In that article they brought forward the private property rights approach and applied it to this problem of maturity mismatching. Barnett and Block, however, limited their conclusions to the legal and ethical aspects of the issue, avoiding completely its ramifications

for economic calculation; in their interpretation, just as fractional reserve banking was fraudulent and illicit, maturity mismatching is fraudulent and illicit as well (Barnett and Block, 2008). Just like Mises and Rothbard and all others, they did not discuss the issue of how this process affects the rationality of economic planning and calculation. Nevertheless, their ethical-logical analysis allows us to make a step forward in understanding how the maturity mismatching affects not only the legal status of property rights in money, but also influences the economic problem. The question Barnett and Block ask is – when person A borrows a $100 from the person B for 1 year, and then lends the same $100 to a person C for 2 years, is there a logical incompatibility between these two operations? Are the property titles multiplied this way in a similar fashion they are multiplied and compromised when the loans are created out of demand deposits? Obviously, during the first year, both person A and person C believed they had the same $100 in their ownership, and they adjusted their consumption and spending patterns according to this erroneous knowledge. Block and Barnett emphasize the ethical side of the issue: that all credit transactions based on maturity mismatching are illicit and fraudulent because they create the inconsistent structure of property rights. However, for our purposes it is much more significant to note that maturity mismatching creates misallocation of the real resources in the same way the ordinary fractional reserve credit creation does, by inducing people to believe that there is more of the real factors of production suitable for long-term investment than there really is.

Barnett and Block established that if fractional reserve banking is fraudulent, then maturity mismatching must be fraudulent as well; we can reformulate that and say that if the FRB creates the credit cycle, maturity mismatching does the same as well. Moreover, we can treat fractional reserve banking as an enterprise in which the zero maturity “loans” given by the depositors are transformed by the banks into long terms loans. Fractional reserve banking would be just the most extreme and detrimental form of maturity mismatching.

Bagus and Howden (2010) analyze the neglected problem of the term-structure of savings; although on the real markets there are several different loan markets for loans of different duration, the Austrian models assume just one market for loanable funds (Rothbard, 2004, Garrison, 2002). Although this is justified for purely analytical purposes when one studies the artificial states like ERE, it leads to unwarranted conclusions if applied to real market situations. All real savings have two distinct dimensions: monetary dimension and duration, or term-structure. All loans made by the lenders are always for specified quantity of money, and for a specified duration. The gross market interest rate is determined by the confluence of those two factors: “The same nominal amount of monetary savings offers a different yield depending on its maturity” (Bagus and Howden, 2010: 70).

The authors say that maturity mismatching would not be a great problem in the absence of the fractional reserve system administered by central banks, because the incentives for excessive mismatching would have been much lower in that situation and entrepreneurial arbitrage would diminish the returns on maturity mismatching overall (ibid). However, we can say the same thing for fractional reserve banking in general; without the central bank tutelage, the problem of cycle would certainly have been much less pronounced. For theoretical purposes, it does not matter how large a distortion of relative prices is brought about by

falsified interest rate; the only thing that counts is that such an effect does exist. We do not have to claim that maturity mismatching in a 100% reserve system would be sufficiently strong to trigger a major financial and economic crisis in order to establish a qualitative law that maturity mismatching creates malinvestment. Because, for that matter, neither the ordinary, free banking fractional reserve system without the central bank or government help and amplification could possibly create large scale financial panics and crises. When talking about the cause and effect, the source of disturbances and so on, we are referring to the qualitative rather than quantitative phenomena. Just as Mises, in our opinion correctly, had emphasized that "issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle", it is equally justified to say that any amount of maturity mismatching always sets in motion exactly the same type of changes in the structure of production Mises is talking about in the context of fractional reserve banking.

To see the dramatic consequences this has, we can go back to the issue of voluntary vs "forced saving". Our initial "monetary" definition was that voluntary saving was that amount of deferred consumption which is possible in the system of 100 % gold standard money. Now, we see that even that is not the entire story. As savings has both its quantitative and time dimensions, true voluntary savings on an unhampered free market would be the one emerging from the monetary system of 100 % gold reserves on bank deposits, with no banks practising maturity mismatching. As Mises had said in the "Theory of Money and Credit": "The date on which the bank's obligations fall due must not precede the date on which its corresponding claims can be realized.' ". Anything less than that would create (at least some amount of) credit cycle disturbance.

V. TOWARDS CONCLUSION

The real reason why there was so much confusion about what the key analytical categories of the ABCT had meant has to do with the non-monetary aspects of the theory, with the fact that all these key categories (natural interest rate, time preference, voluntary savings) were defined by and large for the conditions of a barter economy. Robert Murphy rather convincingly demonstrated that the main weakness in the conventional Austrian exposition of the credit cycle was a non-monetary character of the pure time-preference theory; the interest rate was determined irrespective of monetary factors in the state of an evenly rotating economy. We could see in this paper that this has a tremendous implication for the entire structure of the theory; other categories, such as voluntary savings, malinvestment, supply of capital and so on were also affected.

The problem with the conventional exposition of the credit cycle is that it explains real market phenomena using the categories of a pure theory detached from the real institutional process of the market economy. That approach is maybe equally unrealistic as mainstream macroeconomic theorizing; an abstract model is constructed which is a pure theoretical

exercise (nothing wrong with that per se, since it still can be used for explanatory purposes in some cases) which explains only a phenomenological structure of trade interactions, the praxeological fundamentals necessary to understand the basic structure of the Austrian theoretical claims (ERE, Crusoe economy etc). However, that is a rather ironic outcome: an allegedly "monetary" theory of the trade cycle ends up accepting the explanation of interest and savings that applies only to the barter, Crusoe economy.

Our proposal in this paper was to supplement this conventional Austrian analysis by developing a truly monetary theory of the business cycle, and linking together the credit cycle theory with the theory of economic calculation. This is possible only by shifting the focus away from the abstract constructs of pure theory towards the empirical-institutional processes that create the economic outcomes in the real world of monetary exchange. Instead of defining the "natural" interest rate and voluntary savings as the ones that would exist without money, as if the entire economy was in a barter, we proposed to define all these categories as pertaining to a specific free market monetary regime, a 100% gold reserve system without maturity mismatching.

This modification of the conventional credit cycle theory allows us to show how and why Mises's impossibility theorem and Mises-Hayek credit cycle theory are one and the same theory, just seen from different angles; a consistent and non-contradictory structure of property rights in producers, consumers and exchange goods (including the absence of fractional reserves and maturity mismatching) is equally a precondition for the avoidance of the business cycle as it is for the avoidance of socialist calculational failure. Actually, those two phenomena are one and the same: the failure of the economic system to correctly calculate the prices, caused by the lack of consistent and well defined private property rights.

This renders a reinterpretation of the general Mises/Hayek argument about the impossibility of socialism. Both of them emphasize that the problem is by and large simple: capitalism has private property in capital goods, so it can calculate the cost and prices and hence can coordinate economic life. Socialism, having no private property, has no real market prices and hence cannot rationally plan. Money is understood in this context just as an outside appendix, as a precondition and facilitator of the exchange, not as a participant in exchange and a good to which the same requirement of being privately owned and produced must be applied as well.

However, when we add our amendment of 100 % commodity money (directly based on the Mises's regression theorem!) to this basic theoretical framework, as a condition of a genuine calculability, the picture becomes much fuzzier. It seems now that we do not have capitalism and socialism as antipodes anymore, but capitalism with 100 % gold standard and without maturity mismatching on the one pole, and the entire continuum of different systems with various degrees of informational and allocational irrationality and distortions on the other side, ranging from free banking, fractional reserve gold standard, then central banking with the partial gold standard, fiat money central banking, socialism with some private property, and full-scale socialism without any kind of private property at the end of the continuum. The difference between all those types of economic and social orders is not in kind anymore, but just in the degree or the type of interference with the price sys-

tem. Credit inflation under the free banking regime is one and the same type of economic irrationality as the impossibility to have the market prices for consumer goods in full central planning socialism; only the degree of distortion of the price system is different.

My proposal for a theoretical unification of Mises's impossibility theorem and Mises/ /Hayek theory of trade cycle would be that rational economic planning requires the universal presence of private property rights ***both*** in the means of production and consumption, as well as in the means of exchange. If on either side of the equation we have government or at least government-sponsored interference with private property rights (as in the case of the fractional reserve system), we will incur necessarily a crisis of economic miscoordination. This paper covered primarily what happens when banks, by issuing the fiduciary media, violate the private property rights axiom on the demand side – the side of the money.

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ANARCHISM AND AUSTRIAN ECONOMICS

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ABSTRACT

In the 2011 Franz Cuhel Memorial Lecture, I argue that the study of endogenous rule formation in economic life (what I term the positive political economy of anarchism) should be studied in-depth and that the economic analysis of the Austrian school of economics provides many of the key analytical insights necessary for such study.

KEY WORDS: austrian economics, anarchy, rule formation

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I. INTRODUCTION

It is a great honor for me to give the Cuhel Memorial Lecture at the Prague Conference on Political Economy for 2011. Franz Cuhel rightly holds an honored place in the development of the pure theory of the Austrian school of economics.[1] Ludwig von Mises credits Cuhel (1907) with providing the first presentation of a strict ordinal marginal utility analysis. The confusion in choice theory that eventually lead to the purging of the human element in the economic analysis of decision making would have been avoided had Cuhel's ordinal presentation of marginal utility analysis been more widely accepted. Instead, it was for Mises (1949) and later Rothbard (1962b) to develop that presentation and offer it as an alternative to the neoclassical theory of microeconomics that developed after John Hicks' (1939) *Value and Capital*.

The implications, I would argue, are far greater than the technical issues of ordinal versus cardinal utility and the subsequent debate among ordinal utility theorists of marginal utility analysis and demonstrated preference versus marginal rates of substitution and indifference curve analysis, etc. The implications of the debate in choice theory go to core of how we view the individual that we study in economics.[2] The optimizing agent who must maximize against given constraints belongs to the world of Hicks, but the human actor who is fallible yet capable, who must balance between alluring hopes and haunting fears, belongs to the world of Cuhel and Mises. "Choice" theory in the Hicksian presentation is close-ended, I would argue, while choice in the Misesian framework is open-ended. The implications of this go not only to the way we conceive of the individual in economic analysis, but ultimately determines our analysis of the impact that the diversity of institutions within which men act will have on their acts of choice, their exchange relationships, and their ability to realize the gains from trade, and the gains from innovation.

Adam Smith long ago taught us that man has a natural propensity to truck, barter and exchange, and Thomas Hobbes also warned us of man's propensity to rape, pillage and plunder. Which human propensity dominates any social environment is a function of the institutions in place that provide the rewards and penalties in social intercourse. But this institutional analysis requires that our model of the act of individual choice in economics is logical (predictably rational), yet indeterminate in manifestation. In other words, what is "rational" is contextual in nature and not acontextual, or to use the language of Vernon Smith (2007), rationality in economics should be conceived of as ecological and not constructivist.

The open-endedness of human action can be captured in the ordinal analysis laid out by Cuhel (1907) and developed by Mises (1949), whereas the closed and robotic agent fits

1 See Hudik (2007) for an overview of Cuhel's life and work.

2 Focus should be on the substantive economics of the human chooser in Mises's first part of *Human Action* (1949) rather than his philosophical defense of methodological dualism and the apriori nature of economic theory. More recently, Richard Wagner (2010, 1–26) discusses the differences between 'closed maximization' versus 'open action' for economic analysis and social sciences more generally more cogently to my mind than any other contemporary example.

with the analysis of decision-making provided by Hicks and the subsequent developments of neo-classical price theory. And, as the German sociologist Hans Albert (1979; 2010) acutely argued long ago, the institutional deficiency that was evident in 1950–1970 neoclassical economics would never be completely repaired until the behavioral foundations of neoclassical economics are changed.[3] The maximizing actor model cannot accommodate institutional analysis without diluting it to the point of non-existence.[4] Instead, we need to engage in rational choice analysis as if the choosers were human actors, and this enables us to do institutional analysis as if history and culture mattered. In short, only by moving away from the economics of automatons and the twin obsessions of optimizing and equilibrium, and instead focus on the economics of human actors with a focus on perception of opportunity and processes of adjustment to change can we see how the institutional context of choice not only structures incentives, but shapes the choice context faced by the individual.

While Cuhel's work was a contribution to positive economic theory, I want to argue that this approach to the logic of human action provides the foundation for subsequent developments in comparative political economy that addressed questions in institutional analysis. Thus, my title – "Austrian Economics and Anarchism."

This title is meant to be startling at first sight. Adherents of the Austrian school of economics claim their work to be a scientific body of thought, and not a normative political doctrine. Correctly so, I agree. And clearly anarchism is an extreme and evenromantic political doctrine as far removed from science in the public imagination as is possible. How can the two be put in the same title?[5]

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3 It is important to stress that a goal of neoclassical economists in this period was to develop an 'institutionally antiseptic' theory, and this lead to the counter-reaction of what later was termed "New Institutionalism" in economics – e.g., property rights, law and economics, public choice, 'new' economic history, etc. See the discussion of this counter-reaction in economics and also his discussion of 'new' versus 'neo' institutionalism in Eggertsson's *Economic Behavior and Institutions* (1990).

4 An important illustration of this point is the development of the theory of market socialism by Oskar Lange (1936) and Abba Lerner (1944); though also see Lavoie (1985). They both argued that in the realm of pure theory what they had demonstrated was that the model of market socialism could mimic the efficiency results of the model of capitalism, but that in practice the model of market socialism would outperform the model of capitalism because they could eliminate the real-world problems of capitalism associated with monopoly, externalities, and business cycles. The point I want to emphasize is the pure theory point – in the model the institutional differences between socialism and capitalism were completely neutralized. Lange went as far in his essay as to accuse Mises of "institutionalism" because he thought economic calculation depended on private property. And, in Milton Friedman's (1947) review essay on *Lerner's The Economics of Control* he stressed that it was a mistake for economists to engage in public policy analysis as if administration were done inside of an institutional vacuum.

5 One easy way to square this is to emphasize the Schumpeterian point about the necessity of pre-analytic cognitive acts (what he called 'vision' and what others might call 'ideology') for the analytic cognitive acts that are the domain of positive science (what he called 'analysis'). So an anarchist vision would lead one to engage in analysis differently than an alternative vision, but the positive science concerning the analysis can be judged independently from one's assessment of the vision. I appreciate this point, but that is not the way I am going to pursue my argument.

But it is also true that for the audience to which I am addressing, perhaps my title is not startling at all, but in fact commonplace. The sophisticated audience here at the Prague Conference in Political Economy is no doubt familiar with the radical libertarian writings of Murray Rothbard (1970, 1973, 1982) and those who follow Rothbard such as Walter Block (1976) or Hans Herman Hoppe (2001). Rothbard, Block and Hoppe are foremost representatives of the individualistic and anarcho-capitalist camp of *normative political economy*, and they also are self-styled Austrian economists. Whatever my criticisms or sympathies are with the Rothbardian approach, that is decidedly *not* what I intend to discuss here. My intent to startle remains. Rather than discuss the normative political theory doctrine of anarcho-capitalism, my focus is on the *positive political economy of anarchism* and its relationship to the *positive* economic theory of the Austrian school of economics. In the end I hope to persuade my intended audience that the study of anarchism is part of a progressive research program in contemporary Austrian economics.[6]

The right way to view this paper is as an invitation to inquiry into situations where "alternative institutions that support economic activity when a government is unable or unwilling to provide adequate protection of property rights and enforcement of contracts through the machinery of state laws" (Dixit 2004, vii). It is an effort to persuade students of Austrian economics that embracing an empirically oriented research program focusing on the institutional analysis of situations of self-governance is not only an exciting intellectual endeavor, but perhaps the best way to advance the theoretical and methodological tradition of the Austrian school of economics in the context of modern scientific economics.

By the positive political economy of anarchism, I mean simply the study of historical and contemporary situations where the rules (and their enforcement) that govern social intercourse are not provided, for whatever reason, by a geographic monopoly supplier of law and order. And I am particularly interested in those social relations that concern the recognition of property rights, the keeping of promises, and the transference of goods and service through consent. In standard economic analysis the institutions within which economic activity takes places are treated as given. The rules of the game and their enforcement are *exogenously* provided and constitute the social framework within which individuals engage in economic activity. The positive political economy of anarchism does not accept this assumption of exogenously provided institutions. Instead, the research program we are describing focuses on *endogenous* rule formation.[7]

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6 See my essay "Anarchism as a Progressive Research Program in Political Economy" (Boettke 2005). Also see the comprehensive survey of the literature by Powell and Stringham (2009).

7 James Buchanan (2011) has recently argued again that endogenous rule formation cannot be trusted precisely because there is no analogous profit-loss mechanism in operation in the selection of the framework of rules. This position of Buchanan's is not new, and Israel Kirzner (2000) also shares Buchanan's skepticism. Though more controversial of an interpretation, I would argue that Rothbard also would argue that a spontaneous order analysis of the framework was intellectually flawed and that a more exogenous analysis of the framework would be required. (see, e.g., Rothbard 1962a) For Buchanan, the framework results from a pre-constitution-

II. THE SOVIET AND POST-SOVIET CONTEXT OF TRADING OUTSIDE OF THE LAW

As a matter of empirical reality, there are plenty of exchange relationships that take place in an environment where the rules of the game are in fact still up for question, and certainly not enforced by any legitimated geographic monopoly of coercion. The current market for illegal drugs in the US is one such environment, just as the market for alcohol during the era of Prohibition, but one could also describe the anonymous dealings on the internet involving perfectly legal commodities as transacted on sites from E-Bay to Craigslist in this manner as well.[8]

My interest in endogenous rule formation environments actually began with my studies of the Soviet economy. My Austrian school perspective had alerted me to the fact that Soviet central planning could not have been the operating principle for the economy due to the Mises-Hayek critique of socialism.[9] The disjoint between how the system was supposed to work, and how it really worked became a major theme of my work (e.g., Boettke 1993, chapters 3–4) – and I wasn't alone as this assessment was shared by many economists, political scientists, and historians who studied the Soviet system up close and personal. But those who approached the system from afar tended to obscure the operating principles of Soviet political economy both inside the official planning system and outside that system in the different "colored markets" that ranged from the extra-planning system that enabled state enterprises to meet planned production targets to the underground market in consumer goods that provided some answer to consumer frustrations.

In the late 1950s and early 1960s, as Sovietologistswho gained access to the system that they had been denied since the ascendancy of Stalin observed, the Soviet planning system didn't work according to known models of optimal planning, but instead through a hodgepodge of exchange relations and makeshift alternative supply chains in production.[10] The social glue that held the system together was not the rational plans of Soviet managers, but the system of privileges and side-payments that emerged to coordinate the economic behavior of bureaucrats, managers, and ordinary citizens. "'Blat' is higher than Stalin," was a common phrase used to explain how the informal economic system held together. These

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al process of rational discourse that results in agreement on the rules, whereas to Kirzner and Rothbard the framework is provided by moral discourse over individual rights and commonly accepted social mores.

8 One recent estimate put the magnitude of organized criminal activity at 15% of world output.

9 See my essay on "Coase, Communism, and the 'Black Box' of the Soviet-Type Firm," in Steven Medema, ed. (1998).

10 The consequences of the Soviet system being effectively closed off after this period of "thaw" were dire for economic analysis and steered economic research from the mid-1960s away from this "on the ground" approach to either escape theoretically into mathematical modeling of planning, or empirically into efforts to reassess the economic growth figures Soviet statistical agencies reported. Only during the 1980s did economists start to get back to the economic analysis of the organizational logic of the Soviet system. See Boettke (1990, 1993, 2001).

informal arrangements were neither defined nor enforced by any central authority of law and order, but through a variety of private mechanisms of social cooperation.

Identifying these private mechanisms and the *de facto* property rights and the stream of rents they produced was vital for the analysis of the post-communist transition. And, obviously the standard assumptions of *given* clearly defined and strictly enforced property rights by the state does not apply. The state capacity to define and enforce property rights and freedom of contract was what was being developed. But economic life couldn't wait until that state capacity was in place. There is, in short, an *endogenous rules* formation process that we have to recognize and study. There is *ordered anarchy* both in terms of market theory and the price system and the framework within which the market process guided through relative prices is played out.

The political economy of this ordered anarchy is not just evident in the Soviet and post-Soviet example. In fact, the ordered anarchy of everyday life exists throughout history and across cultures. The way I have put the issue so far given the exclusive Soviet context, is, in fact, overly pessimistic.[11] If you read carefully, it will appear as if I am arguing that the informal arrangements are what exists in the Soviet and post-Soviet environment, but everyone would be better off if we could get the state capacity to define and enforce property rights. We only rely on the informal because we cannot yet rely on the formal.[12] But the day we get formal mechanisms in place, the better off everyone will be. *This reading of my argument would be wrong*. Informal institutions not only serve as the basis of social order, and ultimately constrain the legitimacy of the formal institutions that the state attempts to impose on the population in question, but they can in many circumstances simply outperform any conceivable set of formal institutions that will emerge in the future given the realities of the situation and the range of possible types of government that would be introduced.

Chinese entrepreneurs, for example, have found the informal institutions to be more secure and thus have made long term investments. The situation is different in Russia even though they apparently have formal laws that should provide such security, but there remains a lack of trust (see Rodrik, et. al., 2004). Claudia Williamson (2009) has found that the informal

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11 In my analysis of Soviet and post-Soviet life, I have emphasized the mechanisms that result due to the "black market" nature of the economy and have emphasized the dark side of the "connection based" economy as opposed to the "contract based" economy. As I have often stressed, if the market economy can be characterized as the "strength of weak ties," the Soviet type economy can be characterized as the "weakness of strong ties" – to flip a result from economic sociology. Thus, the mechanism that I focused on in dealing with the Soviet black market dealings were repeat dealings among actors who relied on family ties and with recourse to extra-legal enforcement. And the work tended to focus on how the post-communist extra-legal enforcement agents emerged from the communist era extra-legal enforcement agents who had ties to the party.

12 Though I would argue that a challenge for researchers in the positive political economy of anarchism must confront is the difference between "emergence" and "development," There are plenty of examples of how institutions have emerged historically to enable complex contractual relationships to be realized (see, e.g., the work by Stringham (2003) on the rise of stock exchanges), but the historical reality is that the formal apparatus of state law and order did follow and lead to the greater development of these institutions. So is there an objective limit to "anarchy" or do we see "anarchy unbound"?

institutions that are in operation in any society are a greater determinant of economic performance than the formal institutions of governance. "Good" informal institutions will work to minimize the negative influence of "bad" formal institutions, and will work to reinforce the positive influence of "good" formal institutions. She concludes that yes, institutions rule, but it is informal institutions that really rule. And Leeson and Williamson (2009) argue that in the situations of transition economies (post-communism), less developed economies (e.g., Africa and Latin America), and failed and weak states (e.g., Middle East and Africa) realism is needed, not romance. Governments equipped with power to protect private property have to be constrained in order to prevent government members from abusing their power to predate on citizens. In countries where governments are not effectively constrained, government activity tends to favor members of the ruling elite, making increases in government involvement undesirable from the perspective of economic development. The informal sector in such instances is not only more attractive to individuals in that situation but from the perspective of a realistic political economy would be more productive.

That observation demonstrates the contemporary relevance of recognizing the possibility that escaping from government might be more desirable than living under government (see, e.g., Scott 2009). But we have to move the analysis from "what happened" and "why it happens" ultimately to "how it happens." How does this system of informal institutions work so that individuals can coordinate their plans, realize the gains from trade, and realize the gains from innovation? And can it?

My example of the *samizdat* economy during the Soviet Union enabled individuals to alleviate consumer frustrations in the black-market for commodities, and it allowed managers of Soviet firms to meet the targets of planning authorities by relying on the extra-plan process of bartering and swapping of resources among state firms through intermediaries. But what it didn't do was allow the Soviet economy to realize the gains from social cooperation under the division of labor. As a result, while life muddled through in a way that it could not have had they not had recourse to the informal sector, the sort of economic growth that characterizes a vibrant society eluded the population. Just as the *samizdat* intellectual culture gave some relief from oppressive tyranny while not overcoming it, the *samizdat* economic life did not permit individuals to escape the economic deprivation of the Soviet system.

The real question in the post-communist situation was whether or not the *samizdat* political and economic life of the communist era could serve as the basis for the rise of a working democracy and vibrant market economy.[13] It turned out that the idea that all that was needed was the development of the formal institutional capacity of the state to define and enforce property rights proved to be naïve for the very reasons identified by Leeson and Williamson (2009). But the movement from a low income country to a middle income country and from a middle income country to a high income country does require the *endogenous* evolution of rules of property and contract that takes time.[14] We learn this not only from

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13 See Boettke (1993, chapter 7).

14 On the process of economic development see Bauer's *From Subsistence to Exchange* (2004).

close study of the transitioning and developing economies, but also from a study of the development of Western civilization. There is a process of two-tiered entrepreneurship that is in operation during the development process. Development does follow from individuals realizing the gains from trade, and realizing the gains from innovation through entrepreneurial action, but there is also the entrepreneurial act of rule-creation and enforcement that individuals within social settings must engage in *if* those gains from social cooperation under the division of labor are to be realized (see Leeson and Boettke 2009)

III. RULES, STRANGERS AND LIVING BETTER TOGETHER

What must those rules do if they are to accomplish the goal of realizing the gains from social cooperation under the division of labor, and since access to a central enforcer is denied in these situations how do these rules operate as self-enforcing? That is the fundamental question all researchers on *endogenous rules* must address. Rules that are not respected aren't effective rules; they remain only notional rules. On the other hand, rules that require extremely costly methods of enforcement will not on net be beneficial as they will give by necessity increasing scope for predatory behavior.[15] In order to realize the gains from social cooperation, rules must simultaneously limit predation and maximize the opportunities for mutually beneficial exchange.

Such rules govern the use of resources and our social interactions with one another. Hume recognized that the fundamental institutions of social order were property, contract and consent. We must delineate "mine and thine," we must keep promises, and we must respect transference of property by consensual trade. So at the most basic level, the rules that govern property, contract and consent must become established. At the next level, we must recognize that in an endogenous rule formation process, we can distinguish between form and function in rules. The vast diversity of human institutions we find across cultures and through time does not mean that the gains from social cooperation under the division of labor can be realized under any conceivable set of rules. The rules might take on the form that is culturally specific, but the function they serve is more universally recognizable: they must *limit access* to scarce resources; they must make individual decision makers *accountable* for their use of that resource; and they must introduce *graduated penalties* for those that violate the first two. In Elinor Ostrom's various studies of common-pool resources, this is what she has discovered.[16] And we see the universal character of these functions when we study

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15 As Spinoza wrote, "He who tries to determine everything by law, will foment crime rather than lessen it." The work of Chris Coyne on the post-war efforts of reconstruction addresses this issue in detail, see Coyne (2007).

16 For an overview of the research program of Elinor and Vincent Ostrom and what is called the Bloomington School of Institutional Analysis see Aligica and Boettke (2009).

covenants with and without swords in the field as well as in the lab (see Ostrom, Walker and Gardner 1992). Ostrom's work challenges the Hobbesian presumption that covenants without the sword are but mere words and thus cannot serve as the basis of a secure social order. She finds in a variety of circumstances instead what I have called a Smithian solution to a Hobbesian problem (see Boettke 2009, also see Boettke 2010). We can observe that human beings have a tremendous capacity for self-governance even in situations where we might least expect it to be viable.

But observation is not analysis; it demands analysis. In short, institutional analysis must move to a third stage of analysis, I would argue, which focuses on *mechanisms* of inclusion and exclusion. Standard theory suggests that self-governance is capable in the limited environment of small groups of homogenous agents who possess low discount rates. But such an environment cannot realize the great gains of social cooperation under the division of labor. The cooperation in anonymity that is exhibited in the vast division of labor is among such a large group that the number of exchanges, Adam Smith argued, far exceeds our computation. In fact, the puzzle as Smith put it in *The Wealth of Nations* (1776, 18) is that while we stand in need of the cooperation of a great multitude of individuals in order to survive, we have the ability to make but a few close friends in our lifetime. Thus, we cannot rely on benevolence alone for our survival. We must, and do, rely on the elicitation of cooperation through appealing to self-interest. It is not from the benevolence of the butcher, the baker or the brewer that we get our dinner, but from their self-interest. But again it is not self-interest alone; it is instead the marshaling of self-interest via the institutions of property, contract and consent that coordinates the production plans of some with the consumption demands of others. And this cooperation and coordination takes places among anonymous strangers who are often geographically and socially distant from the market transaction and the people who are striking the deal. Adam Smith gave us the puzzle that as economists we must solve. We often forgot it was a puzzle because we take it for granted since we come to it not as an unknown but amazingly familiar with the situation. Too familiar, I would argue.[17] Smith invites us to be amazed at what we immediately observe everyday. We need to permit ourselves to see the mystery in the mundane. Smith (1776, 15–16) asked us to contemplate the complexity of the exchange relationships required to produce a simple woolen coat, and Milton Friedman (borrowing from Leonard Read) held up a pencil and asked his audience to contemplate the same thing as the cover to his Free to Choose(1980). I ask you today to engage in that same thought experiment on your shoes, your backpack, or your computer. How many exchange relationships are required for you to enjoy the products that you take for granted? And how is it that the people involved in this set of complex relationships come to trust one another even though they have never met, never spoken, and most likely will

17 This, I would argue, is one of the reasons economists were complacent in dealing with the "pretense of knowledge" and the "fatal conceit" that Hayek identified throughout his career. As Hayek said "The curious task of economics is to demonstrate to men how little they know about what they imagine they can design." (1988)

never meet. The institutions of property, prices and profit/loss work to facilitate trust where personal relationships are non-existent.

This "ordered anarchy" of the market is recognized by almost all practicing economists, at least at some level. Still the 18th and 19th century doctrine of laissez faire has sometimes been described by critics as "anarchy with a constable" and the focus of much of 20th century economics was intended to demonstrate the shortcomings of the "ordered anarchy" of the market. Instead of self-regulation, state regulation was required for economic arrangements to be efficiently organized. Complicated contractual relationships required law and order, and could not develop based on profit and loss alone. I cannot adequately address this argument here, but in the narrative of economic theory and applied political economy that I am constructing the mainstream of 20th century economics is overly pessimistic about "ordered anarchy" and overly optimistic about "reasonable regulation."

IV. A PLEA FOR MECHANISM IN THE STUDY OF ANARCHY

As mentioned above mankind has exhibited throughout history two overwhelming propensities: (a) a propensity to truck, barter and exchange; and (b) a propensity to rape, pillage and plunder. Which propensity is manifested in history is a function of the institutions that men find themselves interacting with one another within. And at their core these institutions are about property, contract and consent. The social games based on realizing the mutual gains from trade are radically different from the social games based on predation. When property is not respected, when there is no expectation of promises being kept, and consent is not required, then predatory relationships will dominate the social game. On the other hand, if property is respected, promises are kept, and consent is required, then mutual beneficial exchange relationships will dominate the social game. Predatory societies are poor and sick; exchange-based societies are healthy and wealthy.

But the critical question is the *mechanism* of self-enforcement that permits this exchange-based order to develop. And as mentioned above, to realize the great gains from social cooperation under the division of labor these mechanisms must work among anonymous actors characterized by great geographic and social distance. But the working capacity for standard mechanisms of self-governance, such as reputation, are pushed to the limit as geographic and social distance rises. Think of the puzzle this way:we have the most to gain in exchange from those that are most distant from us, yet precisely because of that distance, we have the least reason to trust them. Strangers are both potentially our greatest teachers and our worst fear.

To ensure our relationships with strangers are mutually beneficial, the mechanisms of self-governance must be transformed to take into account the changing social situation. Or to put it another way, either we must find mechanisms that transform the situation with strangers into a situation of in-group social intercourse, or we must have in operation mechanisms that build trust in institutions that permit cooperation among strangers. In short,

we have to identify historically the mechanisms that *excludedactors* who could threaten the social order, and the mechanisms that *include* those actors who could improve the social order through mutual beneficial exchange.

Among modern Austrian economists, the two economists who have done more on the examination of the mechanisms that make ordered anarchy possible are Edward Stringham and Peter Leeson. Both take seriously the standard game-theoretic result that social cooperation without a geographic monopolist in law and order can only occur in small group settings with homogeneous agents who have low discount rates. Their work, however, respectively demonstrates that this standard theoretical result is defied repeatedly throughout history and in fact in everyday life in the contemporary world. Social cooperation within large group settings of heterogeneous agents happens all the time.[18] When history appears to defy what logic dictates, the economists must show why it appears that way, and how the logic is actually played out in that situation. The "how it works," question is answered by explicating the mechanism in operation.

Stringham's (1999, 2002, 2003) work has tended to focus on how, through the use of "club-like" arrangements, mechanisms of excluding potential bad traders takes place. Stringham emphasizes that most of the literature focuses on the potential effectiveness of *ex post* punishment. But historically, those engaged in the complicated exchange relationship would rather avoid any of the costs associated with *ex post* punishment; they would prefer to have *ex ante* sorting mechanisms that weed out potential bad-faith traders. We do not come into trading relationships with a tattoo on our heads that says "trustworthy" or "cheater," but various institutions have evolved throughout time and across historical circumstances that attempt to approximate that. And the "club-like" arrangements Stringham has studied reveal amazing creativity in efforts at *ex ante* sorting while minimizing the cost of excluding. Stringham mechanisms tend to transform large-group settings into more manageable small group settings, and to pre-sort the group so that even though the population pool is heterogeneous those who are accepted into the club are more or less homogeneous on the character trait that matters for the group. Self-enforcement is thus obtained through these *ex ante* methods of sorting.

Leeson's (2007, 2008, 2009a, 2009b) work, on the other hand, has tended to focus on Mises's argument concerning social cooperation under the division of labor, and show how strangers find mechanisms to become *included* in the trading community.[19] But Leeson

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18 And often even with actors that have high discount rates, see Leeson's work on pirate communities (2009a) and another example is Skarbek's (2010) work on prison gangs.

19 In his chapter on "Human Society," Mises (1949) explains how sympathy, friendship and a sense of belonging follow from realizing the great gains from social cooperation under the division of labor. And he stresses the arrow of causation. It is because specialization and trade increases productivity and wealth that humanity can enjoy the fruits of sympathy, friendship and community. If specialization and exchange did not yield great productivity and wealth creation, then mankind would have forever been destined to be trapped in a relentless struggle for survival and would view each other as deadly foes competing by whatever means to secure a portion of the scarce resources necessary for sustenance provided by nature. He would be in constant conflict

hasn't limited his creative energies to situations of how strangers signal their trustworthiness to potential trading partners, but his work has spanned over a variety of historical circumstances where it would be least likely for the theoretical mechanisms he has explicated to work. In other words, while he started out trying to explain how actors overcome geographic and social distance to realize the gains from social cooperation under the division of labor, his subsequent studies have touched upon not only the *ex antesignaling mechanisms* (e.g., Leeson 2008) but the role that *ex postenforcement mechanisms* play in producing social order (e.g., 2007 and 2009b).

So we have in the recent work of Stringham and Leeson an exploration far beyond the original discussions of the Soviet and post-Soviet situation. They have demonstrated that complicated exchange relationships have emerged and developed in the absence of any geographic monopoly of formal law and order. Sometimes the rules of the game in the historical examples they examine are implicit and enforced by the social sanction of ostracism exclusively, but in many instances they have identified explicit rules and elaborate enforcements as a penalty for violating the rules. In all the cases, the *endogenous rules* they have identified serve to allow individuals in those situations to realize the gains from social cooperation under the division of labor.

There remains much work to be done.

V. CONCLUSION

The Austrian school of economics from its founding has emphasized the logic of human action and the spontaneous order of the market. Contributors to that tradition, such as Menger and Hayek, have also explained how the framework institutions of morals, money and law are examples of institutions that arise not from the brow of a genius, but as the by-product of individuals striving to better their condition in the world and in so doing seeking out the gains from social cooperation. Morals, money, and law, as well as the market economy itself, are prime examples of institutions that are "the result of human action, but not of human design." But note something of importance – morals, money, and law are framework institutions; the market economy operates within that framework. In short, from Menger as well as Hayek, we learn that the most important questions in the sciences of man concern the mechanisms by which the spontaneous evolution of the framework is established, as well as the spontaneous order of the market that exists inside of that framework.

The *positive political economy of anarchism* follows as a research program naturally from this emphasis on spontaneous order one finds in the Austrian school. We cannot treat institutions as given, and we cannot treat state governmental capacity as either easily established

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with any other creature he encountered. It is this caricature of the human condition (more than the absence of a sovereign as Hobbes postulated) that would produce a life for man that was "nasty, brutish and short."

or benign in operation. As a result, the research program of positive political economy of anarchism is empirical and possesses contemporary relevance.

That contemporary relevance is not limited to the post-communist, developing countries or after-war reconstruction situations. Instead, the contemporary relevance can be seen in the contemporary efforts to escape the state provision of public goods in schooling and health, in the rise of private communities, and in the persistence of various private dispute resolution mechanisms and even the growing market share of private security forces. And, perhaps most relevant for the young scholars in attendance – the relevance of research on anarchism is not tied to the *normative* anarchist theory that has had some connection to the Austrian school (whatever your judgment is on that work) but can address what the *Economist* recently referred to as "the great political issue of our times."[20] And that 'issue of our times' is the fiscal crisis that has spread through the western world and the need to rein in the growth of the state and tame Leviathan. Such exercises require a rethinking of the scale and scope of government. In the process of such rethinking, we can explore the old classical liberal wisdom that we must limit the scope of government to those things, and only those things, that is does well, and leave to the market and to civil society those things the government cannot do well. The answer to that question is up for the next generation to answer. The answer provided by your ancestors was wrong, and the answer provided by my generation has proven wrong; it is time for your generation to get it right. As the *Economist* reports, the Chinese policy maker Ma Hong recently argued that "We are in a transition from a big state to a small state, and from a small society to a big society." As we turn more and more to civil society and the market economy to substitute for the state, the mechanisms in operation that permit individuals to realize the gains from social cooperation under the division of labor will need to be continually explicated in our research and communicated in your writing and lecturing. Austrian economics is a progressive research program in economic science, and the *positive political economy of anarchism* is perhaps its best testing ground to prove its worth against the competitive research paradigms in modern economics and the social sciences.

20 See the March 19th 2011 edition of *The Economist* and the special issue on "Taming Leviathan".

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THE VAMPIRE ECONOMY AND THE MARKET: AN ASSESSMENT OF ECONOMIC AND POLITICAL DYNAMICS

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ABSTRACT

The competing political-economic systems of free-market capitalism and fascism are vastly different systems, rather than variants of the same genus, as they are sometimes presented. Though these systems are connected by a continuum of possible levels of government intervention, fascism is a form of hyper-interventionism amounting to socialism. The system of fascism is examined here by reference to the business and economic climate prevailing in Nazi Germany. This shows that the political and economic dynamics of fascism are very different to those of free-market capitalism. In particular, government actions in the fascist political system lead to a business environment where economic entrepreneurialism is gradually replaced by political entrepreneurialism, leading to an entrenched and privileged ruling elite. The productive business class is replaced by an unproductive class of political entrepreneurs. The result of this process is economic decline and ultimately economic collapse, precipitating a drive to war.

KEY WORDS: economic fascism, inverventionism, war

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I. AUTHORITARIAN CAPITALISM (FASCISM) AND LIBERAL CAPITALISM (THE FREE MARKET)

What is sometimes referred to as "authoritarian capitalism," or fascism, is in fact a variety of statism, specifically socialism, the system of political-economy in which the prerogatives of ownership over the means of production and distribution are vested in the State. Under the fascist economic system, private capitalists are nominally regarded as the owners of the means of production, meaning that they hold property titles to these assets and are referred to as "owners" of these assets. However, this so-called "ownership" is merely illusory. The actual prerogatives of ownership are vested, not in the private capitalist, but in the State and its bureaucracy.[1] It is the State which tells the private capitalist how he must use "his" property, under the threat of confiscation or even imprisonment. In the words of economist Ludwig von Mises, it is "socialism in the outward guise of capitalism."[2]

This is a very different political-economic system to "liberal capitalism," also known as "free market capitalism." Free market capitalism is an authentically capitalist system, in which the prerogatives of ownership over the means of production are vested in private citizens, not in the State. Under this system, the means of production are *genuinely* privately owned, and the private property owner holds, not just a property title, but, more importantly, the actual prerogatives of ownership and ultimate control. In the system of free market capitalism, the private property owner is regarded as having property *rights* (i.e., an enforceable moral claim to the prerogatives of ownership) which must be respected by all others, including the State and its functionaries.

In their purest forms, these two systems of political-economy are fundamentally different in kind; in fact, they are polar opposites. However, this opposing nature stems from the degree to which the prerogatives of ownership of ostensibly private property are arrogated to the State – i.e., the degree of State intervention. On the one extreme we have the free market, in which there is no – or at least little – State interference with private property ownership (which is therefore genuine); on the other extreme we have fascism, in which there is plentiful or total State interference with private property ownership (which is therefore illusory).

Since fascism and the free market are distinguished by State intervention we can therefore see that the two systems are separated by a connecting bridge of interventionism through the system of the "mixed economy." The fascist system can be viewed as a system of hyper-interventionism, accruing when State interference with private property rights is so extensive that the alleged private ownership of property becomes a mere farce, and the State may properly be regarded as the *de facto* owner of the means of production and distri-

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1 Shaffer (2009) notes that "[u]nder the system of *fascism*, the title to property remains in private hands, but the state exercises actual decision-making authority (i.e., *control*) over the use of such property" (p. 127). He further explains why genuine ownership must entail the ultimate prerogative to control one's own property, and thus, any claim to ownership, absent ultimate control, is illusory (Ibid, pp. 161–177).

2 Mises (1985), p. 56.

bution – i.e., there is *de facto* socialism. For this reason, the analysis of fascism and its long term viability is very similar to the analysis of interventionism in the mixed economy, and the same kinds of economic and political insights apply.

II. FASCISM AND THE FUSION OF BUSINESS AND STATE

Fascism is unlike other forms of socialism. Its expropriation of the means of production is done without overt nationalization, and is not directed towards an egalitarian goal. It is far more subtle than this, and far more insidious. Fascism can arise by revolution, but it can also arise by gradual measures towards State control in the mixed economy. While noting the similarities between fascism and communism, philosopher Roderick Long observes that "...there is a difference in emphasis and in strategy between fascism and Communism... When faced with existing institutions that threaten the power of the state – be they corporations, churches, the family, tradition – the Communist impulse is by and large to *abolish* them, while the fascist impulse is by and large to *absorb* them."[3]

The fascist *economic* strategy is also one of absorption: the regime attempts to secure economic growth and prosperity by fusing a "partnership" between business and the State, absorbing business into the State in this process. Such a strategy appeals to those who correctly judge that private business is the locus of production and economic growth, but who incorrectly believe that this productivity is enhanced by partnership with government and central-planning of production. The fascists, like interventionists more generally, seek to get the "best of both worlds" from the productive powers of private business under capitalism and the central-planning of the State under socialism.

Of course, the "partnership" between business and State which occurs under fascism is of a coercive nature: the State determines its requirements from business and orders private entrepreneurs to meet these requirements, lest they be expropriated of their remaining property (nominally held), or even imprisoned. In describing the fusion of business and State in Nazi Germany, economist Günter Reimann explains the process as follows:

> *The State orders private capital to produce and does not itself function as a producer. Insofar as the State owns enterprises which participate in production, this can be regarded as an exception rather than a general rule. The fascist State does not merely grant the private entrepreneur the right to produce for the market, but insists on production as a duty which must be fulfilled even though there be no profit. The businessman cannot close down his factory or shop because he finds it unprofitable. To do this requires a special permit issues by the authorities.*[4]

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3 Long (2005), para 5 of Internet article.

4 Reimann (2007), pp. 296-297.

This basic conception of the role of the private entrepreneur puts him at the service of the State, and destroys any notion of self-ownership, including any genuine property rights. He exists, not to pursue his own happiness and satisfy his own personal desires, as is the case under liberal capitalism, but rather, to produce for the fascist State. From here, the remaining regulations on his business affairs under this "partnership" are similarly directed towards the ends determined by the State: the State regulates the prices he can charge for his goods; the amount he can buy and sell; who he can employ or dismiss from employment; the wages he must pay; how much of his profit he may keep (if there is any profit produced); and whether or not he will continue his business or shut it down.[5]

In tandem with the enormous body of arbitrary State regulations is the ever-present threat of expropriation. Without any overt nationalization of property the State may send its auditors to scrutinize a business for breaches of regulations, using minor infractions as a pretext for massive fines, amounting essentially to a confiscation of assets.[6]

III. BREAKDOWN OF THE RULE OF LAW

Even the fact that every aspect of his business is regulated by the State does not give full appreciation for the perilous situation of the titular ownersof property under fascism. In fact, it is not the specific *content* of regulations, but rather the inevitable breakdown of the rule of law that poses the greatest danger under a system of central-planning.[7]

The rule of law under the fascist system is replaced with the arbitrary and unconstrained power of the political elite in the State apparatus.

> *The capitalist under fascism has to be not merely a law-abiding citizen, he must be servile to the representatives of the State. He must not insist on "rights" and must not behave as if his private property rights were still sacred. He should be grateful to the Fuehrer that he still has private property.*[8]

It is the arbitrary power of the fascist regime that is the most important determinant of the relationship between the titular private property owners and the State. However, it affects not only this relationship, but also the relationship between private citizens themselves.

5 For an overview of interventions under the Nazi regime, see Reimann Ibid.

6 For an account of this practice in Nazi Germany, see Ibid Reimann, pp. 11–12.

7 On central-planning and the breakdown of the rule of law, see Hayek (1994).

8 Reimann Ibid, p. 20.

As a rule, the relations between businessmen are still regulated by laws and customs. But customs have changed and modified law, and law has, in turn, been largely replaced by a vague conception of "honor." It is easier for a businessman to win a case in the German courts by appealing to "National-Socialist honor" than by referring to the exact text of the law.[9]

Like other citizens, the businessman cannot find justice or challenge the predations of the State, even on sound legal grounds under the prescribed regulations. This is because the courts are themselves a mere cog in the workings of the ruling regime, which claims total power over the economy. Any private property owner who is foolish enough to seek judicial relief from the impositions of the State quickly arouses the ire of State functionaries who have unlimited means to retaliate to any fleeting victories he might obtain.

IV. FASCISM AND THE MOTIVATION PROBLEM

Although enforceable property rights are non-existent, and titular "ownership" is insecure, the fascist system still avoids the crude problems of motivation experienced under egalitarian variants of socialism (e.g. communism). By allowing inequalities in the nominal ownership of property and the consumption that is contingent on this nominal ownership, the State allows incentives for the acquisition of private property to remain, even though this ownership is subordinate to the whims of the State rulers.

This observation may seem to contradict the previous assertion that the private capitalist is only the *illusory* owner of the property to which he holds title. However, no contradiction exists: although the prerogatives of ownership *ultimately* accrue to the State under fascism, this does not prevent the private capitalist from enjoying additional *consumption* if he is the nominal owner of property. Consumption is consumption, and once a resource is consumed by its nominal owner, or otherwise used for his immediate benefit, the State cannot exercise its *de facto* ownership to prevent this, no matter how authoritarian it may be.

In fact, the acquisition of private property under fascism, even while subordinated to the State, offers more than just consumption benefits. Although all private capitalists are subject to the political power of the State rulers, large capitalists can use the residual economic power they maintain to capture smaller units of political power, particularly in the lower echelons of the bureaucratic apparatus. Reimann explains the interaction between political and economic power in Nazi Germany as follows:

The authoritarian position of the provincial and local bureaucrats – and the degree to which the local Party bureaucracy is independent of industrialists and businessmen –

9 Ibid, p. 18.

varies with the social structure in different sections of the country. In districts where big industrial magnates have direct relations with the top flight of Party leaders, the local bureaucracy is largely dependent on – in some cases, a tool of – the big concern or trust. In districts where only small and medium-sized firms exist, however, the Party bureaucracy is much more authoritarian and independent. A dual power exists under fascism: the indirect power of money and the direct power of the Party leader.[10]

Thus, under fascism, there remains a large incentive for the acquisition of private property. Although the private capitalist has no enforceable property rights against the State, he can protect his titular ownership and subsidiary control of property by acquiring political power. His control over property, even though it is at the mercy of the State, can allow him to capture some of the political power of the State, which can in turn protect his control. If he is a small private capitalist, the local bureaucrats will be his masters, and he will be forced to pay endless tribute to them merely to survive. However, if his business concern is large and profitable, he may be able to form relationships with more powerful political figures, thereby acquiring *political* influence, and bringing himself within the ambit of the State apparatus.

The motivation problem in fascism is therefore of a different and more subtle form to the motivation problem in egalitarian socialist systems. Under fascism, the private citizen is at the mercy of the State, which can take his nominally held property from him at any time. He is therefore motivated to consume more of his property than he otherwise would, and to use his savings to buy political influence, rather than engaging in productive endeavours. He is motivated, in short, to engage in *political* rather than *economic* entrepreneurialism.

V. THE RISE OF POLITICAL ENTREPRENEURIALISM

Under fascism, businessmen may continue to work within the regulatory regime, eking out whatever living they can maintain under the arbitrary decrees of the State bureaucracies. But in order to do so they must seek to obtain influence over the State functionaries in order to survive unmolested. Under fascist regimes that have historically existed, this has given rise to large investments in maintaining good relations with the State, employing “contact men” with connections to politically powerful members of the fascist regime. For example, under the fascist economic system of Nazi Germany such “contact men” became a crucial part of any business concern:

The business organization of private enterprise has had to be reorganized in accordance with the new state of things. Departments which previously were the heart of a firm have become of minor importance. Other departments which either did not exist

10 Ibid, p. 34.

or which had only auxiliary functions have become dominant and have usurped the real functions of management.

Formerly the purchasing agent and the salesmanager were among the most important members of a business organization. Today the emphasis has shifted and a curious new business aide, a sort of combination "go between" and public relations counsel, is now all-important. His job – not the least interesting outgrowth of the Nazi economic system – is to maintain good personal relations with officials in the Economic Ministry, where he is an almost daily caller...[11]

As with political lobbying in the mixed economy, this heavy investment in influence over the State bureaucracies is used by businesses both for protection from the State itself, but also to obtain special privilege. Having invested successfully in political influence, a successful business enterprise will seek to use the State as a buyer of its products or services, and will seek to use State power to destroy its competitors. Economic and political powers jostle for control in this system, and large business entities can come to dominate smaller political units, with businessmen becoming powerful political entrepreneurs in the regime.

This interaction between political and economic power under fascism is very similar to that which exists in highly interventionist industries in the mixed economy. In the latter case, problems of regulatory capture are well known, and it is common for large firms to use their connections with the State to obtain special privileges. This leads to a concentration of economic power in a few large firms, who are able to rely on government contracts to boost their income, while at the same time using captured regulatory bodies as a means to block smaller competitors from their market.[12]

If the level of State intervention in such a system increases, government contracts and captured regulatory bodies become more and more valuable, and more effort is shifted away from productive activities and towards the capture of political power. In short, as interventionism grows, and the economic system moves towards fascism, firms will shift their efforts away from *economic* entrepreneurialism and towards *political* entrepreneurialism.

Under the pure fascist system, State intervention is ubiquitous, and connections and influence in the State apparatus become all important for business. Instead of productive success and economic entrepreneurialism, *political* entrepreneurialism becomes the means to acquiring wealth, and protecting it from State predation. Any firm which fails to forge State connections or find an adequate contact man will be forced out of business, while a few big firms with strong political connections will come to dominate the market.[13]

At the same time, political figures in the regime take advantage of their political power to become wealthy private capitalists themselves. High ranking members of the ruling regime

11 Ibid, p. 44.

12 See Stigler (1971) and Laffont and Tirole (1991). For an example of this process during the United States "Progressive Era" see Kolko (1963).

13 Riemann Ibid, pp. 46-47.

are able to exercise their political power to favour their own business interests and expand their economic power as private capitalists.[14]

Over a period of time, this process means that productive firms and economic entrepreneurs are destroyed, while unproductive (parasitic) enterprises run by political entrepreneurs take their place. Reimann explains the outcome in Nazi Germany:

> *[The genuinely independent businessman] is disappearing but another type is prospering. He enriches himself through his Party ties; he is himself a Party member devoted to the Fuehrer, favoured by the bureaucracy, entrenched because of family connections and political affiliations. In a number of cases, the wealth of these Party capitalists has been created through the Party's exercise of naked power. It is to the advantage of these capitalists to strengthen the Party which has strengthened them.*[15]

The fascist economic systemcauses a convergence of economic and political power, both through the politicization of existing private capitalists, and the enrichment of political figures. The attempt to form a partnership between business and State eventually leads to a situation where business *is* the State, and the State *is* business. The resulting system is fittingly described by what philosopher Ayn Rand called the "aristocracy of pull."[16] Under this system, business enterprises are run by an entrenched class of politically privileged capitalists, with little prospect of outside competition.[17]

VI. WHY CORRUPTION IS NOT THE PROBLEM

It is worth noting that the breakdown of the rule of law under the fascist system means that corruption of the legal and bureaucratic system is likely to be rampant. However, it is not law-*breaking* that is the problem – the problem is the law itself.

The fascist system empowers the State to intervene in all aspects of business, violating property rights at will. Its repudiation of free market capitalism means that central-planners are expected to take an active part in running the economy and cannot merely stand back and leave business alone (at least not without implicitly repudiating the fascist system). This interventionism means that considerations of property rights must necessarily be replaced by the amorphous notion of the "public good" (however this happens to be expressed), cre-

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14 For some historical examples during the Nazi regime, see Ibid Reimann, pp. 35–39).

15 Ibid, p. 35.

16 See Rand (1964), pp. 167–172.

17 Ibid Reimann, p. 39.

ating conditions where business success is determined primarily by influencing the judgement of bureaucrats and powerful political figures.

Because property rights have been discarded, political entrepreneurialism becomes crucial to success, *regardless* of whether bureaucrats are "corrupt." It occurs whether bureaucrats exercise their judgement in a transparent and impartial manner, or sell their power directly to wealthy business entities. It is not the corruption of bureaucrats which is the problem; it is the fact that there is no *honest* way to dole out special favours to business under a system in which the State has total control.[18]

VII. INFORMATION AND CALCULATION PROBLEMS IN THE FASCIST COMMONWEALTH

The rise of political entrepreneurialism is not the only problem with the fascist economy. It is augmented by the standard information and calculation problems of socialism, stemming from the lack of any genuine private ownership and the extensive price and wage controls imposed by the State.[19] (Even if price and wage controls are absent, prices and wages will be heavily distorted by State interventions in the economy, so that these prices are not commensurate to the true costs of resources.)

As with other variants of socialism, the economic exchanges in the fascist economy are *not* driven by the preferences of consumers or the requirements of productive entrepreneurs. Instead, the exchange of goods proceeds, mimicking the market economy in some respects, but the price system reflects the extensive price and wage controls of the fascist State, or, in the absence of price controls, the distorting effects of its other interventions. This means that the central-planning bureaucrats in the fascist State are unable to determine the true value of resources. They distort the prices of goods to such an extent that rational allocation of resources becomes impossible. Misallocations of resources occur as prices of good are artificially suppressed or inflated.

At best, the central-planners can increase output for favoured businesses or areas of the economy at the expense of other businesses and areas of the economy, while at the same time destroying the very price system that allows entrepreneurs to calculate rationally under the free market. Since they have no method to objectively value competing projects, their interventions will involve a misallocation of resources compared with the free market case, and will frequently involve an aggregated loss of resources even *ignoring* opportunity costs. Thus, despite any pretensions to the contrary, the State is unable to increase total economic

18 See Ibid Rand, pp. 167-172 (especially p. 170).

19 On knowledge and information problems under socialism see Mises (2008) and Hayek (2009a), (2009b); on decision making mechanisms, see also Sowell (1996).

output through its central planning; instead, it destroys the price system and causes loss.[20] This gradually leads to economic decline.

VIII. ECONOMIC DECLINE AND THE INCENTIVES OF THE RULING ELITE

The forgoing analysis of the motivations of businessmen and the economic ineptitude of the central-planning apparatus is pregnant with obvious economic conclusions. The more authoritarian the economic system becomes, the more valuable is the capture of political power and the less valuable is the expansion of productive capacity. All other things being equal, the authoritarian system will lead businessmen (and others) to shift their efforts away from production and towards the acquisition of political power.[21]

The result is obvious:under an authoritarian system, political entrepreneurialism increases and production decreases. This further politicises the economy and leads to ever greater distortions of prices, making rational calculation impossible. As authority over the means of production grows, more and more people compete more and more ferociously through the political process for a smaller total economic output. With no genuine conception of property rights to guide them, there is no moral impediment to the coveting of property that is "owned" by others, and there is no legal impediment to its capture.

It is again worth noting that this is merely the most extreme manifestation of the economic effects of interventionism in the mixed economy. Since fascism is, in essence, a system of hyper-interventionism, the economic effects of the fascist system are merely the logical extremes of smaller "pragmatic" interventionist programs. Each intervention in a mixed economy distorts prices, misallocates resources to unproductive endeavours, and results in a net loss of production.[22] At the same time intervention increases the value of political influence and thereby shifts effort from production to political lobbying.

With enough political intervention in the economy, this culminates in economic stagnation, then net capital consumption, and finally, economic collapse, occurring when capital supplies become insufficient to sustain basic services. As this process occurs, parasitic groups in the system suck as much as possible from the dying economy, with their parasitic activities becoming increasingly frantic as the economy collapses and the resources available for capture become scarcer.

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20 Temkin (1996) argues that information and calculation problems were the primary cause of the failure of communism. It is likely that similar problems affected the fascist regimes of the early twentieth century and were responsible for their poor economic performance.

21 The economic incentives for political entrepreneurialism due to political intervention are studied in the economic literature on "public choice theory," notably in Riker (1962), Buchanan (1972), Stigler (1988), Tullock (1989) and Tullock (2002).

22 On the dead-weight costs of intervention driven by pressure groups see Becker (1985).

The problems with the fascist economic system become more and more clear, but there is no incentive for those in control of the State apparatus to avoid the approaching disaster. Since the only antidote to the problem is liberalisation of the economy from State control, the cure for the economic decline threatens the personal livelihoods of the State bureaucrats and the ideological program of the higher level members of the ruling regime.

Of course, it is true that sustained economic decline will eventually threaten the position of the ruling elite, particularly since they must make some appeals to the "public good" in their efforts to maintain their own power. However, their situation is threatened far more directly and far more immediately by the *cure* for economic decline than from the decline itself.

> *The authoritarian State breeds irresponsibility on the part of this ever-growing and legally privileged group. Their position is secure – unless they are purged by their own friends, often as a result of rivalries – whereas the general economy is insecure. They do no work which adds goods or social services to the market.* ***Their job is: to hold their job****. The rest of the community finds itself serving as the hardworking host upon which the bureaucratic clique is feeding and fattening.*[23]

We therefore see the most terrifying aspect of the fascist system. The problem is not merely that its authoritarian controls destroy the economy in the long-term. The greater problem is that as this process occurs, the authoritarian system undermines the human capital of the society it operates on. In particular, it creates a privileged ruling elite, who have wrested all economic and political power from the productive capitalists they have expropriated, at the expense of impossible promises to the masses. Their sole incentive is to maintain the parasitic system that gives them power, prestige and money, and they will do anything to keep it, even as they watch the general economy collapse into ruin.

IX. THE DRIVE TO WAR

The economic decline ensuing from state intervention, misallocation of resources and rising political entrepreneurialism must eventually lead to a crisis of confidence in the State, if not deflected by some nationalistic endeavour to rouse the support of the public, and instil them with some alternative fear. Even the most authoritarian regime must rely on compliance from the public to maintain its power, and so it is natural that the fascist State will turn to war and conquest as its economic problems become a threat to its rule.

War and conquest serve three main purposes for the fascist State. Firstly, notwithstanding its risks, war promises the possibility of conquered territories to serve as resource cash-cows for the declining economy. Secondly, the presence of an external military threat allows the

23 Ibid, Riemann, p. 301; emphasis added.

ruling elite to rationalise their authoritarian rule and expand their domestic power over the public, while imbuing them with nationalist fervour. Finally, the threat of death and ruin from real or alleged foreign enemies makes the predations of the State look to many of its citizens like the lesser of two evils, and so the discontent of the public is directed to an alternative source.

This drive to war is a logical consequence of the ideology and economic program of fascism and interventionism more generally. It is no accident that fascist ideology promotes war as an energizing and righteous endeavour. Since the domestic policies of the authoritarian State revolve around appeals to nationalistic ideals (e.g., the "public good") militarism is a natural corollary, and it is easy for the State to rouse the public to war.[24]

Of course, war is economically destructive, and more rapidly so than domestic intervention. It involves a massive reallocation of resources to military projects, a full or partial withdrawal from the international division of labour,[25] and the direct destruction of resources by enemy forces. Moreover, war involves the risk of military defeat, a prospect which usually ends the rule of the existing political elite. Nevertheless, it is the only option for a ruling class that has repudiated liberalism and hitched its reputation to the fascist system of authoritarian control. In describing the motivation of the Nazis in World War II, Reimann explains that:

> *...Nazi leaders in Germany do not fear possible national economic ruin in wartime. They feel that, whatever happens, they will remain on top, that the worse matters become, the more dependent on them will be the propertied classes. And if the worst comes to the worst, they are prepared to sacrifice all other interests to maintain their hold on the State. If they themselves go, they are ready to pull the temple down with them.*[26]

Or, as Nazi Propaganda Minister Joseph Göebbels expressed it in his diary:

> *The war made possible for us the solution of a whole series of problems that could never have been solved in normal times.*[27]

For those outside the ruling elite there is a sense of inevitability to the whole process, from economic decline to war. They are stripped of any genuine property rights and exist at the mercy of the State and its functionaries. They are devoid of economic or political power, and are mere pawns in the machinations of the fascist State and its leaders.

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24 For an overview of this topic, see Mises (1985).

25 Mises (1985), p. 281.

26 Ibid Reimann, pp. xiii-xiv.

27 Lochner (1948).

The fatalism which was typical of the spirit of the German businessman before Europe was plunged into [World War II] was not due to economic difficulties alone, but far more to a feeling that he had become part of a machine inexorably leading him to disaster.[28]

X. CONCLUDING REMARKS

The economic system of fascism is economically unviable in the long-run, and what is true of this most extreme manifestation of hyper-interventionism is true, to a lesser extent, of any interventionist system of government. The central-planning of the State and the concomitant destruction of private property rights destroy the independent businessman and replace him with a parasitic impostor, the political entrepreneur, who succeeds by special privilege, rather than by economic production.

The vast power of the State leads to a convergence of all economic and political power into a small elite of political entrepreneurs, who will hold on to their power and privilege at the expense of the general economy. Combined with all-pervading regulations, price and wage controls and other distortions of prices under State central-planning, this leads to economic stagnation, then economic decline and collapse.

The long-run result of the fascist or interventionist economic systems is the drive towards war and conquest, with the ruling class desperately seeking to maintain its power at all costs, even if the cost is the complete destruction of the nation. The endpoint is tyranny, death and destruction.

28 Ibid Reimann, p. vii.

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BOOK REVIEW

BOURGEOIS DIGNITY: WHY ECONOMICS CAN´T EXPLAIN THE MODERN WORLD BY DEIRDRE N. MCCLOSKEY, 2010. CHICAGO, THE UNIVERSITY OF CHICAGO, 571 P.

Following 2006's *Bourgeois Virtues, Bourgeois Dignity: Why Economics Can't Explain the Modern World* is an intellectual journey perhaps no one besides Deirdre McCloskey is qualified to take us on. The grand mystery McCloskey challenges us with is what she calls the "factor of sixteen," the startling magnitude of per capita income growth since 1800 after millennia of stagnation. No "traditional" explanation of growth both stands up to historical examination and contains the power to explain the factor of sixteen.

I tell the story of modern economic growth, summarizing what we have thought we knew from 1776 to the present about the nature and causes of the wealth of nations – how we got the refrigerators and college degrees and secret ballots. The book tests the traditional stories against the actually-happened, setting aside the stories that in light of the recent findings in scientific history don't seem to work very well. A surprisingly large number of the stories don't. Not Marx and his classes. Not Max Weber and his Protestants. Not Fernand Braudel and his Mafia-style capitalists. Not Douglass North and his institutions. Not the mathematical theories of endogenous growth and capital accumulation. Not the left-wing's theory of working-class struggle, or the right-wing's theory of spiritual decline. (xii)

McCloskey then turns to changes in sociology, ideology, and words to explain the origin of growth. One historical event that did occur in the 18th and early 19th century was a change in the way in which the public looked upon business, entrepreneurship, and profit. Rather than seeing them as valueless reshufflings, theft, or upsetting the natural order, the public began according the actions of what came to be known as the bourgeoisie a certain dignity in Holland and Britain. Societies in the past, which occasionally secured property rights, never accorded dignity to the bourgeoisie. For instance, even though it secured property, "Ancient Greek society despised physical work as slavish and womanly [...] and above all looked down on the bourgeoisie" (363). McCloskey's theory is a theory of the potentially enormous economic consequences of what economists typically think of as being mere tastes and preferences –attitudes toward entrepreneurship and innovation, the very *gustibus* of *De gustibus non est disputandum*– are what *must* be disputed. Certain *gustibi* are the key to understanding the greatest economic question of all.

The book follows an untraditional structure, and the book often "feels" like it is something different than what one would expect after reading a summary of its ideas. More than one hundred pages are spent on what could be described as "introductory" topics. McCloskey lays out her general thesis with several examples of developing liberal ideology around 1800. But above all, she takes time to demonstrate that growth happened and it was enormous, unprecedented, and good for everyone. She provides some mainstream economic arguments, for example that countries are able to rapidly catch up to Western Europe under the correct conditions. McCloskey also spells out here her methodology, lifted from J.S. Mill, which we will discuss in depth later on. This methodology demands that she examine the alternative explanations of growth in detail, which she then spends most of the book doing.

Besides dignity for the bourgeoisie, few of the competing explanations of growth hold up because they are either empirically untrue or were present historically in other societies which did not experience growth. The presence of coal in Britain, for instance, cannot conceivably cause income to increase by a factor of sixteen, and in any case, was already used by the Chinese without any similar explosive gross (186–196); "the Chinese did it already" is a theme that comes up many times in the book. Others, such as Marxist concerns about the "original accumulation" (153–160), supernormal profits (256–265), and exploiting European colonies (239-248) are simply a-historical. The same can be said of commercialization (249–255), eugenics (266-295), and the Protestant Ethic (140–145). The development of science is also not a plausible historical explanation, as there is little linking the pure science of the eighteenth and nineteenth centuries with the commercial products brought to market during that period (355–365). Of economists' other favored explanations, human capital is only recently important since education was simply not very useful for people like "coal miners and cotton mill workers" (162). Since literacy often has historically led to hostility towards the bourgeoisie, education may have often had net negative effects: "education without the new bourgeois rhetoric is merely a desirable human ornament, not the way to human riches" (163). McCloskey also rejects capital accumulation out of hand due to diminishing returns to capital; what is important is using innovation to figure out what to do with the capital, not the accumulation of capital itself (133–139).

Many other factors perhaps existed, but were far too small to be meaningful, like efficient domestic allocations (168–177), trade (197–216) and the dynamic effects thereof (217–228). None of these can approach the factor of sixteen we find in worldwide growth. McCloskey also rejects the plausibility of the economic growth equivalent of death by a thousand paper cuts; the magnitude of any of these incremental gains in efficiency, such as "trade, coal, education, canals, peace, investment, reallocation" are just too tiny to have sufficient explanatory power, even taken together (192).

Perhaps the most jarring claim McCloskey makes is that Douglass North is entirely wrong about the importance of institutional development. While she sees the protection of private property as a necessary precondition of economic growth, it had already been adequately protected in England for centuries before The Glorious Revolution in 1688, the event North believes was the precursor for explosive growth around 1800. But the primary

economic effect of The Glorious Revolution was to make it easier for government to borrow, which is not particularly important for growth.

Prefacing McCloskey's claims of the historical facts of 1688 is something a bit more unsettling: that "[i]nstitutions cannot be viewed merely as incentive-providing constraints" (296). Institutions do more than give information about relative costs. They have sociological effects that are quite relevant for economics.

Behavior is sometimes best described scientifically as being about incentives given to social actors. But sometimes it is best described as Second City improvisational comedy, with or without the audience. The joke is on the economist. Rakesh Khurma, for instance, gives a typically sociological definition of institutions as "complex and interacting system of norms, structures, and cultural understandings that shape individual and organizational behavior." That's not a budget line facing someone who can tell at once and easily what it is that pleases him. (300)

Economics which looks only at incentives and constraints, or in the words of McCloskey, "prudence-only" economics, misses much of what is important. And while she sarcastically refers to this as Mr. Max U (297), she is *not* criticizing excessive formalization in economics. She is criticizing rational choice theory, namely New Institutional Economics, North, Gary Becker, Deepak Lal, Avner Greif, Steve Levitt (302), Public Choice Theory, the UCLA property rights approach, the Law and Economics movement, the economic theory of regulation, new economic history, quantitative finance, and rational expectations (306). This is coming from someone who self-identifies as a libertarian economist. In a book with many sidebars, this is the one most important for economists. If McCloskey is right –and it is hard to argue with the points she raises– then there are fundamental problems in economics that are well outside the scope of the book.

In such a sweeping world history, it would be impossible to find a single person expert enough to verify each and every one of her claims. However, on the few margins I would call myself knowledgeable, I have significant objections to her arguments. For instance, after reviewing the primary thesis of *Guns, Germs, and Steel*, she concludes that Diamond "doesn't answer the question he poses" (181). The thesis she evaluates is the famous one, that endowments of food sources and the east-west axis of Eurasia caused extensive civilization to first appear there. She criticizes Diamond for saying this is what allowed Europe to grow. Diamond does no such thing. In the epilogue of the book, Diamond argues that the reason why civilization appeared in Europe rather than China was that the geography of Europe encouraged polycentricism and institutional evolution. McCloskey is certainly aware of this type of argument; she discusses it elsewhere (109). Why she mischaracterized Diamond is befuddling. In addition, while attacking what she calls the "eugenic materialism" of Gregory Clark's A Farewell to Alms, she insists bringing up Steven Pinker as the reviver of eugenicism. She cites nothing from the evolutionary psychology literature and for

those familiar with it, the charge is unfortunately common but nonetheless bizarre.[1] It is for these reasons that, while her many arguments seem strong, I treat the rest of her empirical and historical claims with a certain degree of skepticism. This skepticism is important when we later consider the success of the thesis of Bourgeois Dignity.

USE OF "SCIENTIFIC" HISTORY

McCloskey treats historical evidence in ways economists are unaccustomed to and does little to justify herself. She cites various historians as bases for dismissing many theories of growth, but does not always tell the reader why her references are the credible ones. She claims several times that these references are "scientific history," but it is unclear what exactly she means by that, except that she agrees with it and that the reference is not Marxist. Making matters worse is her brash dismissal of the concept of statistical significance. Although she should not be expected to restate her entire argument when it has already appeared as a book (Zillack and McCloskey 2008), one wonders which economist would possibly be convinced of the general veracity of her arguments when she snaps that historical t-tests suffer from the logical fallacy of *post hoc ergo propter hoc* and that "no serious economic issue since the Second World War has been settled by econometricians" (198). Economists use statistical tests because they at least have the potential to differentiate between randomness and causal relations. In *Bourgeois Dignity*, a book written at least in part to change the minds of the profession, she gives no reason to believe her alternative methods of historical analysis are able to do such a thing, even if she calls them "scientific."

MILL'S METHOD OF RESIDUALS

McCloskey claims J.S. Mill as her methodological precursor (33), specifically his method of remainders found in *System of Logic*. Once one has accounted for all other possible causes to a phenomenon, whatever remains, even if immeasurable, is the cause. She examines and dismisses all competing explanations and finds them wanting, so that she may argue that granting dignity to the actions of the bourgeoisie was the cause of growth. One way of interpreting this follows.

1 Consider: "[A]ny biological differences [between races and ethnicities] are minor at most and scientifically uninteresting" (Pinker 2002: 340).

A “typical” economist ascribes a non-zero probability to each of the explanations of growth prior to reading *Bourgeois Dignity*. The probability would be large for explanations economists are amenable to, such as Northian Institutions or Human Capital. It would be small for ones such as expropriation. Upon hearing of the intuition of dignity for the Bourgeoisie as another explanation, the economist would ascribe a small (but non-zero) probability to it. What McCloskey implicitly argues is that she shows that all other explanations are wrong, and therefore of zero probability, so dignity for the bourgeoisie is correct.

But this is not the way economists normally reason. As I suggested, there may be reasons to be skeptical of her empirical claims in areas one does not know inside-and-out. And even if one dismisses my call for caution as nitpicking, the point stands; no matter how strong her arguments are, it is still incorrect to ascribe a zero probability to anything that is not known a priori. Whether one accepts her arguments depends on how one Bayesian update against the evidence she provides, and it’s far from clear that dignity for the bourgeoisie is the most probable.

Moreover, dignity for the bourgeoisie is just one of many theories that economists had not dreamt up yet. One imagines that before hearing any evidence, “something else we have not thought of” would have a much greater prior probability than dignity for the bourgeoisie. To the extent that McCloskey is convincing, she is more successful in demonstrating that we still have a poor understanding of how economies actually function than she is in showing that dignity is important.

TESTABILITY

In the future, as more nations graduate to the status of first world nations, McClosky’s thesis will ultimately become more testable. While no clear pattern exists at the moment, the nations that protect private property without substantial growth should be the same that do not respect the bourgeoisie. If this pattern emerges, it will become a significant empirical confirmation of her hypothesis. Presently, it is difficult to locate nations that adequately protect private property in the modern world without significant economic gains to show for it.

CONCLUSION

McCloskey’s book is essential reading. The breadth of topics covered all but guarantees the reader will learn a great deal about economic history, the growth literature, sociology, and general political economy no matter what one’s background is. The challenges she poses are real ones, and regardless of whether you believe she actually defeated each and

every alternative explanation of growth successfully, the brute force of her attack should at the least make the reader more skeptical of modern growth literature and mainstream economic history.

It is up to the reader how much her attacks on traditional explanations of the origins of growth actually demonstrate the importance of dignity for the bourgeoisie. Besides Mill's method of remainders, her direct evidence of the relationship between dignity and growth is rather light. Of course, this is only the second volume of a six volume series; presumably evidence will be presented more systematically in her future books. Still, it is difficult to endorse the thesis of the book without having seen this.

Frankly, I eagerly await modern experts in each aspect of growth theory to respond to each and every one of her charges. This would require a dedicated volume from a professional journal. No single book review could do it justice in that respect. I hope I have encouraged economists to make it through this imposing volume, as whatever one may feel about her conclusions, *Bourgeois Dignity* contains many important ideas deserving to be discussed.

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