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# DISCOVERING MARKETS

MARIUS KLEINHEYER AND THOMAS MAYER\*

JEL CLASSIFICATION: B53, D84, E71

**ABSTRACT:** This paper extends subjective expectations theory to form a new approach called the discovering markets hypothesis (DMH). Market participants form expectations on the basis of subjective knowledge and communicate with each other through narratives to improve their understanding of factual information before acting in markets. Thus, market prices are shaped by the subjective interpretation of emerging facts and shared narratives. To understand how new narratives replace existing ones, we refer to the theory of scientific revolutions. Winning narratives shape market prices until their victory is confirmed by the facts or they are discredited by facts and replaced by new narratives.

## INTRODUCTION

Prices fluctuate, and especially in financial markets, where they are heavily influenced by expectations of the future. Some economists have explained price fluctuations with the myopia of market participants. For instance, bid and ask prices are based on prices observed in the past, and when supply and demand do not match, prices are adjusted. Other economists have replaced myopia with perfect

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foresight in their models. According to them, all market participants always have all the necessary information to agree on a price equating supply to demand so that prices change only when they receive new information. However, actual price behavior is neither consistent with complete myopia nor perfect foresight among market participants. Sometimes, prices move as if market participants were myopic, sometimes as if they were forward looking. This has prompted another theory, according to which price fluctuations reflect market participants' collective oscillation between rational and irrational behavior.

This paper argues that there is a better way to explain price fluctuations in financial markets. Market participants form their price expectations on the basis of information that they collect and interpret with their individual skills and knowledge of economic relations. They act in the market or communicate with others through narratives to improve their understanding of their factual information before acting. Thus, market prices are shaped by the subjective interpretation of emerging facts and shared narratives. The resulting price movements in return influence narratives and the subjective interpretation of facts.

First, the theories of adaptive and rational expectations and the concept of adaptive markets will be discussed. These theories will then be connected to the theory of subjective expectations and an extension to the latter suggested, the *discovering markets hypothesis* (DMH). Empirical evidence is presented to support this approach, and finally, its utility in making predictions.

## OBJECTIVE THEORIES OF EXPECTATIONS

Economist John Hicks took issue with the idea put forward by Léon Walras that transactions take place at prices where demand is equal to supply. Since traders generally could not know what would be supplied and demanded at certain prices, they could only guess. Hence, Hicks (1939) argued, transactions would generally occur at prices which did not equate supply and demand. Following Hicks, we could describe the market as a mechanism that matches expectations and prices, but not necessarily potential supply and demand.

John Maynard Keynes raised the question of how expectations about the future are formed. Where they could, people would

rationally calculate subjective probabilities for different outcomes and choose the most likely. But they would also often fall back on whim, sentiment, or chance. The latter was especially the case in capital markets, where participants were driven by “animal spirits.” There, it was often necessary to forecast “what average opinion expects average opinion to be” (Keynes 1936). Keynes left the formalization of his macroeconomic expectations theory to his disciples, which often led to a mechanistic reduction of his arguments. An example of this is the theory of adaptive expectations.

In the adaptive expectations model an expected market price depends on the expected price of the previous period and an “error correction” term that is given as a fraction of the difference between the expected and the actual price in the previous period. This model is not only intuitively appealing but benefits also from the advantage that expected prices can be expressed as a weighted average of past prices. Given its user friendliness the adaptive expectations theory has been built into many macroeconomic models and has been used by many econometricians. However, even its most enthusiastic users have had to admit that it describes the formation of expectations in a very mechanical way that falls far short of Keynes’s more sophisticated view (see also Gertchev 2007).

In the early 1960s, the US economist John Muth contradicted the theory of adaptive expectations. He argued that the expectations of economic agents were nothing more than predictions, which could be made with the appropriate economic theory (Muth 1961). In the formation of rational expectations only the future counted, which would be fathomed with the help of economics. If people used all available information efficiently and knew how the economy really worked, then realized prices would differ from expected prices only as a result of random influences. And if the expected value of random influences were zero, market prices would over the longer run equilibrate supply and demand.

Muth’s theory, originally intended to explain price formation in specific markets, was incorporated into an economy-wide, dynamic general equilibrium model by Robert Lucas. According to Lucas, economic agents form their expectations of the future with full knowledge of all economic relations and using all available information. Based on these expectations they maximize their utility over

their lifetime. With his work Lucas not only solved Hicks's problem of imperfect information but also challenged established Keynesian macroeconomics. He argued that robust economic predictions could be made only with models founded in microeconomic theory because macroeconomic relations observed in the past were unstable over time.<sup>1</sup> Economic agents would change their behavior in response to economic policy. For instance, the famous relationship between unemployment and inflation proposed by the Phillips Curve would go up in smoke once people realized that the gains in purchasing power afforded by higher nominal wages were subsequently eroded by higher inflation.

Eugene Fama applied the concept of rational expectations to financial markets and hypothesized that financial prices contained all available information. At a minimum, it should not be possible to use past prices to predict future prices, and at best there would be no difference between market prices and fair prices of financial assets (Fama 1970). Thus, if markets are "weakly efficient," future prices cannot be predicted on the basis of past prices. Already this rather restrained statement contradicts the theory of adaptive expectations, which assumes that past prices contain valuable information for future prices. Markets are "semi-strongly efficient" when prices reflect all publicly available information. In this case, forecasting on the basis of past price movements as well as by considering new publicly available information is impossible. Finally, Fama classifies markets as "strongly efficient" when prices not only reflect all relevant public information but also proprietary insider knowledge. In this case, market prices and fair values of assets would be identical.

Rational expectations theory and the efficient markets hypothesis (EMH) were not only very successful academically—Robert Lucas and Eugene Fama were both awarded Nobel Memorial Prizes for their work—but also highly influential in business and politics. EMH provided the theoretical foundation for "passive investing" through index funds. If no single fund manager could reliably beat the market, why pay fees for active portfolio management? Greater returns could surely be obtained by investing in the entire market at lower costs. And EMH also had a strong influence on government policies. If the market always knew best, why let government

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<sup>1</sup> Lucas's challenge to Keynesian macroeconomics went down in the history of economics as the "Lucas Critique."

bureaucrats regulate it? “Light” regulation was in this case surely better than heavy-handed intervention.

However, Ricardo Campos Dias de Sousa and David Howden (2015), among others, have shown that EMH suffers from logical contradictions. If, as it stipulates, all market participants have all relevant information and interpret it in the same way, all would agree on a price and there would be no incentive to sell or buy. On the other hand, if only a sufficiently critical mass of market participants interpreted relevant information in the same way, transactions could take place, but the price allowing this transaction would be seen as efficient by one and inefficient by the other group. Thus, “efficient prices for one group requires inefficient prices in the eyes of the other” (Campos Dias de Sousa and Howden 2015, 396).

Rational expectations theory and EMH suffered their first practical setback in the early 2000s, when the “technology stock bubble” burst. Apparently market participants were not just cool-headed *homines oeconomici* but could get carried away by emotions. The experience gave a big boost to behavioral economics and finance. Until that point, behavioral economics had largely been an experimental science confined to the laboratories of a few universities—its key protagonists, Daniel Kahnemann and Amos Tversky, were Israeli psychologists. US economist Robert Shiller (2000) applied behavioral economics to finance, publishing a book in which he diagnosed the wild rally of technology stocks towards the end of the 1990s as a bubble just as it was peaking. Not least because of the excellent timing of the release of his book, a serious challenge to the EMH had emerged in science and financial business.

Rational expectations and EMH suffered another setback with the Great Financial Crisis of 2007–08. The systematic mispricing of risk, which became apparent when the credit bubble burst, was inconsistent with the idea that people would base their financial decisions on all available information and with a full knowledge of the true “economic model.” Obviously people in the credit markets had based their actions on inadequate information and a false economic model that indicated risk reduction through asset pooling when risks in fact accumulated as a growing number of people acted on this model.

Despite its obvious failure, EMH has remained the predominant theory of market behavior in academics and large parts of the

business world simply because there has been no other theory in mainstream economics to displace it.<sup>2</sup> In 2017, however, the US financial economist Andrew Lo came up with another challenger to EMH. Conscious of the difficulty of dethroning a theory taught widely at universities and perhaps with the ambition to follow in the footsteps of Nobel Prize winners Fama and Shiller, he named his theory the *adaptive market hypothesis* (AMH) (Lo 2017).

Lo's intention was not to scrap EMH entirely, but to restrict its validity to times of continuous market development. During those times people act rationally, based on a wide knowledge of facts and a good understanding of the valid economic model. But when markets are disrupted for whatever reason, people turn from rational analysis to instinctive behavior. They join others in either rushing into markets for fear of missing out or fleeing them for fear of losing their fortunes. Lo (2017, 188) summarizes his theory in five key principles:

1. We are neither always rational nor irrational, but we are biological entities whose features and behaviors are shaped by the forces of evolution.
2. We display behavioral biases and make apparently suboptimal decisions, but we can learn from past experience and revise our heuristics in response to negative feedback.
3. We have the capacity for abstract thinking, specifically forward-looking what-if analysis; predictions about the future based on past experience; and preparations for changes in our environment. This is evolution at the speed of thought, which is different from but related to biological evolution.
4. Financial market dynamics are driven by our interactions as we behave, learn, and adapt to each other, and to social, cultural, political, economic, and natural environments in which we live.
5. Survival is the ultimate force driving competition, innovation, and adaptation.

Thus, during normal market conditions reward increases with risk. But at times of negative disruption people may shun risks irrespectively of the associated reward. The Capital Asset Pricing Model may

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<sup>2</sup> The confusion in academics about how markets work became evident with the awarding of the 2013 Nobel Memorial Prize to both Eugene Fama and Robert Shiller.



work in normal times but fail in other market environments. Similarly, portfolio optimization according to Markowitz may work in good times but fail in bad times. When there is contagion among different markets, asset diversification may no longer reduce risk (Lo 2017, 282).

Lo's AMH is an intriguing effort to overcome the contradiction between EMH and behavioral finance and connect them by making them state dependent. However, why should "rationally" acting professional investors suddenly turn "irrational" in market downturns, and why should "irrationally" acting retail investors suddenly turn "rational" in normal markets? And why do environments change from "normal" and continuous to "abnormal" and discontinuous? Perhaps we can get a better idea of how markets behave when we study more closely the way that market participants process information.<sup>3</sup>

## A SUBJECTIVE THEORY OF PRICE AND EXPECTATIONS FORMATION

Like Hicks, Austrian economists in the tradition of Carl Menger and Eugen von Böhm-Bawerk acknowledged that people act with imperfect knowledge. However, these economists claimed that although prices realized in transactions may not equilibrate potentially available supply and demand they always cleared the market (in the sense that actual supply matches actual demand). The early Austrian economists introduced real-world outcomes as "points of rest" (Menger) or "momentary equilibria" (Böhm-Bawerk), where market exchanges are carried out without the adjustment of buyers' and sellers' preferences (Klein 2008, 172). Mises coined the term *plain state of rest* (PSR) as opposed to the imaginary construct of the *final state of rest* (FSR) (where all supply equals all demand). He explains: "When the stock market closes, the brokers have carried out all orders which could be executed at the market price. Only those potential sellers and buyers who consider the market prices too low or too high respectively have not sold or bought" (Mises 1949, 245). As an analytical tool, the FSR serves as a hypothetical

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<sup>3</sup> Lo's auxiliary assumption of shifting market environments to retain the EMH could be interpreted, in Lakatos's (1976) words, as a "degenerative problem shift" in a descending research program (see below).

scenario in which basic data of the market are frozen and market participants have perfect information and knowledge. In the FSR all feasible gains from trade are exhausted (Klein 2008, 173). But in reality the FSR never materializes, because market participants have imperfect knowledge that they continuously seek to improve. Thus, during the market process entrepreneurs shuffle and reshuffle resources and capital combinations in response to new knowledge to take advantage of profit opportunities and avoid losses (Salerno 2006). Hence, realized prices generally can be characterized as representing an “equilibrium with error” (Manish 2014). Since the errors of actors with superior knowledge are smaller than those of others, their profits from transactions are larger. As more profitable actors attract more capital at others’ expense, their influence on the exchange process increases. Thus, competition improves the functioning of markets and the economy at large.

Without perfect information and knowledge about the workings of the economy, prices are based on expectations, which are derived from the subjective interpretation of information (Manish 2017). Mises points out: “As action necessarily is directed toward influencing a future state of affairs, even if sometimes only the immediate future of the next instant, it is affected by every incorrectly anticipated change in the data occurring in the period of time between its beginning and the end of the period for which it aimed to provide” (Mises [1949] 1998, 253). From this it follows, according to Mises (1962), that “Every action is a speculation, i.e. guided by a definite opinion concerning the uncertain conditions of the future.” That is—in short—expectations. Thus, expectations “form a crucial component of every act” (Manish 2007, 209). The knowledge used to form expectations is somewhat different in each individual mind, because it reflects the individual’s experience and the specific and unique ability to collect and interpret information. The knowledge is often implicit. Actors may not be able to articulate it, and it certainly cannot be objectively measured. Mises coined the term *thymology* to describe a method that allows historians to “understand” a complex historical event (Mises [1985] 2007). In the same way that historians look into the past, market participants look into the future. This means that just as thymological experience serves as the basis for the historian’s interpretative understanding of past events (so far as they depend on social and not natural causes), it also conditions the actor’s “specific understanding of future events” (Salerno 1995, 309).

After the Austrian revival in the 1970s, debates about expectations and the market process's possible convergence towards equilibrium took on a central role. For Lachmann (1976), expectations are radically subjective and as such radically unpredictable. In consequence, he states: "Expectations must be regarded as autonomous, as autonomous as human preferences are" (Lachmann 1976, 130). This radicality has been criticized as nihilistic (Hülsmann 1997, 25). Of course, experience-based knowledge is fundamentally different from experimentally established facts of the natural sciences, but it is still real knowledge (Salerno 1995, 312). As Mises puts it: "To know the future reactions of other people is the first task of acting man." (Mises [1985] 2007, 311). Kirzner (1973) argued that the alertness of entrepreneurs for profit opportunities leads to a general systematic tendency toward equilibration.

Thus, the market is in a state of continuous disequilibrium but moving toward an equilibrium. Although Mises sees a theoretical final state of equilibrium resulting from the exploitation of profit opportunities from disequilibria by capable entrepreneurs (see above), in reality continuously emerging new facts are changing this equilibrium so that it can never be attained.

## THE DISCOVERING MARKETS HYPOTHESIS

In order to shed more light on the formation of expectations, subjective expectations theory will be extended by including two further observations: (i) The subjective reception of complex contents is communicated in narratives, and (ii) shared narratives shape prices and are shaped by them.

### The Role of Narratives

Before they act, individuals communicate with each other to cross-check their subjective knowledge against the knowledge of others. Complex knowledge is difficult to communicate. When expressed in the form of narratives it is easier to "get across ideas" (Shiller 2017). Robert Shiller has launched a research program (dubbed "narrative economics") to study the influence of popular narratives on seminal events such as the depression of 1920–21 or

the Great Depression of the 1930s (Shiller 2019). Among other things he has found that narratives can spread like epidemics and influence people's behavior, which can feed back into the narratives. While Shiller traces the effects of "big" narratives on historical economic developments, the focus of this text is on the effect of "narrow" narratives on financial market prices. As market participants share narratives and act on them in the market, prices move. In turn, the movement of prices feeds back into the narratives. The legendary stock market trader Jesse Livermore (alias Larry Livingston) explains in the classic book *Reminiscences of a Stock Operator*: "Observation, experience, memory and mathematics—these are what the successful trader must depend on...He must bet always on probabilities—that is, try to anticipate them," (Lefevre 1922, 416).

## Battles of Narratives

Shiller explains the emergence and disappearance of narratives in terms of contagion and recuperation. This can be well applied to "big" narratives evolving and fading with time. The "small" narratives in financial markets, however, do not die of old age but are replaced by other "small" narratives. To understand how new narratives replace existing ones in financial markets, we recur to the theory of scientific revolutions developed by Thomas Kuhn (1970). He argues that scientific knowledge normally increases around a widely accepted paradigm. In normal times, the paradigm itself is not challenged but is fleshed out more by new insights. However, when a critical mass of new facts emerges that is inconsistent with the ruling paradigm a scientific revolution may occur. Previously widely shared and accepted beliefs are questioned and overturned. Uncertainty and confusion may reign until a new paradigm is found that better explains the new facts. After a turbulent period ("extraordinary science"), scientific work returns to its normal state of work ("ordinary science").

Imre Lakatos (1976) speaks of research programs that have a paradigm at their core. According to him, however, the paradigm shift is not abrupt, but a tough struggle between the defenders of the old paradigm in the old research programs and the challengers who question it. When new facts put pressure on a paradigm, defenders find supporting auxiliary hypotheses to save it, but the original core of the paradigm is weakening. Lakatos calls this "degenerative problem

shift.” The challengers, on the other hand, find new explanations for the facts and develop a theory with a higher explanatory value. This leads to a “progressive problem shift.” In contrast to Kuhn, who combines paradigm shifts with radical breaks, Lakatos sees continuous gains in knowledge through the problem shifts in research programs.

The insights of Kuhn and Lakatos into the creation of new scientific knowledge are valuable guides for understanding the effects of the emergence of new knowledge in the market. Participants acting on a new shared narrative influence market prices. For some time, there may be a battle of the ruling and the new narratives. The new narrative may change or bear new narratives during this battle. And eventually the argument will be settled, and a new narrative will rule until the process begins anew. It is possible that the battle of narratives is intense and the victory of the new one absolute, as Kuhn has described the revolutionary paradigm change in science, or that it is drawn out and the new narrative displaces the old one gradually, as Lakatos has argued.

## CONTINUITY AND DISCONTINUITY IN PRICE DISCOVERY

When knowledge improves incrementally narratives change only little and the process of price discovery proceeds gradually. Financial markets are then characterized by relatively small spreads between offer and demand prices (or “bid-ask spreads”) for securities and by moderate price volatility. This notwithstanding, market clearing prices are being found through a process of trial and error and may move around until all participants agree on the price that best reflects their shared narrative. A market “equilibrium with error” (or “plain state of rest” according to Mises [1949] 1998)<sup>4</sup> has then been established, only we don’t see much of these movements.

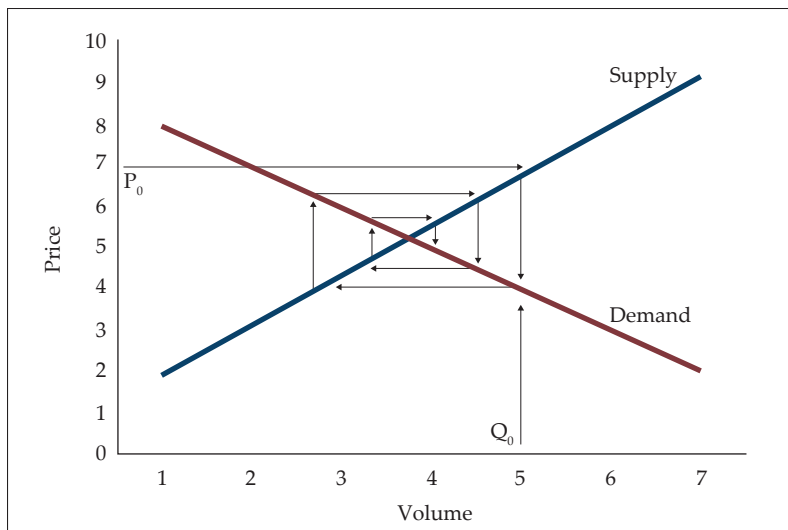
One way to illustrate the search process for a market clearing price is the old-fashioned cobweb model shown in Figure 1. The suppliers want to supply quantity  $Q_0$  at price  $P_0$ . However, the price

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<sup>4</sup> At the “plain state of rest” markets are cleared, but not necessarily in an equilibrium free of all market participant error. This is the “final state of rest,” towards which the market is pushed by competition but which may never be reached in reality.

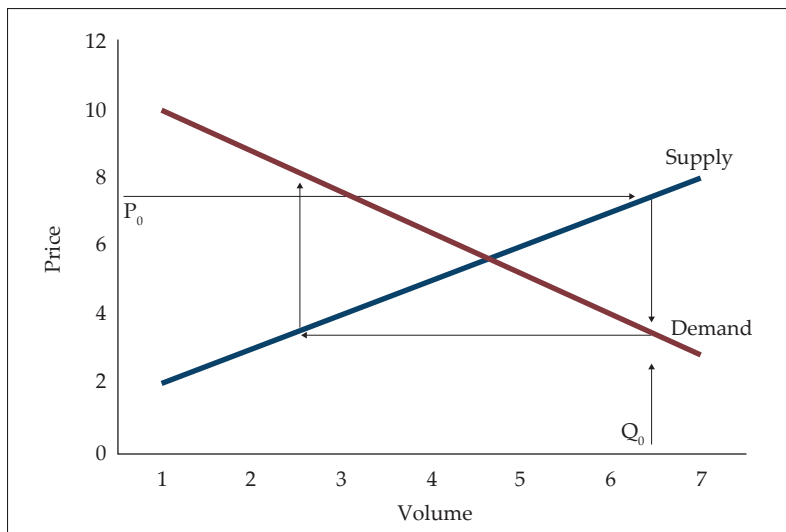
they get when they offer  $Q_0$  is much lower than  $P_0$ . Consequently, many cut their offer so that supply now falls below demand. Excess demand brings suppliers back into the market, but at the new price there is excess supply. They cut back again, only to face excess demand again. The process of trial and error continues until the market clearing price is found.

**Figure 1. Finding the Market Clearing Price in a Cobweb**



In this graph, the market clearing price is found, because the supply curve is more elastic than the demand curve. In consequence, suppliers adjust their prices by large amounts in response to excess supply or demand. But what if suppliers react less and demanders more elastically to excess supply and demand than before? In this case, excess demand and supply grow with each step and a market clearing price cannot be found (Figure 2). This is, incidentally, also true when both sides react with the same elasticity.

**Figure 2. Searching for the Market Clearing Price in Vain in a Cobweb**



Let's now assume that the combination of a fairly inelastic demand with an elastic supply curve characterizes a market where the demanders represent the "wisdom of the crowd" in the eyes of suppliers. This is how people intending to sell securities probably would look at the market. They would adjust their intentions relatively strongly in response to the feedback they get from the market. This is how markets normally behave, when most people share similar knowledge about market circumstances. New knowledge emerges gradually, and prices converge to clear the market.

However, when new and disturbing knowledge drops like a bombshell into the market there will probably be determined (or even forced) sellers in the market and many demanders will be very unsure about what to make of this. In this case, the demanders overreact to sales by the suppliers, and the suppliers in turn underreact to the demand changes by the demanders. No new equilibrium can be found. Bid-ask spreads widen and price volatility increases, because suppliers and demanders are out of synch with each other. Only when the new knowledge has been absorbed and evaluated by everyone can the market return to its "normal" mode of operation.

## Battles of Narratives and Fractal Geometry

Can we identify patterns in the emergence of gradual and revolutionary new narratives in the markets? Fractal geometry, developed by the mathematician Benoit Mandelbrot, may help (Mandelbrot and Hudson 2004). According to Mandelbrot smoothness and roughness alternate in nature and financial markets. There are long periods when little happens and short periods of high turbulence. To borrow from Kuhn, markets are calm when an accepted narrative is not seriously challenged, and they experience heavy turbulence when an accepted narrative is overturned by a radically new one. Or, to borrow from Lakatos, markets shift as new narratives gradually displace old ones. We call the evolution of prices in response to the spread of narratives the *discovering markets hypothesis* (DMH).

## AMH and DMH Compared

Although Lo's adaptive markets hypothesis and the DMH start with the same insight that markets may alternate between continuity and discontinuity, there are important differences. First, AMH takes the change in states as given while DMH explains it as the way in which knowledge emerges and spreads in the form of narratives. Second, AMH assumes schizophrenic minds in market participants and employs psychology to explain alternating behavior while DMH assumes psychologically stable market participants who act continuously and consistently—in a subjectively rational way. By focusing on the process of augmenting subjective knowledge in a battle of narratives, DMH provides a more consistent framework for analyzing and predicting market behavior.

## EMPIRICAL SUPPORT FOR THE DMH

Can we relate market price movements to the emergence of new facts and the spread of new narratives? In this section, DMH is applied to explain a few highly visible market movements, although this does not constitute a test of the theory in the spirit of Karl Popper, in which researchers aim to establish a numerically quantified causal relationship between exogenous and endogenous variables. In view of the complexity of the object of research, F. A.



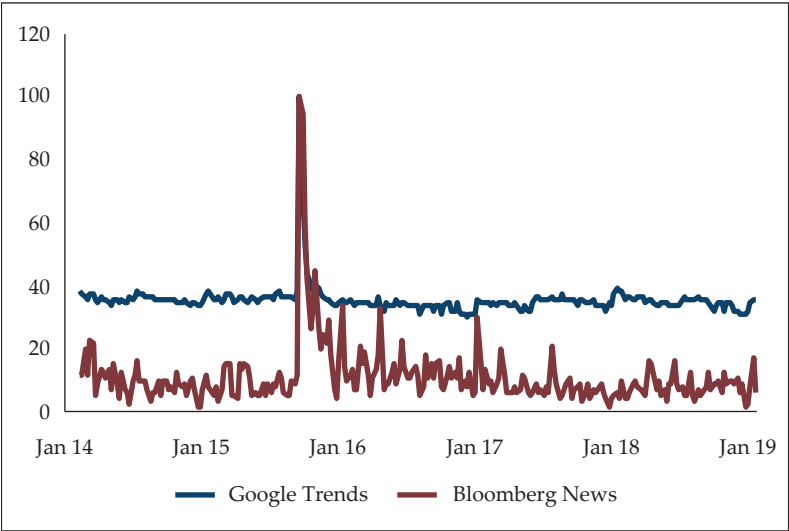
von Hayek's (1974) "pattern recognition" method is employed. Hayek has argued that numerical predictions based on causal relationships between endogenous and exogenous variables are less reliable the more complex the system to which these variables belong is. The complexity of social systems in particular is such that the establishment of causal relationships between variables and their quantification are next to impossible. But this does not mean that falsifiable hypotheses cannot be created and that predictions are unable to be made (Hayek 1974).

Applying Hayek's theory to the analysis of markets, it is possible to establish whether or not the DMH can explain the pattern of market price movements. What cannot be expected is to find a theory with which market outcomes can be predicted. Below a number of cases in which existing narratives were suddenly overturned by new ones (cases 1–2) is examined. This is followed by a study of two cases in which new narratives emerged after a battle of narratives (cases 3–4). A look at two cases in which the narrative shifted more gradually (cases 5–6) concludes the analysis.

### **Case 1: Diesel Shock**

On September 22, 2015, the German car company Volkswagen AG (VW) published a profit warning acknowledging that Diesel engines had been manipulated so as to disguise the true level of NO<sub>2</sub> exhaust. As Chart 1 shows, this attracted a lot of public attention and news coverage of Volkswagen surged (measured by the number of queries including the term "Volkswagen," Chart 1).

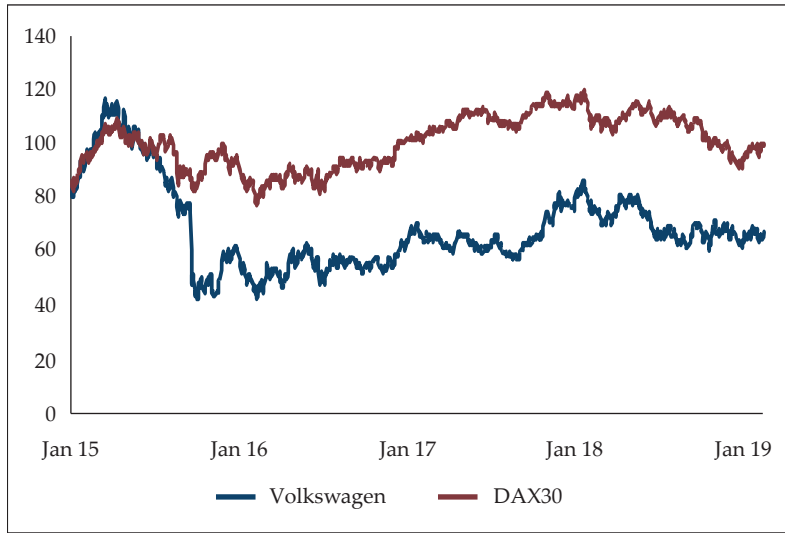
Chart 1. News Concerning “Volkswagen,” 2014–19



Source: Bloomberg, Google Trends, Flossbach von Storch Research Institute.

The share price plunged on the news and then moved along with other share prices represented by the DAX30 stock market index (Chart 2). The observed share price movement is consistent with one-off repricing in response to unexpected news as postulated by the efficient markets hypothesis. It is also consistent with a radical shift of the narrative about the profitability of Volkswagen. From the analysis of the share price development, it is not evident which theory gives a better explanation of the observed pattern.

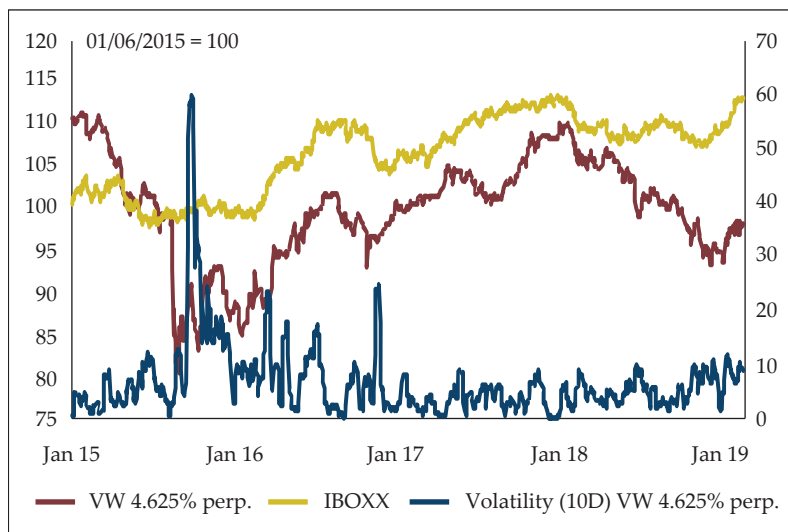
**Chart 2. VW Shares Compared to the DAX30 Equity Price Index, 2015–19 (100 = 01.06.2015)**



Source: Bloomberg, Flossbach von Storch Research Institute.

However, things become clearer by looking at a corporate bond of the company. Until the release of the news the bond fluctuated around the bond price index iBOXX (Chart 3). In response to the release the price plunged in a way similar to the movement of the share price (though somewhat less) and volatility increased. Both markets seemed to follow the same narrative. Thereafter, however, the price of the bond recovered and returned to the level of the bond price index while volatility declined again. The narrative of a company in deep trouble was superseded by the narrative that the company would survive and creditors were fairly safe. If the market was “efficient,” the bond price should have reacted much more calmly than the stock price. But market participants needed to digest the news and differentiate the new narrative in the stock market from that in the bond market before prices in both markets settled.

**Chart 3. Price of VW 4.625 Percent Perpetual Bond and iBOXX, 2015–19**



Source: Bloomberg, Flossbach von Storch Research Institute.

Likewise, the cost of insuring Volkswagen debt against default rose significantly (Chart 4) in September 2015, but it fluctuated at a lower level in the aftermath of the crisis outbreak.

**Chart 4. Price of a Credit Default Swap for Volkswagen (in Basis Points), 2015–18**

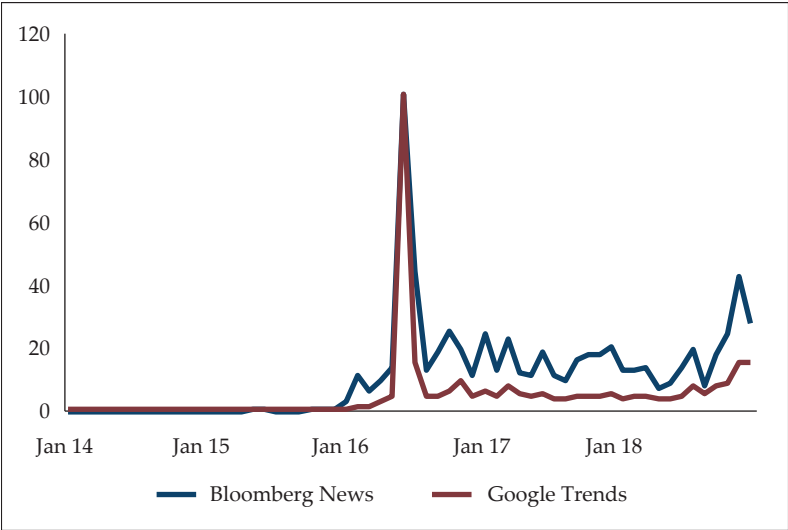


Source: Bloomberg, Flossbach von Storch Research Institute.

## Case 2: Brexit

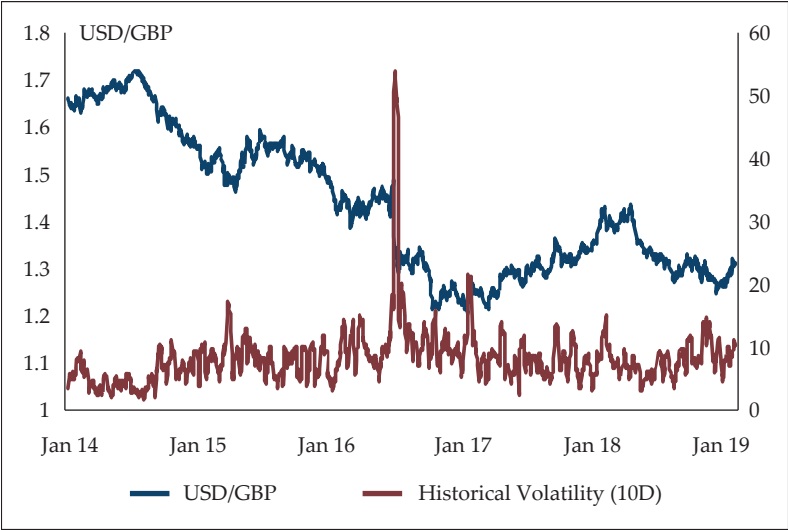
On June 23, 2016, for many people unexpectedly, the British people voted in favor of the country's exit from the European Union. Unsurprisingly, news coverage surged (Chart 5). The exchange rate of sterling against the US dollar took a dive and volatility surged (Chart 6). Following the nosedive, the exchange rate of sterling continued to weaken as it had done before the unexpected news. After some time, however, the initial shock faded and the exchange rate recovered part of the lost ground. Volatility also fell, suggesting that the initially high level of uncertainty gave way to a more stable pattern of views. The observed pattern is consistent with a weakening of the new Brexit narrative over time. As the debate about the terms of Brexit dragged on and the eventual outcome became ever more obscure, the exchange rate flattened. The confusion prevented any narrative from dominating the market.

Chart 5. News Concerning “Brexit,” 2014–19



Source: Bloomberg, Google Trends, Flossbach von Storch Research Institute.

Chart 6. Price Quotation USD/GBP and Volatility, 2014–19

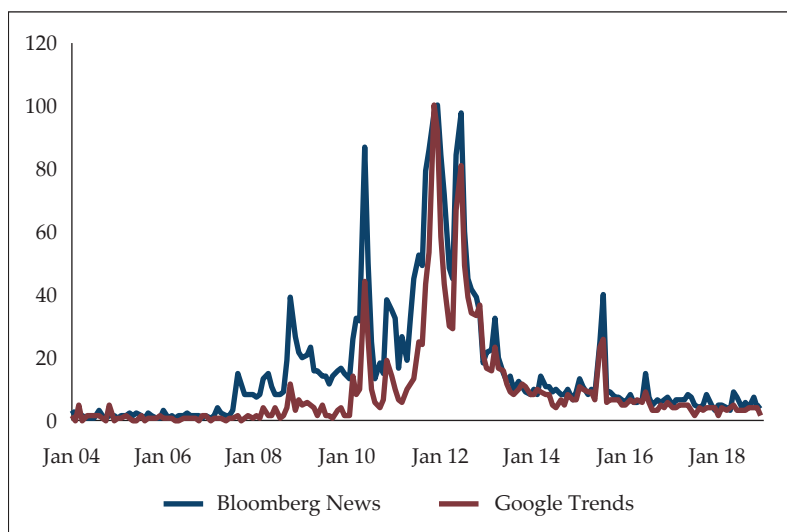


Source: Bloomberg, Flossbach von Storch Research Institute.

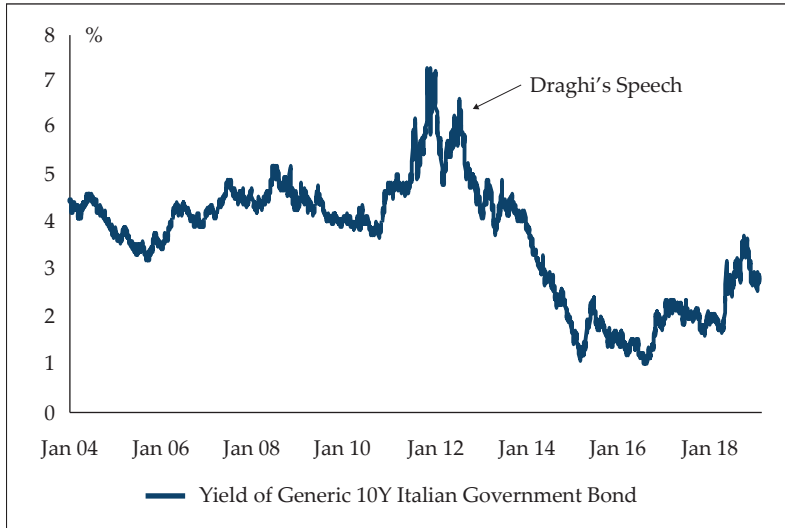
### Case 3: Eurocrisis

Following Greece's debt restructuring in early 2012 markets moved their focus to Italy. While the Greek debt crisis had posed only a limited threat to the survival of the euro an Italian debt crisis could spell its end. Hence, news reports mentioning a "euro crisis" increased (Chart 7). At the same time, Italian bond yields rose (Chart 8). On July 26, 2012, however, European Central Bank President Draghi said that the ECB would do "whatever it takes" to protect the euro. As a result, the Italian bond yields plunged. However, it took the rest of the year for the new narrative of the ECB's survival guarantee to find its way fully into market prices. The pattern observed here is consistent with a new narrative ("whatever it takes") replacing an old one ("euro crisis") in the market.

**Chart 7. News Concerning the "Euro Crisis," 2004–18**



Source: Bloomberg, Google Trends, Flossbach von Storch Research Institute.

**Chart 8. Ten-Year Italian Government Bond Yields, 2004–13**

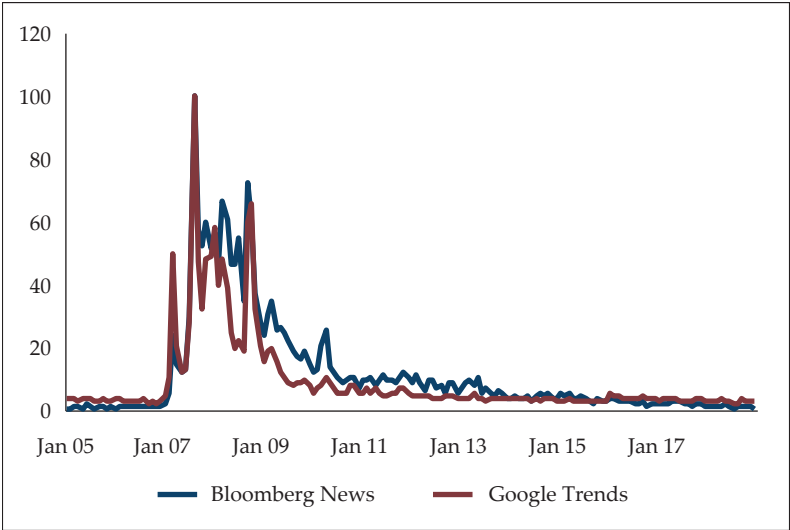
Source: Bloomberg, Flossbach von Storch Research Institute.

### Case 4: Subprime Crisis

In early 2007 defaults in a segment of the US mortgage market—called “subprime”—received public attention. Initially the events were described as problems caused by the mis-selling of mortgages to financially weak debtors and hence as a limited problem in a relatively small market segment (Chart 9). Money markets in the US and Europe were affected as banks lost trust in each other’s solvency, but the stock market remained calm (Chart 10). The narrative changed with the default of Lehman Brothers, causing news on the subject to surge again (Chart 9). Through the remainder of the year and into 2009 stock prices fell and volatility increased. However, by the end of the first quarter of 2009 the crisis narrative had weakened sufficiently to be superseded by a more positive one, first along the lines of “the worst is over” and then of the recovery beginning. The fear of missing out by sticking to the old narrative was a key motivation in the skeptics becoming optimistic.

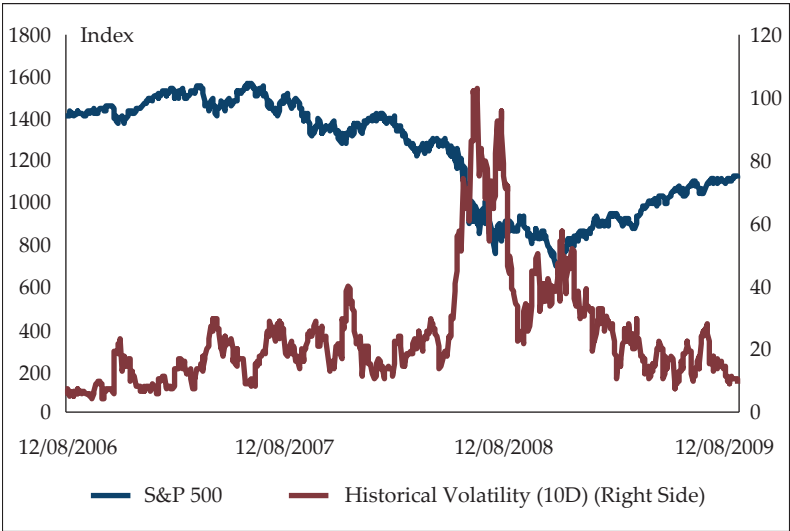


Chart 9. News Concerning “Subprime,” 2005–18



Source: Bloomberg, Google Trends, Flossbach von Storch Research Institute.

Chart 10. S&P 500 Price and Historical Volatility, 2006–09



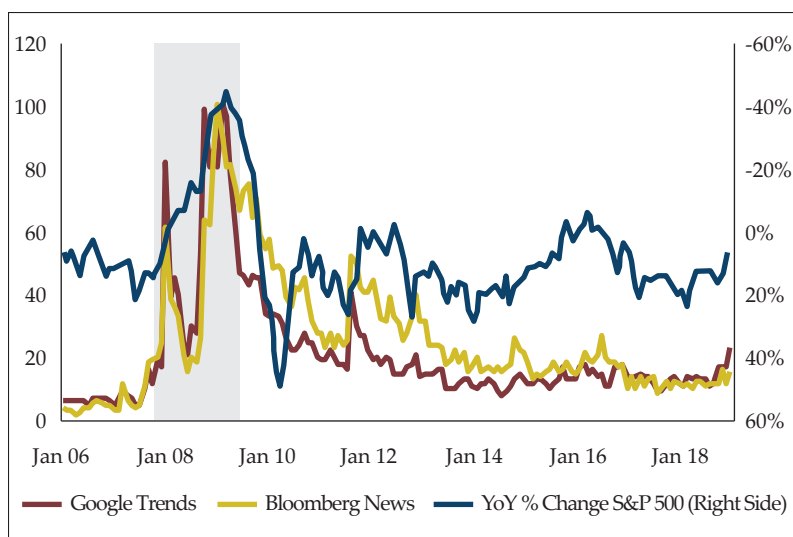
Source: Bloomberg, Google, Flossbach von Storch Research Institute.

### Case 5: Recession

Although during the Great Recession of 2007/08 money markets were already experiencing severe tensions as of mid-2007, recession fears in the US gained momentum only in August 2007 and peaked in December 2007 (as measured by the number of queries for the word “recession” on Google and Bloomberg, Chart 11). Fears subsided during the first half of 2008 but surged again in August 2008, peaking in October 2008, one month after the bankruptcy of Lehman Brothers. Recession fears eased again during the second quarter of 2009.

The absolute peak of Google recession queries in the observation period occurred just at the beginning of the recession in the US in the first quarter of 2008. The return to a more normal level of recession fears in mid-2009 coincided with the (later proclaimed) official end of recession in the US. At the beginning of 2008 the stock market (as measured by the S&P 500 price index) broke below its 2007 trading range but remained in this range until the end of August. Only after the news of the Lehman bankruptcy on September 15 did stock prices plunge. They reached a nadir in early March 2009, coinciding with the easing of recession fears (measured by the number of Google and Bloomberg queries).

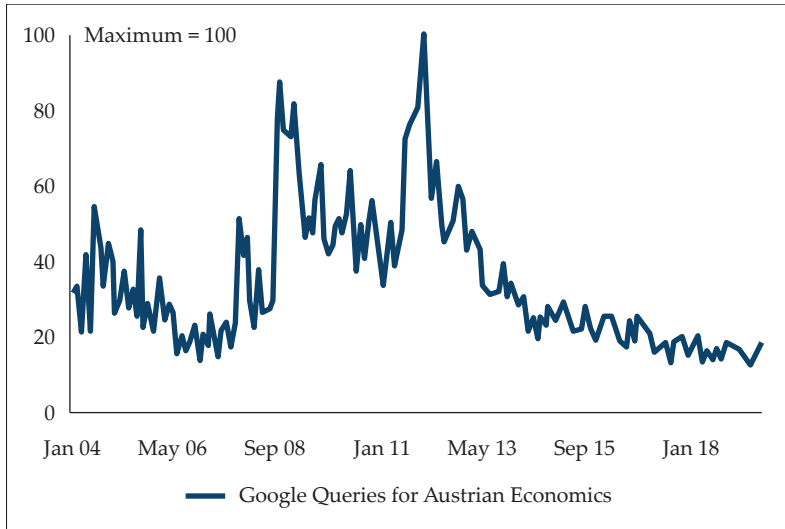
**Chart 11. News Concerning “Recession” and Year-on-Year Percent Change of S&P 500 (Inverted)**



Source: Bloomberg, Google Trends, Flossbach von Storch Research Institute.

## Case 6: Austrian Economics

Conventional New Keynesian economists had not seen the financial crisis and recession coming. This created renewed interest in the explanation of credit and investment cycles in Austrian economics, an explanation which became a narrative of its own. Chart 12 shows queries for “Austrian economics” worldwide. Queries surged in October 2008, the month after Lehman Brothers’s bankruptcy. They jumped to an even higher level in January 2012, when fears rose that Italy would crash out of the European Monetary Union (EMU). As central banks flooded the banking sector with money and Mario Draghi, president of the ECB, effectively guaranteed the existence of the EMU by promising to do “whatever it takes” to preserve the euro, the narrative of “Austrian economics” lost some of its attraction. Past experience suggests that interest will increase again when the financial system comes under renewed pressure in the next economic downturn.

**Chart 12. Queries for “Austrian Economics”**

Source: Google Trends.

## PATTERN PREDICTIONS WITH THE DMH

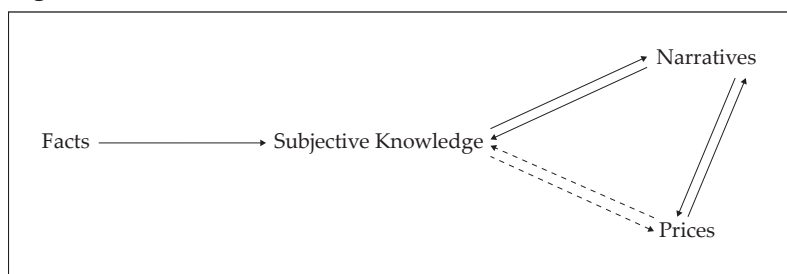
Having found the DMH to explain the pattern of market movements as a competition between different narratives, its use in making “pattern predictions” can now be discussed. Hayek uses the example of a ball game to illustrate what can and cannot be predicted: if we knew precisely the skills and fitness of the opposing teams in addition to the rules of the game, we should in principle be able to predict the outcome with a relatively high degree of certainty. However, the closer the teams come in skills and fitness, the greater will be the role of chance in determining the outcome (Hayek 1974).

The legendary German coach Sepp Herberger once said: “People go to soccer games because they don’t know how the game ends.” In reality, no one has precise information about the skills and fitness of the players at the time of the game, so that not only pure chance but also a lack of information will prevent a reliable anticipation of the outcome. Nevertheless, knowing the rules of the game helps observers focus their attention on what is important to the result.

Moreover, as people observe the game they acquire more information about players' ability and can improve their prediction of the outcome. It is obviously easier to correctly predict the result of a soccer match at halftime than at the beginning, but even then a lot of uncertainty remains.

All this implies that one should not expect to be able to predict market outcomes. But by understanding how markets move we can better focus on what is important to the outcome. Observation of the important drivers of market developments can then help us narrow down the possible range of outcomes. Specifically, the discovering markets hypothesis suggests that we focus on how new facts influence narratives, which shape prices and are themselves reshaped by them. By identifying narratives shared by a large number of people and by finding out whether they are ascending or descending, we may be able to assess the persistence of market price movements. In some cases, narratives that precede price movements may even be identifiable. This is illustrated in Figure 3.

**Figure 3. Formation of Prices**



Facts create subjective knowledge, which may induce financial market participants to act. More likely, however, they will exchange this knowledge with other participants with a view to identifying shared narratives, which have a more powerful influence on prices than individual action does.

## SUMMARY AND CONCLUSION

Expectations of the future shape the movement of prices, which clear markets, although not necessarily at the point where potential

supply is equal to potential demand. This paper followed the argument of Lachmann and Mises that market participants form their expectations on the basis of their ability to collect information and interpret it. In keeping with Shiller, it was observed that market participants tend to communicate their views about the future in the form of narratives and that they learn by listening to the narratives of others. Narratives compete, and winners emerge by knocking out or gradually wrestling down competitors. Winning narratives shape market prices until the facts confirm their victory or until they are discredited by the facts and replaced by new narratives. When we understand how market prices form we can predict the way they adjust to changing economic conditions.

Could artificial intelligence and machine learning replace human actors in financial markets? Those who believe in more mechanical models of expectations—assuming “rational,” “irrational,” or state-dependent “rational/irrational” behavior—may be inclined to say yes. However, if market participants indeed act subjectively rationally and interdependently based on proprietary knowledge accumulated through experience and incomplete information transmitted through narratives—as described in the discovering markets hypothesis—the hurdle to clear for artificial intelligence to beat human intelligence seems fairly high.

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# ON THE IMPOSSIBILITY OF INTELLECTUAL PROPERTY

JAKUB BOŻYDAR WIŚNIEWSKI\*

JEL CLASSIFICATION: K00, L26, O34, P48

**ABSTRACT:** The concept of intellectual property (IP) has been variously criticized as incompatible with natural rights and detrimental to the dissemination of innovations. In this paper I argue that it can be criticized on an even more fundamental level—namely as a praxeological impossibility. More specifically, it is suggested that since ideas are not economic goods, but preconditions of action, and since physical goods transformed by ideas become as heterogeneous (and thus as intellectually unique) as the individuals who enact such transformations, no economic goods can be meaningfully designated as appropriable in virtue of embodying the objectively definable value of one's intellectual labor. In view of the above, I subsequently suggest that IP protection laws constitute an exceptionally arbitrary and thus exceptionally disruptive form of interventionism directed against the very essence of the entrepreneurial market process.

## 1. INTRODUCTION

The concept of intellectual property (IP) has been criticized from a number of distinct perspectives. Proponents of libertarian ethics have criticized it as incompatible with the axiom of

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self-ownership and the resultant structure of natural rights. More specifically, they have pointed out that the category of property applies exclusively to scarce goods, while ideas—that is, the fruits of intellectual labor—are superabundant in virtue of their infinite replicability. Thus, forcibly restricting their replication amounts to a major act of aggression against the bodily integrity and physical property of the replicating agent (Kinsella 2008).

On the other hand, mainstream economists have demonstrated that patents and copyrights, far from promoting innovation, actually hinder economic development and Schumpeterian creative destruction. This is due to the fact that patent and copyright holders are effectively intellectual monopolists, capable of nipping in the bud the commercial development of any given idea (Boldrine and Levine 2008).

While acknowledging the validity and significance of the above criticisms, this paper offers a different take on the titular concept. Instead of suggesting that intellectual property is morally indefensible or economically harmful, it suggests that it is praxeologically impossible. In other words, this paper suggests that intellectual property laws constitute not so much an attempt at monopolizing a praxeologically distinct category of resources, but rather an arbitrary curtailment of entrepreneurial initiatives aimed at resource heterogenization. This, in turn, implies that the so-called protection of intellectual property creates not so much “intellectual monopolists,” but rather uninvited institutional co-owners (Hülsmann 2006) of their potential business competitors’ arbitrarily selected physical property.

The following section states the argument in more detail. Section 3 considers some potential counterarguments to the proposition, and section 4 concludes with a presentation of some of its further ramifications.

## 2. THE ARGUMENT

The fundamental insight of the marginalist-subjectivist tradition in economics is the observation that what makes a good is not its physical characteristics, but its ability to enter into causal relationships with subjective preference scales of purposive agents.

Thus, even physically identical goods may differ significantly in terms of their economic value in virtue of their differing causal histories and ideational connections.

However, this crucial emphasis on the subjective nature of economic value does not change the fact that genuine economic goods, in order to qualify as such, have to exhibit objective physical scarcity. Otherwise they are not goods, but the “general conditions” of action (Rothbard 2004, 4). In other words, the marginalist-subjectivist tradition—particularly as exemplified by the Menger-Mises branch—avoids the twin pitfalls of hypersubjectivism and panphysicalism: it postulates that physically scarce objects become economic goods by being “mixed” with the ideational processes of intentional beings.

Hence, ideation turns out to be a psychological rather than a praxeological activity—in and of itself it does not fall within the purview of economic analysis, nor, by extension, within the purview of property valuation. It is only when it is translated into action that it becomes a fundamental datum of economic theory and history. And yet, as soon as it enters the realm of demonstrated preferences, it inevitably heterogenizes the resulting goods, thereby ensuring their intellectual and valuational distinctness.

This is because human action is necessarily future oriented and thus entrepreneurial in the broad sense of the term—it consists not in frictionless adjustment of supply and demand, but in the deployment of scarce means toward specific ends to be accomplished in the uncertain future (Salerno 2008). Hence, ideas, viewed as preconditions of agency, are never, strictly speaking, replicated—instead, they are adapted to one’s specific circumstances, plans, and capabilities. This, in turn, implies that as soon as a particular agent transforms particular physical objects in accordance with a given idea—even if this idea is “borrowed” from someone else—they become unique goods, infused with his unique productive touch. It should be noted here that this argument is independent of the contention that property rights apply exclusively to the physical integrity of a resource, not to its value, since the latter derives entirely from the mental states of all those individuals who are interested in putting it to some use (Hoppe and Block 2002). Although few may be willing to reject this contention in full and endorse the notion

that maintaining the value of one's resources can extend to owning others' mental states, some may be willing to concede the inadmissibility of certain actions that diminish the value of another's assets. Underselling the originator of a "novel product" by offering exact replicas of his merchandise could be thought of as a canonical example here. However, the argument advanced in the present paper uproots this issue entirely, since it points out that physically identical products cannot be regarded as identical in terms of the sources of their value, thus making their putative ownership and their potential positive externalities a moot point.

This observation is exceptionally striking in the context of entrepreneurship narrowly conceived—that is, in the context of exercising the ownership function over capital structures of production created and recreated under conditions of uncertainty (Foss and Klein 2012). After all, the essential determinant of the success of any given business plan is not the physical capabilities of the resources owned by a given businessman, nor even the objectively definable ideas embodied in them, but the subjective evaluation of the potential residing in these and other elements of the overall entrepreneurial vision and the corresponding capital stock (Kirzner 1997). Objectively definable inventions are technical, not economic, phenomena—it is only when they help bring about subjectively conceived innovations that they contribute to economic growth and development (McCloskey 2010). This is by no means simply a repetition of the anti-IP argument that an idea is a general prerequisite of production and not subject to ownership. It is also the realization that, as far as their productive potential is concerned, ideas implemented in concrete processes of production are entirely dissimilar to ideas conceived in abstract terms. Thus, to regard all physical objects whose creation involved some use of the fruits of one's mental labor as falling within the ambit of one's "intellectual property" is to commit a fundamental categorical mistake—i.e., to confuse the results of subjective plans with their objective mental preconditions.

If, on the other hand, one were to claim that it is precisely the specific conceptual content of those mental preconditions that can be subjected to intellectual property protection, then an equally flagrant categorical mistake would be made. After all, such a claim would amount to trying to obtain exclusive use not of the results of any given action, but of a necessary prerequisite of a potentially infinite

range of actions. In other words, it would amount to trying to put a price tag on something that is naturally priceless—on something that is not just contingently nonscarce (as so-called free goods are), but is necessarily so (as all general conditions of action have to be).

To use a specific example, this would involve attempting to obtain exclusive use not of any particular product of, say, spelling or singing, but of the very concepts of spelling or singing. Taken to its ultimate conclusion, such an approach would paralyze all human action, destroying humankind almost on the spot by making everyone unsure of whether engaging in perfectly mundane activities violates someone else's intellectual property rights. And if one tried to avoid this conclusion by suggesting that it is only sufficiently complex concepts that merit this kind of exclusive appropriation, one natural response would be to point out that such a suggestion smacks of sheer legalistic arbitrariness, since it has to rely on a purely discretionary standard of "sufficient complexity." Admittedly, making it a matter of pure legal convention which ideas are subject to IP protection would not be a logically incoherent move, but it would be a move bereft of any appeal to economic justification. More specifically, it would offer no support for the claim that the purpose of licensing the use of complex concepts is to allow their authors to reap their full market value, since it would not involve laying down any precise methods of measuring the extent to which the market value of any given good derives from its embodying any such concept (Cordato 1992, 80).

Furthermore, it has to be borne in mind that all entrepreneurial activity involves resource heterogenization (Lewin and Baetjer 2011), even if it does not consist in the Schumpeterian kind of entrepreneurship, which is typically associated with the introduction of innovations and other quintessentially conceptual tasks. Hence, for instance, buying a trademarked product and simply relocating it from a relatively saturated market to a relatively unsaturated one in order to sell it at a profit suffices to create a substantially new product, associated with uniquely specific preference scales, valuational conditions, and organizational structures. In fact, in today's age of electronic transactions an act of physical relocation is not even necessary: it suffices to engage in online arbitrage to heterogenize physically and conceptually identical goods in a productive manner. After all, if all human action is broadly entrepreneurial—that is, it

requires creative confrontation with the uncertain future—then exploiting arbitrage opportunities is solidly innovative in its own right (Kirzner 2009).

In other words, even, say, using a general scientific formula in production without in any way altering it should count as an instance of adaptation rather than replication, since its successful commercialization requires integrating it with a specific, time- and space-bound capital structure of production. To repeat, ideational replication is a purely mental operation, and it is only entrepreneurial implementation of replicated ideas that can be economically meaningful in this context, since only the latter can be economically profitable or unprofitable, and thereby also more or less successful in addressing the problem of natural (i.e., nonartificial) scarcity.

Moreover, it must be stressed that the argument presented here is not reducible to the more familiar contention that ideas cannot be subject to property rights, since rights are, by definition, enforceable claims, with the “force” component tying in to the physical aspect of human control over scarce resources. Although this contention is perfectly reasonable, it does not immediately answer the objection that the originator of a certain idea may regard himself as a partial owner of all the scarce resources that in some degree embody its distinctive conceptual features. Of course, at this point one might make a solid case that the creative process, although certainly capable of increasing the value of specific goods, nevertheless does not automatically imply ownership of them, be it complete or partial. This, however, would shift the discussion to the normative level, having to do with defining the ethical or legal criteria of genuine appropriation. This argument is purely praxeological: it points out that there is no necessary valuational link between the conceptual features of ideas contemplated in abstract terms and the conceptual features of specific goods that incorporate those ideas.

In other words, the process of ideation might be thought of in terms of identifying potential profit opportunities, but from a realistically conceived entrepreneurial standpoint such opportunities are only imagined rather than discovered (Klein 2008). And since the fruits of one’s imagination can be translated into actual business ventures in an endless variety of ways, it is incoherent to claim that the value of imagined profit opportunities can be automatically

imputed to their actually exploited counterparts, entitling the originators of the former to the proceeds from the latter.

In sum, the subjectivist theory of value coupled with a praxeological understanding of the market process leads to the conclusion that, economically speaking, intellectual property is a contradiction in terms. In short, ideas are not economic goods, but preconditions of action, while physical goods transformed by ideas become as heterogeneous (and thus as intellectually unique) as the individuals who enact such transformations. This, in turn, implies that as important as it is to point out the efficiency-reducing and normatively troubling consequences of so-called intellectual property protection, it is possible to raise doubts about the concept on an even more fundamental, purely logical level.

### 3. POTENTIAL COUNTERARGUMENTS

Let us now analyze some potential counterarguments to the suggestion advanced in the present paper.

First, it might be claimed that, regardless of one's views on the normative aspects of the titular concept, it is an overstatement to deny its descriptive coherence. After all, one might say, it is perfectly reasonable to define the fruits of one's intellectual labor as goal-specific technical recipes,<sup>1</sup> readily identifiable in terms of the specific material effects that their implementation produces. This, in turn, should make it conceptually unobjectionable to designate the goods that embody such effects as bearing the marks of one's intellectual property, even if we do not believe that such "property" is associated with enforceable natural rights or economically beneficial consequences.

The main problem with this suggestion is that, once again, it conceives of goods in technical rather than economic terms and treats ideas as if they were praxeological rather than psychological factors. Since, however, economics deals with subjective evaluations embodied in demonstrated preferences, not with scientific discoveries and their technical content, it must reject the notion that

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<sup>1</sup> For the purpose of this paper, the terms "recipe," "idea," and "concept" are treated as interchangeable.

there always exists a unique, objective description of the way in which any given good can usefully incorporate a technical recipe. On the contrary, subjectivist economics, coupled with a mature theory of capital and entrepreneurship, clearly recognizes the fact that productive factors are essentially characterized in terms of their subjectively perceived attributes, functions, and uses (Foss, Foss, Klein, and Klein 2007). Hence, there is a potentially infinite number of ways in which any given technically defined object can be imbued with the fruits of entrepreneurial creativity, alertness, and foresight, thereby becoming not just conceptually novel, but also endowed with unique economic value.

Another objection that might be leveled against the titular contention is that it cannot claim universal economic validity, since it refers to a strictly normative concept (i.e., property), while economics is a positive science. Thus, one might argue, it is a category mistake to ascribe inherent incoherence to a phenomenon whose definition is ultimately a matter of legal convention or moral imagination.

The primary error of this counterargument lies in confusing the value freedom of economics with its supposed value irrelevance. Although clearly value-free as far as the contents of its theorems are concerned, economics is crucially dependent on the evaluative and normative concepts contained in its descriptions of the catallactic order (Casey 2012). For instance, the theorem of the impossibility of rational economic calculation under socialism clearly refers to the importance of certain normative institutions (private property in the means of production, free exchange of private property titles, etc.), but it does so exclusively in order to elucidate the nature of the corresponding logically necessary causal relations, without proclaiming their ethical desirability. By the same token, the theorem in question also demonstrates that certain normative visions—such as that of an economically thriving socialist commonwealth—are not so much ethically wrong as they are inherently unviable. To put it differently, ethical evaluations of intrinsically incoherent concepts are inevitably futile, since they run afoul of the principle of “ought implies can,” which often reveals such concepts to be misleading placeholders for something altogether different.

Thus, the fact that the titular contention refers to a normative concept in no way detracts from its strictly positive character.



After all, it does not matter in this context whether or not one endorses the notion of intellectual property on ethical grounds—what matters is that such an endorsement cannot be couched in economically meaningful language. Consequently, the argument of this text does not violate the distinction between the positive and the normative—instead, it aims at demonstrating that it is the proponents of intellectual property who necessarily violate the distinction between the psychological and the praxeological.

At this point, one might argue that the above train of thought rests on the dubious premise that if an idea is by nature a general condition of action, this cannot be changed by legal enactment. In fact, however, no such premise is presupposed. Although it is clearly possible to legislate artificial scarcity into existence, it is impossible to ground such legislation in praxeologically meaningful facts. In other words, although it is possible to prosecute individuals or organizations for the supposed unlawful use of another's ideas, it does not change the purely praxeological observation that anchoring any given abstract idea in the specific circumstances of one's individual venture turns it into a fundamentally distinct idea, with no necessary valuational link between the two akin to that postulated by the Mengerian law of imputation. Hence, appealing to the conceivability of artificial scarcity in no way impugns the value freedom of this paper's contention.

Finally, it might be suggested that the supposed economic coherence of the notion of intellectual property can be established by pointing to the specificity of the interventionist effects caused by IP protection laws. If, for instance, one subscribes to the claim that such laws hinder economic development and the corresponding creation and dissemination of innovations, then one implicitly recognizes the existence of a special category of goods whose preemptive appropriation by patent and copyright holders leads to economically suboptimal results. Thus, one might argue, intellectual property emerges as an economically meaningful concept in virtue of the economically meaningful effects of its legal enforcement.

The chief weakness of the above contention is the implicit assumption that praxeologically specific consequences must be associated with a praxeologically distinct category of goods in order to retain their analytical meaningfulness. It is the case,

however, that they might as well be associated with a praxeologically distinct kind of activities. For example, in the context under consideration it might be suggested that IP protection laws hamper not so much the production and dissemination of “intellectual goods,” but the very process of heterogenization of goods—that is, the process whereby physically scarce objects become increasingly differentiated through their association with individual entrepreneurial visions. In other words, IP laws might be plausibly regarded not as a means of preemptive appropriation of “intellectual goods,” but as a tool for implementing the principles of “conservative socialism” (Hoppe 1989, chap. 5). Hence, it seems perfectly feasible to recognize the economically harmful effects of interventions aimed at the suppression of entrepreneurial utilization and reutilization of generally accessible ideas without being simultaneously committed to accepting the economic meaningfulness of the concept of intellectual property.

In sum, far from being an exaggeration, the claim that so-called intellectual property is incoherent as an economic notion appears to be a solidly justifiable proposition. Let me now conclude by briefly exploring some of its further analytical ramifications and practical implications.

#### 4. CONCLUSION

If intellectual property is indeed a praxeologically meaningless concept, then, as proposed in the previous section, IP laws do not prevent entrepreneurs from utilizing freely a specific, precisely definable category of goods, but instead serve as a pretext for essentially arbitrary acts of opportunistic interventionism. This indicates that they are far more capable of paralyzing the operation of the market process than is suggested by the traditional arguments centered on the economically stifling influence of “intellectual monopolies.” More concretely, IP laws’ definitional arbitrariness appears particularly capable of saddling entrepreneurs with a highly troublesome layer of regime uncertainty (Higgs 1997), which does not generate additional (though predictable) costs for entrepreneurial activity so much as it makes such activity essentially unpredictable on the institutional level (Kinsella 1995, 150–51).

Furthermore, the laws in question are especially likely to cripple the operations of specifically “Schumpeterian” firms (Mueller 2003, chap. 4), that is, those that rely exceptionally heavily on creating value through resource heterogenization based on ingenious adaptation of existing technical recipes. Such firms, which are typically at the forefront of robust economic development, are especially exposed to the arbitrary interventionism of the established players, who are constantly on the lookout for excuses to accuse the newcomers of “intellectual free riding.” In addition, this kind of environment gives the management of Schumpeterian firms an extra incentive to join the establishment’s interventionist game as soon as possible, thereby perpetuating and further strengthening the vicious circle of rent seeking, cronyism, and enforced economic petrification.

Finally, the unhampered entrepreneurial transformation of various technical concepts is a phenomenon whose continuation is particularly important to a globally interconnected and organizationally complex society. If such a society suddenly becomes irresponsive to the economic challenges continually generated by its dynamically changing environment, which is bound to happen under conditions of repressed resource heterogenization, it will fall victim to institutional fragility (Taleb 2012) and become incapable of sustaining its complexity, ultimately collapsing under its own weight.

In conclusion, since intellectual property is a praxeologically incoherent term, IP laws turn out to constitute an exceptionally arbitrary and thus exceptionally disruptive form of interventionism directed against the very essence of the entrepreneurial market process (Kirzner 2017). Hence, intellectual property laws should be viewed as an even more fundamental obstacle to robust economic development than has been suggested by hitherto prevailing arguments.

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# BEYOND CALCULATION: THE AUSTRIAN BUSINESS CYCLE IN THE SOCIALIST COMMONWEALTH

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JEL CLASSIFICATION: B51, B53, E32, P21, P51

**ABSTRACT:** This paper extends Austrian business cycle theory to the command economy and demonstrates that Mises's socialist commonwealth would not be free from Rothbardian error cycles, which J. Guido Hülsmann has argued must originate in "institutions in which the error of many persons is inherent." Booms and busts are shown to be unavoidable under socialism because (1) the central planner's incomplete understanding of the opportunity costs associated with any given rate of growth would result in growth targets that are unsustainably high and (2) the planner would be blind to the resulting imbalances until they became sufficiently severe to become "visible" in the statistical data that form her only picture of the world. In this case, Hülsmann's "erroneous institution" is central planning, which misidentifies the state's image of the economy with the totality of economic reality.

"Economic construction proceeds in wave-like fashion with its ups and downs, and one wave chasing another. This is to say that there are balance, disruption, and balance restored after disruption."  
–Mao Zedong (1959)

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It is often supposed that business cycles would not occur under central planning. Indeed, in most business cycle models a central planner should be able to improve upon the “anarchy of the market.” Keynes’s ([1936] 1997) animal spirits could be eliminated, the adaptive expectations of Samuelson’s (1939) accelerator/multiplier model could be replaced by a rational program, the planner’s supposed informational advantages would solve the incomplete information problem in the Lucas (1972) rational expectations story, and, in the absence of the “exploitation” of labor by capital, Marx’s ([1863] n.d., chapter XVII, part 6) “crises of accumulation” would not occur.

Although most business cycle theorists have not explicitly advocated central planning, explanations based on the limitations of private actors can easily be misinterpreted as implying that eliminating market forces would be an improvement. Keynes ([1936] 1997, 320) makes this claim explicitly, arguing that “the duty of ordering the current volume of investment cannot safely be left in private hands.” Here the implicit assumption is that the state official will behave more rationally than the businessperson, a view entirely consonant with Keynes’s lifelong advocacy of socialist policies (Fuller 2019). His argument is a good example of what Demsetz (1969) calls the “nirvana approach”—a case for state intervention made by contrasting real-world free market outcomes with what an ideal government could achieve in a “first best” world. Keynes is essentially saying that a system directed by angels would be preferable to one run by fallible human beings.

In the Austrian tradition the planner tends to be seen as demonic rather than angelic. Here too, however, we find claims that central planning would not generate economic fluctuations. In *Human Action*, for example, Ludwig von Mises ([1949] 1998) argues that the periodic crises experienced in free enterprise economies, which he attributes to incompatibilities among the plans of different economic actors, would not occur under socialism, which would allow for only one plan—that of the dictator. “If the dictator invests more and thus curtails the means available for current consumption,” he writes, “the people must eat less and hold their tongues. No crisis emerges because the subjects have no opportunity to utter their dissatisfaction” (566). Although rational decision-making would be impossible in his socialist commonwealth, there would at least be no booms and busts.

Similarly, for Huerta de Soto (2006) the claim that “an economy of real socialism offers the advantage of eliminating economic crises is tantamount to affirming that the advantage of being dead is immunity to disease.” If cycles are not observed in socialist countries, this is not the mark of a superior system but rather a sign that they are “are continually and permanently in a situation of crisis and recession” (472–73).

Yet the economic history of socialist countries includes boom-bust episodes that in many cases have been even more extreme than those observed elsewhere. Kornai’s (1992) classic study of the Soviet Union and Eastern Europe found that “while some socialist economies grow relatively smoothly, others show wild fluctuations, even larger ones than in many capitalist countries” (187). He noted that the coefficients of variation for annual investment growth in Yugoslavia, Poland, and Hungary were 278 percent, 187 percent, and 171 percent, respectively, all higher than those for the –capitalist countries in his sample, which covers the period from 1960 to 1989. (Of these, Ireland had the highest value, at 159 percent.) Similarly, the Chinese economy has experienced dramatic cycles in fixed asset investment going back to the Great Leap Forward in 1958 (Eckstein 1976; Fan and Zhang 2004; Wang 2008; DeWeaver 2012).

Research on Soviet-type economies has generally attributed cyclical fluctuations to inconsistencies in the central plan. Wellisz (1964, 233), for example, describes the plan as being “fitted together like a jig-saw puzzle,” where “an individual piece cannot be trimmed or replaced without spoiling the whole picture.” This meant that “a weakness is tolerated as long as possible in order to avoid rearrangement of all the pieces. Finally, when the situation becomes unbearable, radical steps are taken to remedy it. Thus, the economy proceeds by starts and jolts, with successive drives or campaigns to eliminate this or that mistake.”

Winiecki (1988) shows how this state of affairs resulted from enterprises’ efforts to have their projects included in the five-year plan (FYP) by exaggerating the projected benefits and underestimating the costs. “In consequence,” he finds, “the FYP typically starts with significant built-in distortions in its investment component. These distortions exercise, over time, an increased pressure on aggregate equilibrium...shortages multiply and excess demand begins to



grow." In the majority of cases, the cycle peaked in the second or third year of the plan, at which point the planners "resign themselves to the fact that all planned investment projects will not be completed by the end of the FYP...many projects are 'mothballed', with further construction postponed until the next FYP, and some others discontinued altogether" (1988, 20–21).

In practice, it is evident that central planning has never been an antidote for economic fluctuations. It might still be argued, however, that these historical precedents do not rule out in principle the possibility of a stabilizing role for the planner. If administrative arrangements specific to the countries involved account for the volatility of the socialist economies, perhaps the system might somehow be "perfected," for example by improving the incentives facing enterprise managers and local-level officials. Under ideal conditions, socialism without booms and busts might yet be achievable.

Here my objective is to show that this is not the case. I extend Austrian business cycle theory to the command economy by showing that malinvestment will still occur under central planning whenever any form of economic growth is prioritized. The model, which combines Friedrich Hayek's (1945) insights on the importance of local knowledge with Scott's (1998) concept of "legibility," assumes a planning authority with a limited, though time-varying, statistics-based picture of economic conditions. Cycles then correspond to changes in what can be "read" through statistical data. I find that Mises's calculation problem implies not only static but also dynamic inefficiency.

The fundamental issue is the planner's lack of access to local knowledge, which makes comprehensive planning an impossibility regardless of how the plan is formulated. Ideal local-level officials might selflessly follow the leadership's directives in every particular but will find that these are incomplete. Much will still have to be left to the discretion of the "cadre on the spot," as Hayek might have put it, who will have to set aside his local-knowledge advantage to focus on plan fulfillment. Investment fluctuations will be unavoidable, because (1) the planner's incomplete understanding of the opportunity costs associated with any given rate of growth will result in growth targets that are unsustainably high and (2) the planner will

be blind to the resulting imbalances until they became sufficiently severe to become “visible” at the aggregate level.

Although the institutional setting is different—administratively set targets take the place of monetary expansions—these dynamics are essentially the same as those described in Austrian business cycle theory. In both cases, faulty signaling of society’s rate of time preference leads to the misallocation of resources into more roundabout production, resulting in distortions that must inevitably be corrected through an investment slowdown. When shortages become sufficiently severe, the central planner will be forced to restore order through administrative measures much as central banks in today’s market economies have to “take away the punch bowl” when faced with rising inflation.

Today, the socialist business cycle is not only of theoretical and historical interest but also of great practical importance. In China the investment cycle continues to be primarily a state-led phenomenon, operating in much the same way as it did in the pre-reform era (DeWeaver 2012). Booms continue to be driven by investment promotion at the local government level while busts result from central government administrative interventions designed to reimpose macroeconomic stability. Although prior to the beginning of the “reform and opening” period in 1978, the Chinese economy’s ups and downs had relatively little relevance to the outside world, today they impact everyone from Swiss watchmakers to Zambian copper miners.

The business cycle in the socialist commonwealth can be considered as an example of what Hülsmann (1998), following Rothbard ([1962] 2004, ch. 11), calls an “error cycle.” The root cause of any business cycle, he argues, is what he refers to as an “illusion”—an error that is independent of time and place and can therefore give rise to recurring erroneous behavior. In this case, the illusion is built into the very idea of central planning. It is the misidentification of the image of the economy that is visible to the planner with the totality of economic reality.

The remainder of this paper traces the origins of this illusion, demonstrates why it gives rise to booms and busts, and describes how Austrian business cycle theory can be extended to the centrally planned economy to account for these aberrations. Part I shows

how socialism was built on a denial of the economic significance of local knowledge, which made it possible for theorists to believe in the possibility of an all-seeing planner. Part II presents a model of fluctuations in an ideal socialist commonwealth and demonstrates that these fluctuations can be considered as a subspecies of the Austrian business cycle where state-set output targets play the role of free market interest rates as a signal of society's rate of time preference. In part III, I review Hülsmann's argument and argue that his "essentialist" error-cycle approach is particularly well suited to this case. Part IV concludes.

## I. THE BIRTH OF AN ILLUSION

The founders of the Soviet system believed that industrial modernization would give rise to the conditions necessary for central planning to work by eliminating the relevance of local knowledge. This idea is implicit in Marx's claim that with advanced factory technology "the motion of the whole system does not proceed from the workman but from the machinery," implying that "a change of persons can take place at any time without an interruption of the work." (Marx [1887] 1999, 285). Standardization and automation would leave Hayek's man on the spot with no particular informational advantages. Anyone could take his place.

Similarly, Engels ([1894] 1975) believed that modern industry had "freed production from restrictions of locality." "Water power," he noted, "was local; steam power is free" (351). Where "knowledge of the particular circumstances of time and place" (Hayek, 1945) would obviously be important for siting a water-powered mill, replacing water with steam could potentially make an understanding of locality-specific geographic conditions largely irrelevant. Engels expected that it would become possible for any factory to be located practically anywhere as technological progress swept aside the myriad local differences that had formerly constrained economic development and would allow "industry to be distributed over the whole country...on the basis of one single vast plan" (Engels [1894] 1975, 351).

Lenin (1920) later updated this conception, replacing steam with electric power. Capitalism, he claimed, "depends on small-scale

production and there is only one way of undermining it, to place the economy...on a new technical basis, that of modern large-scale production. Only electricity provides this basis." Hence his famous dictum, "Communism is Soviet power plus the electrification of the whole country."

The backwardness of peasant Russia, he went on, would be transformed by power stations, which would become "strongholds of enlightenment." Electricity would not only light up the night but would also create a manufacturing base free from the idiosyncrasies of traditional economic arrangements. The central planner would not be groping in the dark but able to see clearly. Lenin was aiming at something much more than the electrification of the whole country. He hoped to leverage the rationalizing potential of technology to achieve what Scott (1998) refers to as the "thoroughly legible society," which "eliminates local monopolies of information and creates a kind of national transparency" (78).

There would then be no need for the "new dispositions made every day in the light of circumstances not known the day before" that Hayek (1945, 524) argued were essential to the "continuous flow of goods and services." Instead, as Nikolai Bukharin and Evgenii Preobrazhensky claimed in their 1920 book *The ABC of Communism*, the state will "know in advance how much labor to assign to the various branches of industry, which products are required and how much of each it is necessary to produce; how and where machines must be provided" ([1920, trans. 1922] 2001, chap. 3). Chaotic interactions among privately owned firms would give way to a smoothly functioning state-directed mechanism.

In China, where Bukharin and Preobrazhensky's readers included Mao Zedong, Deng Xiaoping (Wu and Ma 2016, 23), Beijing mayor and Politburo member Peng Zhen, and People's Liberation Army founder Zhu De (Snow 1968, 271, 335), this notion was taken up uncritically by the Chinese Communist Party. It is, for example, the unstated assumption behind the "chessboard strategy" described in the famous 1959 *People's Daily* editorial "The Whole Country as a Chess Game" [*Quan guo yi pan qi*]. Written in response to the chaos following the launch of the Great Leap Forward in the previous year, it called for a return to disciplined central planning, likening the national economy to a chessboard, on which the movements of

each piece must conform to an overall strategy based on the rules of the game. Implicit in this analogy is the idea that it would be possible for economic life to be just as transparent to the planner as a board game is to the players.

In practice, of course, technology has not created anything like the level of national transparency envisaged by any of these authors. The operations of a large-scale factory can no more be reduced to a straightforward set of rules than the techniques of the traditional artisan. Modern forms of communication have not eliminated “knowledge silos” in complex organizations. Computer algorithms seem unlikely ever to penetrate fully the opacity of asset markets.

Innovations may render older categories of economically significant local knowledge obsolete but may be equally likely to create new ones. Consider the case of the defense aerospace industry. There, Gilli and Gilli (2018) note that “the number of components in military platforms has risen dramatically: in the 1930s, a combat aircraft consisted of hundreds of components, a figure that surged into the tens of thousands in the 1950s and to 300,000 in the 2010s.” As a result, “the number of potential incompatibilities and vulnerabilities” has increased “geometrically” (150) and “the knowledge related to a given weapon system has become increasingly less codifiable—it has become tacit” (163). Unlike the knowledge required to produce a World War I era biplane, which could to a large extent be derived from a blueprint, the essential knowledge resources behind a platform such as Lockheed-Martin’s Joint Strike Fighter are primarily local, residing in the collective memory of an organization and difficult if not impossible to express in any explicit form. From this example it is easy to see that advances in technology can have exactly the opposite effect from that expected by the early socialists, making the workings of the industrial system ever more opaque.

There can thus be no central planning that does not rely on “state simplifications” that are “always some distance from the full reality these abstractions are meant to capture,” as Scott (1998, 77) puts it. These, he argues, differ from the full reality because they (1) “cover only those aspects of social life that are of official interest,” (2) “are nearly always written,” implying that nondeclarative knowledge is necessarily left out, and are (3) “typically static,” (4)

“aggregate,” and (5) “standardized.” In the real world, where the relevance of different types of information is constantly changing and the particular circumstances of time and place continue to be economically relevant, there will unavoidably be significant blind spots in the planner’s “synoptic” view.

The problem, as Hayek (1988, 85) pointed out, is that “what cannot be known cannot be planned.” But even in the absence of an adequate basis for decision-making, plans will still be made. Decisions will be taken based on whatever the central planners can “see” at any particular time as the bureaucracy collectively succumbs to the illusion that this is a complete picture. Policy goals will necessarily be limited to targets for “synoptically observable abstractions” while the unobservable details of their implementation are left to officials at the local level. The extent to which such a system gives rise to booms and busts will thus depend critically on the activities of these lower-level cadres.

## II. BOOMS AND BUSTS UNDER CENTRAL PLANNING

The local cadre’s responsibility for realizing targets for aggregate variables will be economically destabilizing, because he will be incentivized to generate outcomes that the central government can observe but not to take the associated unobservable economic costs into consideration. As a result, resources will be diverted into planned policy priorities at the expense of activities that are not emphasized, or even contemplated, by the plan. There will be chronic contradictions between the needs of the actual economy and the plans of the economic decision-makers.

When increasing economic output is the primary objective, as has generally been the case historically, this may in principle be achieved through either extensive or intensive growth. But only the former (increasing output by using more inputs) falls within the competence of the planner. Intensive growth, which relies on increased productivity, is intrinsically unplannable. It is straightforward to set material targets for specific items (tons of steel, kilometers of railway lines), as was commonly done in the Soviet Union (Davies 1974), or goals for aggregate measures such as provincial or municipal GDP growth, which have been typical in post-reform

China (Zhou 2004). But similar “state simplifications” (e.g., number of patents issued) do a poor job of incentivizing genuine innovation.

Attempts to transform the “mode of economic growth” in the Soviet Union and, more recently, in China have been notably unsuccessful. In the 1980s, the Soviets adopted the policy of *uskorenie* (acceleration), “subordinating everything to the aim of making the economy more intensive and achieving higher production outputs with smaller inputs and less resources” (Tikhonov 1981, 24), which was to be facilitated through the “universal introduction of fundamentally new machinery and materials and the large-scale use of highly efficient energy- and material-saving technology” (Tikhonov 1981, 29–30). This produced few breakthroughs. The difficulties can be seen from the experience of the machine-building industry, a top priority sector, where of the three thousand new products introduced in 1986 to satisfy innovation targets, 40 percent were found to have involved “no substantial shifts” in technology (Matosich and Matosich 1988).

Similarly, every Chinese five-year plan since 1981 has emphasized the importance of greater economic efficiency for the country’s future development (DeWeaver 2012, chap. 9). Yet levels of excess capacity in industrial sectors such as steel, cement, float glass, and aluminum—to name but a few—have skyrocketed while China’s incremental capital-output ratio has been on a steady uptrend since 2007. And although the jury is still out on Beijing’s “National Medium- and Long-Term Plan for the Development of Science and Technology (2006–2020),” its goals illustrate the difficulty of transitioning to intensive growth using command economy methods: R&D expenditure is supposed to increase to 2.5 percent of GDP, reliance on foreign technology must fall to 30 percent, China must reach fifth place globally in number of patent filings, and so on (McGregor 2010).

Given the obvious problems with raising productivity by fiat, the planner will generally find that extensive growth is the only viable option. As she cannot be aware of all of the opportunity costs associated with any given growth rate, she will necessarily set growth-rate objectives (whether for the entire economy or for specific sectors) that are unsustainably high. The cadre on the spot will respond by investing in infrastructure and the manufacturing base. Hitting material targets will require additional fixed assets



once the existing capital stock is fully employed. Investment drives will also be the surest route to an aggregate output benchmark, both because fixed asset accumulation is itself a part of aggregate output in the period in which it occurs and because it makes it possible to increase output in subsequent periods. Although the cadre might conceivably attempt to introduce local-level productivity enhancements, his first choice will be to mobilize factors of production that he perceives as having an opportunity cost of zero because they are currently employed in activities that lie outside the planner's field of vision.

Murray Rothbard ([1962, 1970] 2004, 337) notes that intertemporal transactions may take the form of either credit extension or the "purchase of producer goods and services." The latter, he points out, are effectively "future goods" because they will be converted into final products in future periods. In the socialist commonwealth, although money and credit may not exist at all, it will be no less true that the employment of producer goods and services constitutes a substitution of future for present output. And in the absence of changes in productivity or in the availability of land and labor, any growth rate set by the planner will imply a specific requirement for additional capital, which will in turn require some particular increase in investment at the expense of consumption.

Thus, under central planning, state-set targets for output increases based on an extensive growth strategy play an analogous role to the interest rate in a free market system. Both are signals of the rate at which society is willing to sacrifice present for future consumption, that is, of its rate of time preference. Prioritizing economic growth under central planning will therefore give rise to the same outcome as artificially lowering interest rates in a credit-based economy: resources will be shifted into more roundabout production processes. Growth targets have essentially the same effect on the cadre on the spot as do interest rate cuts on Hayek's man on the spot. Both skew the investment decision-maker's incentives in favor of subsequent periods, resulting in a mismatch between the aggregate requirements of investment projects and the means available to carry them out.

Alfred Zauberman (1964, 25) notes that historically central planners have generally behaved as "managers of a joint stock



company whose shareholders are future generations." In other words, we may think of them as assigning a discount rate of zero to outcomes occurring at some indefinite date in the future. That Austrian business cycle theory, with its emphasis on faulty signals of society's true rate of time preference, should be applicable to "actually existing socialism" is thus unsurprising.

In both the socialist and free market cases the outcome will be the same: an initial boom that eventually leads to a crisis as the resulting imbalances become unsustainable. Although in a free market such a crisis can be resolved more or less spontaneously, in the absence of price signals a resolution will not be possible until the essential features of the situation at last come clearly into focus for the planner.

Even under central planning a course correction will eventually be possible, because the planner's picture of the world, although always incomplete, will not be unvarying. The presence of widespread problems in parts of the economy that the planner cannot see will eventually manifest itself through the aggregated information that she can see, revealing disruptions such as raw materials shortages, crop failures, power outages, and transportation bottlenecks. At this point, the threat to longer-term economic growth will force the planner's attention to shift from growth targets to the alleviation of shortfalls. Investment plans will have to be cancelled or put on hold as resources are redirected toward previously neglected activities. This will lead to a crisis analogous to those observed in the free market case, though centrally directed rather than the result of a multitude of individual decisions. Given that the planner is the only truly autonomous decision maker, there will be only a single determination that the plan is incompatible with the available resources rather than the mass panic that occurs when "all or nearly all businessmen find that their investments and estimates have been in error" (Rothbard [1962] 2004, ch. 11). Rather than running for the exits on their own, the local cadres will have to be instructed to do so. "The brake" as Kornai tells us, "is applied by central control," after which a period of austerity will be necessary until such time as the leadership is "reassured that tension has fallen, or even a measure of slack, an apparent underuse of resources, has appeared" (Kornai 1992, 190, 192).

These socialist slowdowns will be no less prone to inefficiencies than the booms that precede them. Lacking the ability to determine whether or not specific activities make economic sense, the planner will have to use arbitrary criteria such as project size or industry type in determining which investments to halt. There will be no way to avoid throwing out the baby with the bathwater.

Just as in a free market economy, the fact that decision-makers have experienced one cycle does not mean that they will be able to avoid another. The details may be different the next time—novel investment rationales may be imagined, innovative technologies may be employed, new sectors may be involved. But as long as economic growth remains the priority, the fact that planning must be conducted in the absence of local knowledge guarantees that recurring rounds of malinvestment will be unavoidable.

Investment booms are not merely a possibility under central planning, but a logical inevitability. This conclusion follows from the following three premises:

(1) The planner's primary objective is economic growth, whether this be growth in an aggregate measure such as GDP or in output statistics for particular priority sectors.

(2) Local knowledge will be economically significant regardless of how the economy is organized.

(3) Plan fulfillment is the sole objective of the cadre on the spot.

Premise (3) means that the cadre on the spot will take advantage of the lacunae in the plan resulting from premise (2) to meet the planner's targets. And because (1) implies that future output increases will be targeted, it will be optimal for him to overinvest in roundabout production processes regardless of the resulting malinvestment at the macroeconomic level.

Busts are a logical inevitability as well if we add the following two additional premises:

(4) The macroeconomic effects of malinvestment must eventually become general knowledge.

(5) These effects will pose a threat to longer-term economic growth if left uncorrected.

These imply that the planner must at some point become aware of the intertemporal distortions resulting from the extensive growth

strategy and introduce new policies to resolve them, thereby terminating the boom. Although the subjects may have “no opportunity to utter their dissatisfaction” and initially have to “eat less and bite their tongues,” as Mises argued, this state of affairs will obviously have to end at some point before the entire population has starved to death.

### III. SOCIALIST ERROR CYCLES

J. Guido Hülsmann (1998) presents an alternative approach to modeling business cycles based on what he refers to as an “essentialist” account of the errors in investment decision-making that drive them. He believes that conventional “consequentialist” stories are unsatisfactory because “as long as human beings choose, that is, as long as they are beings with free will, the correctness of choice must in principle be unrelated to preceding events and choices” (8). The problem with traditional Austrian business cycle theory (ABCT) specifically, he argues, is that it is not generally valid to claim that increases in the money supply *cause* entrepreneurs to invest in projects that will later turn out to be unprofitable. There is no reason in principle why they could not foresee that these investments would fail and choose not to make them.

During a boom a significant number of people make the same mistake at the same time. Consequentialism explains this clustering of errors as the result of an event (e.g., a money supply increase) that leads decision-makers to err in some particular way. Hülsmann proposes that we instead take error as “the ultimate given.” The question then becomes not “how does error come about?” but rather how can we explain the “repetitive occurrence of more or less synchronous errors of many persons.” This requires identifying “more or less permanent patterns of action (institutions) in which the error of many persons is *inherent*.” Such an institution must be built upon “a kind of error that is independent of time and place,” which Hülsmann calls an “illusion” (1998, 8–9).

For Hülsmann, this institution is government, which he sees as founded on the illusion that society cannot function in the absence of the institutionalized violence of the state. The task for the theorist is then to “identify particular instances of government intervention and spell out precisely where the illusion is manifest.” There will be

“various specific error cycle theories (the economic aspect of which would be specific *business* cycle theories)” (1998, 14).

My argument in part II is consequentialist—error is caused by the planner’s failure to access local knowledge, which results in the provision of malincentives to her subordinates. Note that this model differs from conventional ABCT in that the faulty decision-making is centralized. While in both explanations the malinvestments occur at the local level, these are only truly errors for the man on the spot. The cadre on the spot is a representative of the state, not an autonomous individual. His activity consists solely in carrying out instructions, using the resources at his disposal in a manner that is optimal for his plan-fulfillment objective. Ultimately it is the planner who errs by mistaking statistics for reality, thereby choosing means that must ultimately prove suboptimal for achieving her long-term goal of maintaining economic growth. This difference is a natural consequence of the cadre’s relative lack of decision-making autonomy. Unlike his free market counterpart, he is not really at liberty to decide whether or not to invest. This decision is imposed on him by the logic of a system set in motion by a single authority acting in the name of the “people” as a collectivity rather than by the aggregation of decisions made by the individual citizens themselves via the market process.

On a more fundamental level, reformulating the story in essentialist terms reveals that the socialist cycle may be thought of as a particular instance of Hülsmann’s general theory. If government is indeed an “illusory institution,” under socialism, where economic life is entirely dominated by the state, recurring erroneous behavior will be unavoidable, though this behavior will be concentrated in the person of the planner, who is uniquely empowered to set the objectives for society as a whole. (Alternatively, we may think of Hülsmann’s “synchronous errors of many persons” as being made by ideal cadres whose individuality has been entirely merged into a single collective “popular will” and therefore err collectively rather than individually.) And we may identify central planning as being “precisely where the illusion is manifest.” Indeed, we can be even more certain that “it is not money but government intervention that accounts for the business cycle,” as Hülsmann concludes, in a commonwealth where interest rates are not relevant to investment and money, at least in a theory, might not even exist at all.

Mihai Macovei (2015, 433) finds that “the essentialist approach is useful, but lacks convincing arguments to become a general theory of business cycles”. He challenges Hülsmann’s claim to generality on two counts. First, a story premised on the idea that government is essentially a form of institutionalized aggression can easily be rejected by anyone who does not happen to share this view. Second, “except for the ABCT, Hülsmann only mentions two other possible examples, such as the ‘military-imperialistic’ and the ‘social security’ cycle. He does not develop them further in order to explain their workings, which is a clear shortcoming in terms of expounding a theory that claims to be general and all-encompassing” (2015, 427). Furthermore, Macovei argues that even the “argumentation” underlying the essentialist reconstruction of the ABCT is “not irrefutable” (2015, 433).

Our consideration of the socialist business cycle, although not relevant to Macovei’s specific objections to this argumentation, suggests possible counterarguments to his two more general points. It suggests, first of all, that the key characteristic of the state for the purposes of business cycle theory may be blindness rather than violence. This position is defensible given the obvious economic importance of local knowledge and the fact that planning is no less a part of any government’s activity than coercion. In addition, one can point to the socialist cycle as an additional special case, thereby strengthening the assertion that the theory is “general and all-encompassing.”

We may think of central planning as one specific instance in which the illusion of government, as Hülsmann characterizes it, is manifested, thereby arriving at a specific version of his general theory appropriate to the socialist commonwealth. But we may also restate this general theory by considering faith in governments’ ability to plan, rather than belief in the necessity of state property rights violations, to be the illusion underlying government itself—not an unreasonable view given that the former must presumably precede the latter. The business cycle then becomes less a consequence of the expropriation of private property than of the state’s inability to use what it has taken in an efficient manner. This restatement has the advantage of making the essentialist position easier to defend while leaving it basically intact.

## IV. CONCLUSION

In *Economic Calculation in the Socialist Commonwealth*, Mises argues that without access to the local knowledge embedded in the price system, the socialist economic order will end up “floundering in the ocean of possible and conceivable economic combinations without the compass of economic calculation” (23). In the absence of any rational basis for decision-making, “the wheels will turn, but will run to no effect” (19).

Here, I have made a case for going beyond Mises’s essentially static framework to explore his argument’s dynamic implications. The planner may never see a complete picture of the economy, but what she does see can nevertheless be expected to vary over time. As a result, her mistakes will be serially correlated, leading to a pattern of alternating overinvestment and austerity not unlike a series of private sector manias and panics. Although the wheels will “run to no effect,” they will run faster during some periods than others.

The incentive issues and political factors characteristic of real-world socialism complicate the story without changing its essential features. The main difference between our idealized commonwealth and existing socialist countries is that real cadres will find ways to influence the contents of the plan and strive to overachieve its goals (Winiecki 1988, Kornai 1992, Zhou 2004). Their priority is typically not plan fulfillment *per se* but advancing their own careers. But the basic problem—the diversion of resources from activities outside the planner’s field of vision—will be the same, though exacerbated by cadres’ attempts to game the system. The possibility of eliminating booms and busts through administrative reforms can also be ruled out. Central planning is inherently destabilizing.

It is straightforward to generalize Austrian business cycle theory to include both planned and market economies. In either setting, the essential features of the cycle are: (1) an expansionary impulse resulting in (2) a distorted signal of society’s rate of time preference, followed by (3) malinvestment, (4) excess demand, and finally (5) contraction. Under socialism, we simply have the planner in the role of the banker, with the planner’s economic growth policy replacing money supply increases as the expansionary impulse and unrealistically high output targets taking the place of below

equilibrium interest rates as the distorter of the time preference signal. In either case, the result is malinvestment, while the excess demand may be manifested either directly, as physical shortages, or indirectly, as inflation. The final contraction will provide the same necessary readjustment whether it results from administratively imposed austerity or interest rate increases.

Far from being an impossibility, as many have imagined, the socialist business cycle may in fact be the state-driven business cycle *par excellence*. Without markets and private property, policy does not have to be transmitted indirectly to the private sector through a monetary or fiscal “transmission mechanism” nor are there any truly independent decision-makers. The state’s economic management will have a direct and immediate impact and cannot fail to produce booms and busts under the five assumptions enumerated at the end of section II.

The socialist business cycle is also arguably the Hülsmannian error cycle *par excellence*. Where there are no private sector “animal spirits,” the source of the “recurring erroneous behavior” is unambiguous. It can only be the state’s blindness to the “particular circumstances of time and place,” whether considered as a specific manifestation of the illusion of government or as this illusion’s ultimate source.

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REVIEW ESSAY

PLANNED ECONOMY AND ECONOMIC  
PLANNING: WHAT *THE PEOPLE'S REPUBLIC  
OF WALMART* GOT WRONG ABOUT THE  
NATURE OF ECONOMIC PLANNING

MÁRTON KÓNYA\*

JEL CLASSIFICATION: P21

**ABSTRACT:** Leigh Phillips and Michal Rozworski's *The People's Republic of Walmart* entered the scene in 2019 with the remarkable idea that mammoth firms such as Walmart and Amazon, by being able to direct huge volumes of resources—sometimes with the capacity of entire countries—without an inner market to signal prices, are living evidence of the viability of a collectively planned economy. Moreover, they argue that the nondemocratic command system that often accompanies the structure of firms is due to their operation in a profit-seeking market system. Using the Austrian arguments propounded during the economic calculation debate, this essay shows that not only are firms, like other organizations, unable to substitute the market in coordinating their economic plans, but that their nondemocratic elements arise precisely from their function as “miniature planned economies,” demonstrating that the authors have misunderstood the nature of economic planning in a market economy. It is further argued that the problems that a planned economy would face

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without market signals would no less obstruct the efficient and successful operation of private firms if they ever tried to eliminate the market creating them.

## INTRODUCTION

*The People's Republic of Walmart* contains many ideas that are truly provocative to someone with Austrian views. In some everyday political circles, the book is cited as exposing how many neoclassical scholars' objections to the high ideas of socialism are in fact unsubstantiated. It would seem that this book has become one of the fundamental "weapons" of today's socialists. While reading it, the possible sources of its ideas became ever more apparent and its errors in economic theory showed themselves, which with a more careful study of Mises's works would not have occurred.

The book's argument, grossly simplified, is the following: socialist governments of the past failed to produce an efficient planned economy that could rival the market system, but this failure is almost entirely due to technological constraints that have since disappeared. Not only is a modern planned economy not impossible, but capitalism is partially operating it right before our very eyes. Megacorporations, such as Amazon and Walmart, are working at an economic capacity far greater than that of most of the former socialist countries. They are not only afloat, but can supply millions upon millions of consumers and arrange their production processes without having an inner market, which would need a price system based on private property to operate. These companies are the living evidence that the fears and objections of Austrian thinkers such as Ludwig von Mises and F. A. Hayek are wrong and that we have a system that can coordinate human efforts without a market.

This critique revives, in their accurate forms, the thoughts of Austrian school thinkers, mainly Ludwig von Mises, for he refuted the errors in the book long ago. Although this might be true for other arguments in the book as well, those elements which are not strictly connected to economic calculation will be avoided. Some of the book's other fundamental ideas often appear in socialist works: for example, the exploitation theory of capital, the robber baron myth, the denial of the tragedy of the commons, the linking together of anarchism and the command economy, the idea that overproduction

causes depressions, etc. These questions have been dealt with in countless books and essays. Instead, this essay's purpose is to show that Mises and Hayek's writings, if read correctly, already refute Phillips and Rozworski's arguments and that Austrian economics provides more insight into the workings of large corporations than the book's authors claim to.

This essay will first consider the book's main terminological confusion, followed by a short restatement of the basic problem of economic planning. The second section applies these findings of the Austrian thinkers to the cases of large corporations. The final chapter briefly discusses the relation between planning as it occurs in a market economy, and in a collectivist economy.

## I. PLANNED ECONOMY AND ECONOMIC PLANNING

The central error of the book is that it uses two fundamentally different terms synonymously, *economic planning* and *planned economy*, and views both as incompatible with the market. But one of them is not only compatible with market economies, but is one of their foundational tools: economic planning. In order to make a clearer distinction between the two phrases, they need to be defined first. Simply put, economic planning is the process by which the various participants in the economy make calculations about the economic steps they must take in the future. In contrast, a planned economy is an entirely centralized system in which the allocation of everything from raw materials to capital goods, to consumer goods is implemented by a central authority, without the market mechanism.

To a naïve reader the only difference may be the scale of the planning operation, but the distinction is much more fundamental. To briefly summarize and illustrate the problem<sup>1</sup> that Mises originally pointed out in *Economic Calculation in the Socialist Commonwealth* ([1920] 1990) and later elaborated in *Socialism* ([1922] 1981) and *Human Action* (1949), let us take a planned economy. There are no profit-oriented firms or capitalists, and all means of production (including labor) are under central control. Let us suppose that the

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<sup>1</sup> The illustration here used is heavily influenced by an example given in a YouTube video by the Learn Liberty channel (2015) called "What If There Were No Prices?"

board of directors is tasked with building a railroad connecting two cities between which there is a high mountain. Let us suppose further that somehow the board of directors knows that the routes going through and around the mountain would increase social welfare to the same degree, and that their goal is to use the society's resources in the most economical way (meaning that they must only use up resources that are not needed by an enterprise that promises a higher increase in social welfare). In short, we have simplified the scenario so that the directors only have to wrestle with the problem of finding the lowest cost possible. For the sake of simplicity, let us say that only two means of production are necessary to build a railroad, engineering and steel, and let us establish that the route through the mountain requires a lot of engineering work but less steel, and that the route around it takes more steel and less engineering. The problem, then, is to determine whether the society needs steel or engineering more. How can this be discovered? The other uses of the two factors must be known.

Consider engineering. It is the foundation of modern industry. There are immeasurable known uses for it (and even more that are unknown!). What if, it might be asked, more tractors are made instead of the railroad, as they might be more beneficial? How can this be known? With more tractors, there could be a larger output of goods that require the use of tractors. But these are usually not final goods, but various crops in their raw forms, so it is not known how much these would increase the utility of people. We have to go further down the chain of production: it must be known how much the increased crop yield would benefit the industries that use them (such as livestock farms, canning factories, restaurants, mills, etc.). It needs to be realized that an increase in the quantity of tractors affects a huge number of processing industries that serve the consumer in a wide variety of ways. In the end, what the consumers think about these alternative uses of more tractors, manifested as final products, would need to be known. The citizens would presumably have to be asked for their preference between the railroad route and every existing and potential food and drink item whose production at some point involves a tractor. But in this case, the same process would have to occur with every existing and potential use of engineering as a means of production, not just tractors, since engineering can also has many other applications. (Of

course, this assumes that collecting the data of people's preferences is technically feasible, despite the known fact that there are various obstacles that prevent the acquisition of some basic information. It would be wrong to assume that a person expresses the same pattern of preferences under surveying conditions as he would when acting under real circumstances. He might answer carelessly, just to get the survey over with. It may even be in his interest to falsify a survey.)

The same exercise can be done with steel. Social welfare might be increased in millions of ways using steel, not just by laying down rails. For example, frying pans might be made out of it. But how important are frying pans? In order to know this, we would have to know how much every consumer (and potential consumer) of frying pans would value more pans. If, for example, the people have various kinds of frying pans, they might want the railway between the two cities more than an additional pan. But if they have nothing to cook scrambled eggs in but would happily go from city A to city B on foot, they would probably want the pans more. And we must consider not only consumer goods, but the staggering multitude of production goods made of steel (machinery, for example), not to mention those consumer goods that can be created with production goods made of steel.

Add technology to this problem, which, although in a free market society is a blessing, in this case appears to be a great problem. In *Human Action*, Mises writes: "It is permissible to say that the present state of technological knowledge makes it possible to produce almost anything out of almost everything" (p. 695). A couple of lines later he gives the example of tap water: in modern society, we gain drinkable water by cleaning local water deposits or by using expensive aqueducts to transport spring water to the cities. But with modern technology it is equally possible to produce drinkable water synthetically. Today, of course, people smile at such a suggestion, but only because they cannot even imagine a world without sensible economic planning. Water-supplying companies (mostly government owned in Europe) can choose these efficient means of "producing" and transporting clean water, because market prices make these solutions the most economical for them. Without such guidance, they would have no idea whether to build huge cleaning facilities or synthetic water "factories," or which

option deprives society of the most precious resources relative to the “value” of output. There would be real chaos of production.

It is easy to see that even in this elementary example, with just two nonhuman factors of production, the examination of all their possible involvement in production would require that we know (1) who the possible consumers are and (2) whether they would prefer that a new railroad route be built or some other use of the factors and their resulting consumer goods. Here the problem is not, as the authors of *The People’s Republic of Walmart* wish to present it, to have a sufficiently accurate method of linear programming that could process the available data and solve the optimization problems before the data becomes obsolete. Rather, the problem is that in order to make just one economic decision we need to know all the preferences of all the participants in economic life. Just in the case of steel and engineering, we can say that we have to know all the latest thoughts of every consumer about every existing and potential consumer good. Due to the intertwining of production processes, almost all factors of production affect almost every other factor of production (and we have not even mentioned human labor, which is part of every production process and must be economized as well, since it is also a scarce resource). As a result, just to assess the extent of a few costs, we would have to be aware of all the thoughts of all the economic participants.

And here it is not enough, contrary to the authors’ assertion, to find partial solutions.<sup>2</sup> As will be seen later, a planning unit in a market economy can resort to such simplifications, but in our example, which is a genuine planned economy, what can be simplified? There is nothing precise to approach. In the case of a railway project, wasting a bit of steel or wasting a bit of engineering skill might not seem drastic, but if the methods and inputs are

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<sup>2</sup> As the authors write: “That’s the trick: to find the best possible, even if partial, approximations. Amazon’s modelers work to bring intractably complex problems down to size, to build plans that neither stretch into infinite time, nor respond to all the possible random events that could happen at every step, but that simply work. This means coming as close as possible to the true answer of a planning question within a realistic time frame and with the use of available computing power. When it is impossible to use an ‘algorithm of algorithms’ to mechanically find the algorithm that best approximates the original problem, creativity then comes into play” (Phillips and Rozworski 2019, 34).



chosen randomly, or just without precision, in every conceivable line of production, soon society will find itself with shortages of resources that can have catastrophic consequences.

The book is noticeably quiet about the failures of socialist attempts at solving this problem. We can read about Otto Neurath's brave revolutionary deeds (Phillips and Rozworski 2019, 10), but his central "calculation in kind" idea, which has long been debunked, does not appear. Marx's and Engels's critiques of capitalism rage through the pages (*ibid.*, 27), but the "labor theory of value" that they advocated is not discussed. In fact, all these previous failures point to the central distinction between economic planning and a planned economy: money prices.

If a railway company is in the hands of a private entrepreneur, he has every incentive to choose the method of construction with the lowest monetary costs, assuming the same utility to the consumers (the total income of the project in monetary terms), in order to achieve the highest degree of profit. However, this also serves society best. What does it mean that engineering is too expensive? It means that other participants in the market (for example, farmers) are willing to pay engineers more. The reason for this is most probably that the farmers' consumers (producers of foodstuffs) are willing to pay *them* more for their goods (crops). These producers of lower-order goods, in turn, are willing to pay more, because their own customers are willing to pay more for their final goods (foodstuffs). In accordance with the marginalist theory of value elaborated by the founders of the Austrian school, such as Carl Menger ([1871] 2007, 114–65), a change in consumer demand (at whichever stage of production it may occur) creates a signal for producers at higher stages that tells them which needs are to be satisfied more and which less urgently. A rise in the price of engineering means that engineering is being used in production processes that are creating goods which the consumers urgently need, and thus only producers satisfying even more urgent needs may acquire it.

The price system, based on the maximization of profit and utility, seemingly coordinates economic participants without any planning. Looking at the big picture, this is certainly true. Yet planning as such not only does *not* disappear, but is *only* possible in a free market environment. The Austrian thinkers, such as

Hayek (1945), were right in calling the price system a system of information sharing. The price system does nothing more than divide a kind of mental labor between several miniature “planned economies,” mental labor that could not be carried out by a single, publicly owned planned economy. Its tool for this task is money. Money provides the common denominator which the socialist thinkers were unable to invent. It is the tool which enables market participants to use accounting methods to compare the incomes and costs of their activities, and to plan their future steps accordingly (Mises 1949, 230). It is at this level that the important act of economic planning happens. Accounting is how corporations, governmental organizations, nonprofit organizations, the army, the police, the nationalized schools and hospitals, every level of human organization is able to solve its planning problems: via money prices established by the market process based on the private ownership of the means of production. This holds true, of course, only if the preconditions of the formation of a market price are satisfied. In the case of the armed forces, police, and other governmental monopolies, the consumers do not get to decide the price which they would be willing to pay for these services, and as a result prices of production factors employed in these branches (such as policemen’s and soldiers’ wages or the prices of various weaponry) can’t accurately reflect their value relative to other resources, leading to waste. (Later the reason such a monopoly (be it governmental or private) on factors of productions would impede the economic actor’s ability to determine their prices will be explored.) It is fair to say, therefore, that although governmental monopolies *can* calculate with money prices, their presence in the economy in fact obstructs the economic calculus (on a long-term basis, as opposed to private monopolies, whose errors in calculation are not compensated by taxation).

The authors fell into the same trap as earlier socialists. The difference is that while the authors discuss large firms, earlier thinkers spoke about governmental bodies, since earlier in history those organizations were the largest economic units without an inner market. Mises ([1922] 1981, 136), however, showed that government institutions’ ability to calculate is only due to the market surrounding them:

State and municipal enterprises calculate with those prices of the means of production and of consumption goods which are formed on the market. Therefore it would be precipitate to conclude from the fact that municipal and state enterprises exist, that socialist economic calculation is possible.

The same principle applies to the modern case: considering that large corporations, however great the volume of their activity, plan in terms of market prices, corporate planning on a huge scale is not sufficient evidence for the feasibility of a planned economy without market prices. It would still be “just groping about in the dark,” using Mises’s (1949) words.

## II. SCALE AND DEPTH

Before it can reach the consumer (especially with today’s refined technology), a consumer good must go through several long stages of production. From the extraction of raw materials from nature through the various steps of manufacturing, time-consuming and complex processes are connected so that in the end some member of society may receive the final good or service. As has been shown above, the central management of the whole process would require complete knowledge—a supernatural if not impossible condition. But the reason for this is not the size of the economy or the greatness of cash flows occurring in it, nor the number of consumers. The constraint of a planned economy is not *volume*, but the *complexity* of alternatives.

Let Amazon and Walmart be as large as possible, even the sole monopolists of their industry on the entire globe. Still they could only coordinate their activities with market prices. True, their size would be gigantic, but this is not what makes economic calculation difficult. They are wide but thin slices of the entire system. And it is depth that really matters in calculation. Here it is worth mentioning the irony that the main activity of both Amazon and Walmart is the distribution of final goods. Mises (1981 [1922], 118) himself has pointed out in his works that the prices of (already available) consumption goods may be asserted even by a planned economy. Simply, the central planner should give money to the citizens and then hand out the final goods to the highest bidders. This is the

farthest a socialist community (with available final goods) may go as far as gathering information is concerned, and only because the prices are expressed in terms of privately owned money and this process is still permitted by our definition of a collectivist society (producer goods still remain common property, but money is private property).<sup>3</sup> It is clear from what has been said above that the real problem only starts with the possible uses of the available production goods, and with finding production methods that are yet unknown. The latter point is illustrated by Ericson (1991, 21) when he writes about the Soviet Union's tendency to only replicate the methods of production already used by capitalist firms and its inability pioneer such methods.<sup>4</sup>

Knowing this, the book's lengthy discussion about how complex and high-level technology is used by these corporations to find out the demand for different goods, seems only to be the knocking on an already open door. Moreover, the authors' description precisely backfires: trading with final goods is just the ending move of the process of production, and this already requires a huge and costly computing system based on complex mathematics from these mammoth firms. Yet all this is only one function. We must not be deceived by the multitude of products these firms are selling, because Walmart and Amazon fundamentally produce only one good: they link the producers with the final consumers. Huge scale, little depth. And in order to carry out this function they must align their activity with market prices, much like every other corporation. Every step toward the complete ownership of the market would make their tasks exponentially more complex,

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<sup>3</sup> Mises's example goes as follows: "True, a socialistic society could see that 1000 litres of wine were better than 800 litres. It could decide whether or not 1000 litres of wine were to be preferred to 500 litres of oil. Such a decision would involve no calculation. The will of some man would decide. But the real business of economic administration, the adaptation of means to ends only begins when such a decision is taken. And only economic calculation makes this adaptation possible. Without such assistance, in the bewildering chaos of alternative materials and processes the human mind would be at a complete loss. Whenever we had to decide between different processes or different centres of production, we would be entirely at sea."

<sup>4</sup> As he wrote: "The [Soviet] system has been particularly effective when the central priorities involve catching up, for...the problems of what to do, when and how to do it, and whether it was properly done, are solved by reference to a working model, by exploiting what Gershenkorn...called the 'advantage of backwardness.'"

since, as the example above showed, at every stage the number of different real and potential alternative uses of the factors multiplies until the point at which they would need complete knowledge. The need for calculation arises from the variety of alternative uses of the means of production. As long as this is solved by the market, Walmart can calculate how much income it has received from the suppliers who want to sell their goods at its stores (how high a need the members of society have expressed for the service rendered by Walmart), how much it had to spend on wages, capital goods, public utilities (how important the resources used up by its activity are to society), and how much profit these two leave (the difference between the valuation of its services and the resources used up). If all these were the property of Walmart, its efforts toward an efficient economic plan would also be in vain, since it would be unable to decide the most economical way of employing its production goods.

This problem is greatly elaborated in many relevant sections of Rothbard's *Man, Economy, and State* ([1962] 1970, 547–48), especially those highlighted by Klein (1996) concerning the constraints economic calculation imposes upon the possible size of business units. Here Rothbard shows that firms require markets in order to efficiently calculate and plan their methods of production and operation. If a firm integrates stages of productions, it is required to conduct transfers within its divisional units without the market. If the managers want to know how profitable the operations of and transfers between the various units were, they have to use some kind of reference price in the accounts of the units. When a market of the transferred factor exists outside the firm, they can use its price as a "substitute price," which helps them determine costs and thereby the most efficient methods of production. But if such a market does not exist, if, for example, the firm in question is the sole owner of the factors of production, then the managers have a very small chance of accurately determining the opportunity cost of the factors. This would result in gross misallocation of factors of productions, meaning not only losses on the firm's accounts but also a wasteful, inefficient management of society's resources. Rothbard argues that this problem forms an upper boundary on the size of the firm. The greater its share in the ownership of a factor of production, the less accurately it will be able to determine

the factor's opportunity cost, and the greater its losses will be on existing markets.<sup>5</sup>

There is no doubt that this is true in the case of Amazon and Walmart. It may well be, as the authors have noted, that Walmart is able to utilize the huge volume of its capital equipment without an inner market. As they write, “[t]he different departments, stores, trucks and suppliers [of Walmart] do not compete against each other in a market; everything is coordinated” (Phillips and Rozworski 2019, 12). But if Walmart were the only owner of trucks in the world (or if it were somehow isolated in a such way as to be oblivious of the costs of transportation determined on the market), the only way of vaguely deciding the costs of trucking in order to plan the feasible amount of capital used for this purpose would be to approximate based on some other mode of transportation that does have a market price—and this would still lead to great inaccuracies. The fewer the reference points for this approximation are, the more inaccurate the calculation will be and the greater the amount of wasted resources will be.

### III. ISLANDS OF TYRANNY

As it is evident from the first sentences of their introduction, the authors more or less had to explain themselves in front of their fellow socialists. After all, writing a revering book about two corporate giants is quite a foreign thought in the circles to which the book is mainly addressed. To avoid confusion, after every admiration of planning comes an establishment of the fact that both Amazon and Walmart use planning for profit-induced reasons characteristic of capitalist corporations. We can read at length about how the firms, after buying the time and energy of the working class (Phillips and Rozworski 2019, 26–27), use them as they please, and that the workers are forced into this dictatorial system because they would starve to death without a salary. The working conditions,

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<sup>5</sup> In Rothbard's words: “The force of this law multiplies as the area of the economy increases and as islands of noncalculable chaos swell to the proportions of masses and continents. As the area of incalculability increases, the degrees of irrationality, misallocation, loss, impoverishment, etc., become greater. Under one owner or one cartel for the whole productive system, there would be no possible areas of calculation at all, and therefore complete economic chaos would prevail.”

the authoritarian methods of force, the strict inner bureaucracy, the tools for the surveillance of workers are well detailed (Phillips and Rozworski 2019, 38). All this, of course, is attributed to the fact that despite being the living evidence of the possibility of planning, in a capitalistic environment all this efficiency benefits the capitalist class and oppresses the working class, which is forced into an autocratic system. They use the words of Noam Chomsky, who claims that firms, contrary to the “black box” concept of standard microeconomics and the cooperation models of business economics, are indeed “Islands of Tyranny.”

These are perhaps the most ironic parts of the book. The book’s main idea is that large corporations prove the viability of a planned economy, but its authors are forced to accuse these very examples of “planned economy” of using autocratic methods. And this, most ironically, they blame on the market economy surrounding these corporations. For those familiar with the ideas of Austrian economics it might be obvious that the case is just the other way around. It is easy to derive from what has been said above that the whole point of a market economy is to minimize the amount of planning necessary for an efficient economy. This is the “mental division of labor” of the market. It coordinates personal and organizational plans the central and complete coordination of which would take supernatural powers. However, the top-down organized hierarchical structure is an indispensable element of every planned economic process.

It seems expedient to mention here one of the most crucial chapters in *The Road to Serfdom*, “Planning and Democracy” (Hayek [1944] 2001, 59–74). In this chapter, Hayek clearly explains that in every planning process only one plan may exist and that it has to be one concrete aim. In such a process we are looking for a democratic element in vain. Every participant who opposes the plan constructed by the experts is sabotaging its realization. And if we want to plan the entire economy, there is no room for coexisting inner plans, either. There cannot be a separate steel industry plan, which contradicts the agricultural plan or the infrastructural plan. This leads to the centralizing nature of planning: in the end, only one plan can prevail. Under such conditions, it is impossible to create a consensus between people’s different motives, aims, and moral judgments. At most we can create an outcome which would not satisfy anyone. As Hayek explains:



That planning creates a situation in which it is necessary for us to agree on a much larger number of topics than we have been used to, and that in a planned system we cannot confine collective action to the tasks on which we can agree, but are forced to produce agreement on everything in order that any action can be taken at all, is one of the features which contribute more than most to determining the character of a planned system. (Hayek [1944] 2001, 65)

Speaking of “islands of tyranny,” the authors only listed those attributes of planning that are required for the realization of a certain goal. We know from business economics that the nonmarket inner world of a firm necessitates a high degree of harmony among its workers. If the experts at the top of the company have set a goal of opening a new plant, lessening administrative costs, installing a new technical system, changing some aspect of production, or anything else, every employee has to adjust his activity according to the company’s plan. Otherwise, they would sabotage the plan. In such a case, the leadership may choose to penalize lack of cooperation through the withdrawal of certain grants or privileges, by firing the employees or even starting lawsuits against them. But none of this originates from the profit motive of capitalism: it is inherent in planning as such. Profit only tells the managers how they can serve best the consumers as far as profit in a competitive industry represents the difference between the high valuation of the produced good and the low valuation of the factors of production used up. This profit system is not, however, what requires the centralized command structure, but firms have to employ undemocratic means precisely because they are the only effective way of carrying out a plan.

It would be mistaken to think that a completely planned economy would have not less but more democratic elements. The intertwining of production processes demands the cooperation of every part with every other:

A complex whole where all the parts must be most carefully adjusted to each other, cannot be achieved through a compromise between conflicting views. To draw up an economic plan in this fashion is even less possible than, for example, successfully to plan a military campaign by democratic procedure. As in strategy it would become inevitable to delegate the task to the experts....But the ends of an economic plan, or of any part of it, cannot be defined apart from the particular plan. It is the



essence of the economic problem that the making of an economic plan involves the choice between conflicting or competing ends—different needs of different people. But which ends do so conflict, which will have to be sacrificed if we want to achieve certain others, in short, which are the alternatives between which we must choose, can only be known to those who know all the facts; and only they, the experts, are in a position to decide which of the different ends are to be given preference. It is inevitable that they should impose their scale of preferences on the community for which they plan. (Hayek 2001 [1944], 68)

It must not be denied that in the final sentences of the book, the authors themselves gave voice to the concern that the idea of a planned economy arouses in people:

It is not enough to say, "Nationalize it!" We have to think hard about how to ensure that the already enormous amounts of information controlled by large, unaccountable corporate bureaucracies do not become the basis for new unaccountable bureaucracies (state-run or otherwise). As the two twins of undemocratic planning, Soviet Union and Walmart, show, planning on its own is no synonym for socialism. (Phillips and Rozworski 2019, 103)

However, all these concerns are naively set aside as the matter for some other book. After this paragraph, a remarkably humorous quotation (at least for an Austrian scholar) follows by Friedrich Engels, who expresses his deep contempt against all those who call every planned system "socialistic." He says that if this were so, then "Metternich and Napoleon would be counted as the founding fathers of socialism," and "the Royal Maritime Society and the nationalized Royal Porcelain Manufactures could all be called chief socialist institutions." To the advocates of a free market economy, the elaboration of the irony surrounding these sentences is not necessary.

## CONCLUSION

The economic calculation debate was perhaps the most important debate of the entire history of economic science. It has moved such brilliant minds that it is safe to say that the problem has been processed to such an extent that practically everything has already been said about it. Neurath, Böhm-Bawerk, Lange, Hayek, Lerner, Mises, and Dickinson have examined this area in such detail that

the following generations only have to pull one of their works from the shelves in order to come across an answer for almost any question about it. In order to counter every collectivist supposition, it is enough to find out where in the twentieth-century debate we have to “look closer.”

To *The People's Republic of Walmart* we can assign several such dates, but certainly to its early sections, since in them even the necessity of money prices is missing, which neosocialists (such as Oskar Lange and Abba P. Lerner) have already discovered. The ideas in Hayek's *The Road to Serfdom* about economic planning, well-trodden ground, are also absent. But implicitly we can find the tendency characteristic to the economic calculation debate, namely that in every one of its stages the debate has approached step by step the triumph of the market economy. It is a history of constant concessions: first the collectivist idea of the common ownership of consumer goods had to be discarded, then the untenable ideas of the labor theory of value and the elimination of the market, and finally the entire idea of the public ownership of the means of production. It is a slow awakening from a deep slumber, in which during every doze we have to shake the dreamers awake. In the words of Ludwig von Mises:

The socialists cannot help admitting their crushing final defeat. They no longer claim that socialism is matchlessly superior to capitalism because it brushes away markets, market prices, and competition. On the contrary. They are now eager to justify socialism by pointing out that it is possible to preserve these institutions even under socialism. They are drafting outlines for a socialism in which there are prices and competition. (Mises 1949, 702)

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## BOOK REVIEW

### RIBATARIANIZUMU: AMERIKA WO YURUGASU JIYŪSHIJŌSHUGI (LIBERTARIANISM: THE ULTRAFREE- DOMISM SHAKING UP AMERICA, PUBLISHED ONLY IN JAPANESE)

YASUSHI WATANABE

TOKYO: CHUOKORON-SHINSHA, 2019, 213 PP.

JASON MORGAN\*

Libertarianism never really caught on in Japan. That is strange when you stop and think about it. For a country that was ruled by a military dictatorship for six hundred years, it might seem that “Freedom!” would be on the lips of every man, woman, and child whose ancestors suffered for centuries under the yoke of martial law.

And yet that’s not at all how things stand here. “Military dictatorship” and “martial law” probably conjure up images of Suharto, Robert Mugabe, and Michael Bloomberg, but the rule of the samurai was not the typical reign of ideological terror. It is a cliché but still

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true to observe that Japanese society has traditionally placed a premium on *wa*, variously translated as “harmony,” “concord,” and “getting along well with the neighbors.” *Wa* is a very nice thing, and as a longtime resident of Japan I have come to value it highly. There is not much need for a tinpot dictator when folks tend to prioritize good order and mutual friendliness on their own. There are just as many opportunities here as anywhere to think of one’s fellowmen in a less-than-charitable way (translation: Japan, too, has dolts and ingrates), but people in Japan are usually very good about putting the long-term *wa* of the community above the fleeting satisfaction of insisting on having things all one’s own way. Freedom is just not a big factor in the day-to-day social equation.

In fact, “freedom” has traditionally had a somewhat negative connotation in Japan. The word *jiyū*, which is used to translate “freedom” was coined only as the military dictatorship was crumbling in the latter third of the nineteenth century and Western tracts on liberalism and liberty were beginning to be widely studied in Japan. *Jiyū* is a very common word today, but if one squints and looks at it with a pinch of historically grounded skepticism it begins to seem quite odd. “Doing whatever you want” is a rough literal translation of *jiyū*—not at all the ideal in a country where a much older and more common expression goes, “the nail that sticks up gets hammered down.” Far from being an absolute condition of human life, “freedom” in Japan has almost always been, not even an anomaly, but simply off the radar. Duty and honor have traditionally been valued, and “doing whatever you want” was not really anyone’s ideal.

For all these reasons it is a surprise that Watanabe Yasushi’s fine introduction to libertarianism—a phrase which is translated even more provocatively as “ultra-do-whatever-you-want-ism” (*jiyūshijōshugi*)—has turned out to be one of this year’s steady sellers. Watanabe completed his PhD at Harvard and is a highly respected interpreter of all things American for highbrow Japanese readers. Watanabe also writes regularly for *Chūō Kōron*, a prestigious big-ideas journal with a storied history in Japan. So, the author’s sterling reputation as a public intellectual surely does not hurt his new book’s numbers on Amazon. But it still takes one aback to find that there is such a big reception to libertarian ideas here.

Perhaps this should not be so surprising, however. In a discussion I had with Watanabe earlier this spring, he told me that the book had found a big audience mainly among Japanese young people. Aha. Now it was starting to make sense. The Japanese economy has been circling the Keynesian drain for more than twenty years, and politicians have tried and tried the only Keynesian method available for plugging a hole: pumping more water into the tub. Needless to say, this has not worked. Young people enter an economy badly bruised by political-economical hijinks and worry that their future is not as bright, the way forward not as secure, as were the prospects which greeted their parents and grandparents a generation or two ago. Libertarianism makes broad sense to those who will now have to pick up the pieces after Keynesianism's bone mauling of the Japanese economy. In a system that is transparently rigged to benefit the politically connected, "ultra-do-whatever-you-want-ism" does not sound half bad at all.

There is something else, too, one suspects, which may be keeping Watanabe's latest book on the shelves here. Before the election of Donald Trump—indeed, right up until the hour of his victory over the Faerie Queene of Keynesianism herself—the Japanese press and soi-disant intelligentsia tended to know virtually nothing about America beyond what they could find in the *New York Times*. The news about my homeland here was pretty thin gruel, long on Washington process and Wall Street speculation but very, very short on the genetic makeup of the American mind: namely liberty. After Donald Trump won the White House, sober journalists (yes, they still have those here—eat your heart out, CNN) began searching for the real America, and honest intellectuals started venturing beyond the East and West Coast elitist enclaves to find out what the rest of the country had to say. Libertarianism has been part of America since before the beginning, and anyone who knows America knows, if not Lysander Spooner, then at least Ted Nugent. But this giant swath of Americana has completely passed the Tokyoite America hands by.

Not Watanabe, though. He has long been a thinker of great integrity and an above-board observer of the US, and all of this made him a perfect candidate to research and report on libertarianism in America. His new book is a model of fairness and in-depth investigation. He visited the various headquarters of libertarianism

in the States, including the Mises Institute, and interviewed people working there. There are many misconceptions about libertarianism, both in the US and in Japan, but Watanabe has done his level best to dispel them. For example, he allows Jeff Deist and Mark Thornton to have their own say about what the Mises Institute is and what it does. He also counters the pernicious lies of the Southern Poverty Law Center about “white supremacy” and various other slanders against libertarians in general. Watanabe is an intellectual historian of the first rank and is the ideal person to introduce libertarianism to a country that has not heard much that is good about it in the mainstream press (I refer, of course, to the United States, but I hope Watanabe meets with much success in Japan, too).

As far as Japan goes, perhaps Watanabe’s book will contribute to a revitalization of the Japanese economy and to a rebirth of the country’s vibrant innovative potential and creative thinking. In a strange way, studying libertarianism may also help historians to rethink the Japanese past. The fact that there was no word for freedom in Japan may mean that there was no concept of it—or it could mean that the concept was so embedded that there was no need to make it explicit. After all, whatever the word for freedom might be, everybody wants to be his own man. This is particularly apparent in Japanese aesthetics. The arts and artisans of Japan have *always* displayed the kind of new-and-old blending that make Japan great in so many ways, both culturally and commercially. An aspiring painter or tea ceremony practitioner might spend decades apprenticed to a master, but when the time is right, voilà, a masterpiece all his own. Likewise, pottery from the Jōmon period may be more than ten thousand years old, but it still conveys a sense of dedicated application of artistic genius and human whimsy that merges perfectly with whatever is coming out of the design studios of the top Japanese firms today. Maybe the Japanese have always been libertarians but just did not know it. Maybe freedom is in the DNA here, too. Indeed, seen in another light, *wa* implies freedom, presupposes it. (Why go to all the trouble of emphasizing harmony if it comes naturally anyway?) In discovering libertarianism, Japanese young people may be surprised to find that they are rediscovering their own country’s deepest traditions in a new way.

For the time being, the United States remains the world capital of libertarianism, and Yasushi Watanabe’s book on this very

Western-toned subject is the absolute must-read first step toward what will hopefully be a long and beautiful friendship between East and West.



## BOOK REVIEW

# UNPROFITABLE SCHOOLING: EXAMINING CAUSES OF, AND FIXES FOR, AMERICA'S BROKEN IVORY TOWER

TODD J. ZYWICKI AND NEAL P. MCCLUSKEY, EDs.  
WASHINGTON, DC: CATO INSTITUTE, 2019, 268 PP.

JASON MORGAN\*

Anyone who has been on a college campus these past few decades, or even skimmed a newspaper during that time, knows that American universities are in bad shape. Voices from inside the academy have become among the most forceful detailing the shipwreck of the humanities on the shoals of political correctness. Michael Rectenwald, Jordan Peterson, Nicholas Christakis, Bret Weinstein, Anthony Kronman, Peter Wood, Jonathan Haidt, and Amy Wax—all scholars with impressive resumes and educations at top-flight institutions—are just a few of the bellwethers who have tried warning the rest of the country that something is rotten in academe. (Peterson, for his part, is an academic whistleblower in Canada, but his Harvard years give him more than enough cachet

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to join the Americans in crying foul on US higher education. If anything, the situation in Canada is even worse.)

A little library work reveals that critiques of colleges are hardly new. Russell Kirk, who wrote regularly on higher education for *National Review*, was a jolly detractor of the hypocrites and pseudo-intellectuals whom he saw as running many American universities. (Kirk delighted in referring to Michigan State University president John Hannah, a poultry scientist, as a “chickenologist.”) David Lodge, Evelyn Waugh, and Kingsley Amis, among a score of others, have made colleges in the US and England the scene of much satire in novel form. H. L. Mencken famously called for American professors to be hanged. Thorstein Veblen excoriated the entire business of the American academy. And even before there were more than a handful of American universities of which to speak, Karl Marx was receiving letters from his father warning him to stop brawling in the pubs and hit the books instead. (Marx eventually had to transfer schools.) Universities, American and otherwise, have always, it seems, been down in the mouth.

So, why do we keep funding them? Why has funding for universities skyrocketed in the past half century? What do we expect to get from our tuition, tax subsidies, and mammoth student loan schemes?

These questions and more are taken up with all due scholarly regard in *Unprofitable Schooling*, a very useful volume edited by Todd J. Zywicki and Neal P. McCluskey and commissioned by the libertarianish Cato Institute in Washington, DC. The editors of *Unprofitable Schooling* have sagely assembled fourteen authorities with backgrounds in education history, education policy, economics, and law. Divided into three parts and eleven chapters plus an introduction, *Unprofitable Schooling* is the go-to book for anyone who wants to understand, in depth, the debates raging about why, and even whether (there are dissenters from the skeptics in the book, which ironically makes it very unlike academia itself), the academy is in such a sorry state.

Part I, “Historical Perspectives on Competition and Government’s Role in Higher Education,” begins where many diachronic debates about American universities either start or wind up: the Morrill Land-Grant Act. Jane Shaw Stroup’s chapter, “What Really Spurred the Morrill Act?,” and Richard K. Vedder’s contribution,

"The Morrill Land-Grant Act: Fact and Mythology," are very good at presenting the history of the federal government's insinuation into higher education. Vedder—an emeritus distinguished professor in economics at Ohio University and an adjunct scholar at the American Enterprise Institute—richly contextualizes the Morrill Act in the longer sweep of American history. "Expansive claims for the Morrill Act," Vedder argues, which claim for the Act a transformative, even legendary, status in the annals of the United States, "are, minimally, greatly exaggerated." (p. 31) Vedder shows through a bevy of facts, figures, and charts that the Morrill Act, and the general tide of federal meddling in higher education that it inaugurated, created the usual decline in quality that contact with the government elsewhere produces, along with "rent seeking... gone amok" (p. 62).

The many splendors of "rent seeking" (a phrase often repeated in *Unprofitable Schooling* and a practice that comes as naturally to bureaucrats as napping does to felines) are explored in great detail in part II, "The Current State of Higher Education in America." Here Daniel D. Polsby tackles the "runaway tuition phenomenon," Roger E. Meiners delivers the *coup de grace* to academic tenure, Zywicki and Christopher Koopman probe the mysteries of "the political economy of administrative bloat in American higher education" (building partly on Benjamin Ginsberg's 2011 book *The Fall of the Faculty*, about "administrative blight" on college campuses), and Scott E. Masten takes an optimistic look at "shared governance" and "academic bargains." Masten's chapter is particularly useful, as he is trying to get at the cause of administrative inefficiency while also calling for the preservation of a system that he argues has the potential to "respond to [a] new educational environment" (p. 193). (Masten is up against some stiff competition, though: Adam Smith, another early critic of higher education, lambasted shared governance in *An Inquiry into the Nature and Causes of the Wealth of Nations* ([1776] 1985, 428, cited p. 191n79).

The heart of the volume, and the pivot of the debate about universities in the United States, comes in chapter eight, "All Education Is For-Profit Education," the lead-off for part III, "Competition in Higher Education." In this seminal essay, reprinted in *Unprofitable Schooling* but which "originally appeared on the website of the James G. Martin Center for Academic Renewal on June 25, 2014"

(p. 197n1), the late Henry G. Manne, formerly dean of the George Mason University School of Law and eminent scholar at a dozen other universities and organizations besides, handily dismantles the myth that nonprofit education is any better than for-profit education, or that there is any such thing as nonprofit education in the first place.

In “All Education is For-Profit Education,” Manne—who in his 2014 piece was responding to a veritable onslaught by the Obama administration (which always knew how to protect enclaves of Democrat voters) against for-profit schools in favor of traditional party bastions such as state universities and private colleges—argues that what universities put in the nonfungible column of the balance sheet—tenure, cushy offices, light (or no) teaching loads, long sabbaticals, early retirement, fancy on-campus dining facilities, faculty lounges, banker’s hours, research funds, and the like—are very much profits in their own right. “There is no such thing as a non-profit organization,” Manne declares. “What there is, of course, is a well-designed system of obfuscating the distribution of...profits” (p. 199).

This reminder that “nonprofit” is a smokescreen for other kinds of rent seeking is the rub of the question and the centerpiece of the book. The other three chapters in part III—Jayme S. Lemke and William F. Shughart II’s “Assessing For-Profit Colleges,” Michael E. DeBow’s “Public Policy and the Future of For-Profit Higher Education,” and David A. Hyman’s “Nonprofit and For-Profit Enterprise in Health Care: Birds of a Feather”—as well as several other chapters in *Unprofitable Schooling* engage with Manne’s thesis in some way.

Indeed, another way of arranging *Unprofitable Schooling* would have been to divide it into just two parts, Manne’s short essay and everyone else’s writings, because so much of the rest of the debate turns about the points that Manne raises. Time and again in *Unprofitable Schooling*, and in the much more voluminous literature about university (mis)management overall, the question is either implicit or glaringly obvious: who is the owner of a university? The answer is the same as for anything else: if nobody owns it, then it will go to the dogs (QED).

The lack of clear ownership of universities and the rent seeking that passes for the responsible husbanding of resources that one

would expect to find at other institutions have together been an unmitigated disaster for the United States, one that carries with it both obvious and not-readily-apparent social and financial costs.

For example, in the 2011 volume *Academically Adrift*, Richard Arum and Josipa Roksa found that most students learn virtually nothing during their undergraduate years. Graduate students, speaking anecdotally, surely learn even less. In my own experience I have found that a BA in a humanities subject is basically a certificate testifying to strength of liver and libido, while an MA or a PhD testifies to preparedness for socialist revolution. Whatever studying goes on in college is purely coincidental to the real mission, which is the perpetuation of a kind of tribe and the raising of funds to achieve it. This explains why attendance at football games generally beats attendance at philosophy classes by factors in the tens of thousands and why, when I graduated with a PhD from the University of Wisconsin in 2016, the fancy, gold-embossed black portfolio I received as I walked across the stage contained not a diploma, but an application to become a dues-paying member of alumni and boosters clubs. Like a government, a university produces nothing but more and more hangers-on, and an equal number of schemes for funneling cash to them.

And, if the Bennett hypothesis (named for Reagan-era secretary of education William J. Bennett) is correct—namely that government subsidies for higher education have produced tuition costs that long ago blew past average rates of inflation—then the political and financial consequences of saddling young people with essentially unrepayable debt will be much, much worse than the general uselessness of college itself. This hypothesis, and various opinions for and against it, are also explicated in *Unprofitable Schooling*, further increasing its value to the interested reader (see, e.g., p. 91). As politicians for national office float ideas of a debt jubilee for baristas with quarter-million-dollar gender and sexuality studies degrees from Swarthmore, it is vital that voters know that, according to many scholars, it is precisely the government that got us into the loan crisis to begin with.

There is much good information in this volume, but I wish that some of the chapters had been a bit more economical with the statistics and policy details. As an introduction to the literature on

education and economics, *Unprofitable Schooling* is hard to beat—especially, I suppose, because in some places it recreates the eyelid-drooping density of specialist journal work on the subjects at hand. However, better to have too much information than too little, and the clear structure of the book and of most of the chapters makes it easy for those who wish to glean argumentative thrust to do so without getting lost in the minutiae.

Higher education in the United States, and in much of the rest of the world, is in very bad shape. My own sympathies are with Manne, who I think scores a direct hit on the university administrators and their juicy cartel with his brilliant essay on “nonprofit” colleges. But before one can engage in a real debate, one must know the lay of the land. *Unprofitable Schooling* is an excellent guide, and will, hopefully, be the starting point for long-overdue reform.

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## BOOK REVIEW

# AMERICAN BONDS: HOW CREDIT MARKETS SHAPED A NATION

SARAH L. QUINN

PRINCETON, N.J.: PRINCETON UNIVERSITY PRESS, 2019, 289 PP.

PATRICK NEWMAN\*

This is a frustrating book. Quinn's *American Bonds* shows that the federal government's credit policies were important factors behind the particular evolution of securitization and credit markets in the United States. Quinn's historical narrative, from the country's founding to the present day, is intertwined with a brief overview of important business cycles and economic crises that affected credit markets, such as the Panic of 1819 and the 2008 financial crisis. Although Quinn investigates how federal legislation and institutions were important in facilitating the intermediation of credit in various markets, including in land, railroads, and mortgages, she completely omits an analysis of the policies' efficiency. She also fails to contribute to our understanding of whether the government was necessary for the formation and development of these particular

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markets or if private actors could have provided similar financial specialization in the absence of government involvement. In the end, *American Bonds* merely provides a historical overview of credit markets without seriously investigating whether the government's intervention was indispensable or weighing the costs and benefits of its involvement.

The main problem of the book is its theoretical framework. According to Quinn markets cannot function, let alone exist, without significant government assistance and intervention. Moreover, misguided government intervention does not promote inefficiency or economic recessions, because without government involvement the outcome would have been even worse. In fact, *laissez-faire* is “a utopian dream,” and “attempts to move into a *laissez-faire* world would mean deregulation, which inevitably causes instability, crisis, and human suffering, leading people to demand protection from the government” (p. 203). Although Quinn argues that free markets are an illusion, quite astonishingly this does not stop her from describing various financial markets as “*laissez-faire*” because they lack (or purportedly lack) direct government oversight. Quinn naturally leaves out the indirect oversight of those financial markets, such as the Federal Reserve's regulation of the banking system and its ability to inject credit into financial markets. Although Quinn utilizes the theories of Hyman Minsky and recognizes that “all bubbles depend on credit expansion,” expansionary monetary policy is surprisingly absent from the list of potential culprits in the start a boom (p. 27). Whenever the government does clearly contribute to a financial crisis, the escape hatch is that the unfettered market would have been much worse, so that in reality the government did nothing wrong. Quinn succinctly states her view when she discusses the recent 2008 financial crisis and the government's decades-long involvement in securitization of mortgages and cheap credit policies:

Does this all mean that the federal government is to blame for the crisis? After all...the government played a central role in keeping credit cheap, and cheap credit fueled the crisis. While it is a fair question, I nevertheless worry that it is a misleading one. It is obviously bad policy for a government to hit the accelerator on financial markets while also removing the brakes. Aside from the issue of whether this question deflects responsibility from Wall Street...it carries the unspoken



assumption of a world where advanced capitalist markets somehow exist without extensive government participation....the real problem was not regulation but overzealous deregulation. (p. 210)

Quinn's theory of markets and the indispensable nature of state assistance allows her to sidestep investigating the efficiency and possible adverse consequences of government policies. Thus, Quinn is able to write about the development of land sales on credit without questioning whether it was an important factor behind the land speculation that led to the Panic of 1819. More importantly, Quinn fails to discuss how the government's suspension of specie payments from 1814 through the post-War of 1812 era (with only nominal resumption in 1817) and the newly created Second Bank of the United States (established in 1816) were important factors in facilitating an increase in the money supply and a postwar boom. A similar lack of analysis is shown in Quinn's section on federal assistance to railroads in the post-Civil War era, because she does not link the generous loan and land assistance with the transportation companies' inefficiency and corruption (pp. 23–36).

Most aggravating are her overviews of the development of credit markets in the early twentieth century. Quinn champions the Federal Farm Loan Act of 1916, which established a system of land banks to lend to farmers. She documents the Treasury's subsequent assistance and describes how the banks had lent roughly \$350 million by the end of 1920. However, she does not link these actions at all with the difficulties that farmers experienced in the post-World War I era (pp. 82, 86–87). Could the new legislation, in addition to the European demand for US agricultural products during the war, have encouraged an overexpansion of farming and then delayed recovery by subsidizing agriculture after it was no longer needed in such large amounts? Quinn provides no answer. Quinn also neglects how other misguided government regulation in the housing market around this time gave a superficial indispensability to federal assistance. She recognizes that during the Progressive Era housing reformers advocated new construction codes that were important factors in driving up building costs beyond the increase in consumer prices, as well as how the war increased the profitability of manufacturing relative to the real estate market and led to rent controls and prohibitions on the construction of houses. However, Quinn then documents the government's subsidization

of home construction through the Army's Ordinance Department, the Emergency Fleet Corporation, and the United States Housing Corporation without ever raising the possibility that the government created the crisis that the public and intellectuals came to believe only it could solve (pp. 92–93, 99–103). Instead, "the defenders of laissez-faire had good reasons to be worried," because there was a clear need for the government to step into the breach (p. 103).

Overall, although this book provides important empirical information on the development of credit markets and various related government programs, it lacks a serious theoretical and interpretative framework.

## BOOK REVIEW

# THE ECONOMISTS' HOUR: FALSE PROPHETS, FREE MARKETS, AND THE FRACTURE OF SOCIETY

BINYAMIN APPELBAUM

NEW YORK: LITTLE, BROWN AND COMPANY, 2019, 439 PP.

DAVID GORDON\*

Binyamin Appelbaum is unhappy. He is the main writer on economics for the *New York Times*, and he thinks that economics has taken a wrong turn. In the first half of the twentieth century, economics was appropriately progressive. The free market was considered to be good, but only if severely restricted. It had to be constrained by a rigid institutional framework and guided by the state to promote research, help workers subject to exploitation by heartless monopolists, and prevent mass unemployment, among many other things.

All this changed beginning around 1950. Nefarious free market economists no longer recognized the limits of the market. "But a revolution was coming. Economists who believed in the power and the glory of markets were on the cusp of a rise to influence that

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transformed the business of government, the conduct of business, and, as a result, the patterns of everyday life.” (p. 4) Instead, these economists sought to show that antisocial behavior such as predatory pricing promoted efficiency. In doing so, they acted at the behest of powerful economic interests who did not want to be restricted and resented high taxes. Concerning a famous paper by Armen Alchian and Harold Demsetz he says, “A footnote told readers the professors had reached these conclusions with funding from the pharmaceutical giant Eli Lilly” (p. 14). (By the way, the summary of the paper’s argument that Appelbaum offers shows little understanding of it (p. 340n.33).) Among these economists, Milton Friedman stands out as the main villain.

An objection at once comes to mind, but Appelbaum has anticipated it and has an answer. Certainly there were free market economists in the years after World War II, but were there not also Keynesians who continued to be progressive? Were not Chicago, Virginia, and UCLA matched by Harvard and MIT on the other side? (Appelbaum is aware of Austrian economics but devotes much more attention to Friedman and his colleagues.) Appelbaum answers that the “leftists” of Harvard and MIT conceded too much to the free market arguments. For Appelbaum, even the quintessential Keynesian Paul Samuelson has let down the side. On many issues, he was hardly better than Friedman. “Even liberals like Paul Samuelson and James Tobin regarded unions as cartels and insisted that minimum wage laws increased joblessness, a consensus that made it easier for politicians to attack unions and ignore wages” (p. 326). At Henry Manne’s law and economics programs for judges “some of the judges asked Manne to explain the difference between the liberal and conservative economists ‘since Paul Samuelson seemed to be teaching the same economics as Armen Alchian.’” (p. 149)

Appelbaum’s arguments against the free market are not convincing. They do not in all cases lack merit, but they suffer from two fundamental failings. The first of these is that his arguments take this form, “The free market has such-and-such good features, but there are competing values which it neglects. That is why we need to bring in government to limit the market.” The trouble with this argument is that, even if you accept Appelbaum’s account of the competing values, he offers no systematic way of assessing the benefits and costs of the free market.

For example, he says that there are genuine benefits from free trade, and he explains this in a way that supporters of the market would readily accept.

The embrace of markets lifted billions of people around the world from abject poverty. Nations have been tied together by the flows of goods and money and ideas, and most of the world's 7.7 billion people live wealthier, healthier, and happier lives as a consequence...Markets make it easier for people to get what they want when they want different things, a virtue that is particularly important in pluralistic societies which value diversity and freedom of choice. (p. 6)

But, he says, people care about more than consumption. People care about production as well, and the free market in some cases ruthlessly sweeps aside people in industries that cannot meet foreign competition. He quotes Albert E. Kahn with obvious approval:

In a 1954 book, *Fair Competition*, he defended the idea that the government should protect small business at the expense of consumers. "One cannot simply equate the 'public interest' in a democracy with the 'consumer interest,'" he wrote. Adam Smith had famously asserted that consumption was the purpose of production. Kahn rejoined that this was "not true, even though Adam Smith said it." People, he wrote, also had interests as producers and as 'citizens of an urbanized civilization.' It was not good for a factory town to lose its factories. (p. 172)

Suppose that this is right. I do not think it is right, because people have no right to have their current jobs guaranteed by the government, but let us put this aside. Appelbaum offers nothing but his own hunch that the free market needs to be curbed for the reason he states.

How might Appelbaum reply to this objection? His answer is that people should decide democratically how the values of the free market should be balanced against competing values. This is an odd response, because Appelbaum himself recognizes that special interest groups often use the government to advance their own ends, though he resists the implications of this point. He says,

In 1971...[George] Stigler wrote, "regulation is acquired by the industry and is designed and operated primarily for its benefit." The innovation in Stigler's paper was his conclusion that government should stop trying. Criticizing regulators for protecting business, he wrote, "seems to me exactly as appropriate as a criticism of the Great Atlantic and Pacific Tea Company for selling groceries."

The historian William J. Novak has described Stigler's call for government to surrender as a remarkable departure from the American political tradition...Generations of legislators...wrote rules, and when those rules came up short, they tried to write better rules. Stigler was proposing to trust markets instead. (p. 165)

Appelbaum's argument is incredible: never mind the evidence that special interests capture the government. Regulation *must* be in the public interest because "we" traditionally have believed this.

Why should we think that a "democratic" vote reflects accurately people's preferences? If the special interests control the government, does it not make more sense to limit government rather than to enhance its powers? Far better, as Mises pointed out, are the dollar votes of free market consumers. As Mises remarks in *Human Action* ([1949] 1998, 741),

It would be more correct to say that a democratic constitution is a scheme to assign to the citizens in the conduct of government the same supremacy the market economy gives them in their capacity as consumers. However, the comparison is imperfect. In the political democracy only the votes cast for the majority candidate or the majority plan are effective in shaping the course of affairs. The votes polled by the minority do not directly influence politics. But on the market no vote is cast in vain. Every penny spent has the power to work upon the production processes.

There is a further problem with Appelbaum's "democratic" response. It transpires that he is hardly a democrat at all. He thinks that businesses can readily manipulate the ignorant consumer.

Some economists still deny that people are confused by inflation, or at least that such confusion has significant consequences. Meanwhile, in the real world, movie studios take advantage of inflation to advertise box office records—which are records only in nominal terms, since no movie has ever surpassed *Gone with the Wind*—because the studios think that people are confused by inflation. It seems likely that Hollywood has the better handle on human nature. (p. 364n.108)

People are irrational and must be protected by the government, acting as their guardians. Why we should trust the government to do this he does not say.

Appelbaum is caught in a contradiction. If people are too irrational and uninformed to resist business propaganda, why should they be trusted to elect public-spirited leaders through democratic voting? Murray Rothbard long ago called attention to this faculty. In *Man, Economy, and State* ([1962] 2009, 886), he says:

the partisans of intervention assume that individuals are not competent to run their own affairs or to hire experts to advise them, but also assume that these same individuals are competent to vote for these experts at the ballot box. They are further assuming that the mass of supposedly incompetent consumers *are* competent to choose not only those who will rule over themselves, but also over the *competent* individuals in society. Yet such absurd and contradictory assumptions lie at the root of every program for “democratic” intervention in the affairs of the people.

Let us now turn to the second of the fundamental failings in Appelbaum's assault on the free market. He often blames the free market for the failures of government. In the most glaring instance of this fallacy, Appelbaum rightly notes how many of our current economic problems stem from risky speculation by banks. Why does he consider such speculative ventures, made possible by fractional reserve banks joined in the Federal Reserve System, a failure of the free market rather than a government failure? Oddly enough, in criticizing bank speculation in Iceland, Appelbaum cites an article by Philipp Bagus and David Howden that appeared on the Mises Institute website. These excellent economists have presented their analysis in a short book, *Deep Freeze: Iceland's Economic Collapse* (2011). It did not occur to him to ask whether the commodity standard defended by these authors, rather than a policy of monetary expansion sponsored by the government, is the true free market view. He ought to read Dr. Ron Paul's *End the Fed* (2009).

Appelbaum's book is not without value. He has done a great deal of research and he has a good eye for anecdotes. But as a criticism of the free market, the book is a manifest failure.

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## BOOK REVIEW

# THE GREAT REVERSAL: HOW AMERICA GAVE UP ON FREE MARKETS

THOMAS PHILIPPON

CAMBRIDGE, MASS.: HARVARD UNIVERSITY PRESS, 2019, 343 PP.

DAVID GORDON\*

Thomas Philippon, a French economist who teaches at New York University and advises both the US and French governments, likes the free market. He says:

Economists like competition for several reasons. The first reason is that competition pushes prices down, since the most direct way for a company to increase its market share is to offer a lower price than its competitors...In a competitive market, firms seek to attract customers not only by reducing prices, but also by offering a wide menu of quality goods and services. Competition leads to more choices for consumers as businesses cater to different segments of the population and then try to differentiate their products from those of their competitors. (pp. 18–19)

Given the manifest superiority of competition as a way to allocate scarce resources, why don't we have a fully free market? Philippon knows the answer: "The lack of competition is explained largely

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by policy choices, influenced by lobbying and campaign finance contributions...[A]cross time, state, and industries, corporate lobbying and campaign finance contributions lead to barriers to entry and regulations that protect large incumbents" (p. 9). He discusses in great detail lobbying and the influence of money on politics. These ways of interfering with the free market help to explain the "great reversal." Most people think that America has a freer and more competitive economy than Europe, and for the most part this is right. In some goods and services, though, such as air travel and cell phone plans, Europe has a freer economy and lower-cost products than we do, and this latter fact is what he means by the "great reversal."

The way to proceed seems obvious. Government should stay out of the economy. In that way competition, unhindered by the "regulatory capture" of government agencies by entrenched interests, will be able to satisfy consumer demand.

Philippon unfortunately does not accept this simple view. As readers of the book will quickly discover, he is a convinced technocrat who cannot restrain his desire to "improve" the free market. To attempt to do this requires many technical tools, and he explains these with great enthusiasm. You will learn all you ever wanted to know about the Herfindahl-Hirschman index, Tobin's  $q$  and the fundamental law of investment, the North American Industry Classification System (NAICS) way of classifying industries, and other arcane matters.

What is the problem with the simple view? Sometimes, Philippon says, large firms take over too much of the market for their product, and the government needs to break them up. By no means does he think that large firms are always bad. To the contrary, they sometimes become large by giving consumers what they want:

The growth of Walmart provides us with an example of efficient concentration. Its profit margins remain stable or even decline, and, most important, prices go down. Consumers benefit from Walmart's expansion. It is fair to debate and challenge Walmart's labor and management practices, but there is little doubt that Walmart has been good for US consumers. (p. 34)

Sometimes, though, concentration as Philippon measures it does not have such beneficial results. Why not? "If the industry is

competitive, the price must equal the marginal production cost—the price to build one extra car or to produce one extra ounce of chocolate....[W]hen firms have market power[,] [t]he price is now above the marginal production cost” (pp. 27, 29). In this sad circumstance, “consumer surplus” is less than it could be. Hence the government might need to take corrective measures. As is usually the case with Philippon’s presentation of his views, this requires qualification. It’s often very hard to establish whether an industry is concentrated and, if it is, whether the concentration is “efficient.”

From an Austrian perspective, we have to distinguish two cases. Is the industry concentrated because the government has granted certain firms special privileges that enable them to exclude or restrict competition? Then, there is indeed a reason to act. These measures must be repealed. Matters are different, though, if firms do not get special privileges from the government but simply fail to generate enough “consumer surplus.” This is an artificial standard imposed on the free market, and Austrians reject it.

Philippon does not mention the Austrian view, but he does note a Chicago school position that is different from his own: “an idea from the Chicago School is that high concentration does not necessarily imply market power as long as the threat of entry is real, that is, as long as the market is contestable” (p. 87). This idea makes perfect sense, and it is difficult to understand why Philippon is more demanding.

Philippon also fails to confront another problem for his view, one that he himself recognizes. Suppose that he is right about concentration. How can the government remedy the situation, given the probability of regulatory capture by the very entrenched firms that he wishes to regulate? He has no answer to this, so far as concerns the US economy. He just hopes for the best.

He also embraces another idea at odds with the free market. He rightly notes that subsidies to particular businesses distort the market. If the government uses tax money to help a business, then the company’s success isn’t entirely a response to consumer preferences. Unfortunately, he takes “tax breaks” to be subsidies as well:

Lobbying for lower taxes is fundamentally inefficient because tax breaks create distortions in the allocations of economic resources, and because

someone else must then pay these taxes...You might think that lower taxes can have beneficial incentive effects...When economists advocate for lower taxes, we mean lower marginal tax rates on as broad a base as possible. The tax breaks obtained by lobbyists take the form of loopholes and rarely improve investment and hiring decisions. (p. 163)

Later in the book, Philippon condemns “corporate tax evasion, which is legal for the most part but costly and inefficient nonetheless.” (p. 263)

Murray Rothbard brilliantly exposed the fallacy of this view in *Power and Market* ([1970] 2009, 1219–20):

Many writers denounce tax exemptions and levy their fire at the tax-exempt, particularly those instrumental in obtaining the exemptions for themselves. These writers include those advocates of the free market who treat a tax exemption as a special privilege and attack it as equivalent to a subsidy and therefore inconsistent with the free market. Yet an exemption from taxation or any other burden is *not* equivalent to a subsidy. There is a key difference. In the latter case a man is receiving a special grant of privilege wrested from his fellowmen; in the former he is *escaping* a burden imposed on other men. Whereas the one is done at the expense of his fellowmen, the other is not. For in the former case, the grantee is participating in the acquisition of loot; in the latter, he escapes payment of tribute to the looters. To blame him for escaping is equivalent to blaming the slave for fleeing his master. It is clear that if a certain burden is unjust, blame should be levied, *not* on the man who escapes the burden, but on the man or men who impose it in the first place. If a tax is in fact unjust, and some are exempt from it, the hue and cry should not be to *extend the tax to everyone*, but on the contrary to *extend the exemption to everyone*. The exemption itself cannot be considered unjust unless the tax or other burden is first established as *just*.

Despite these problems, Philippon does have some good suggestions. He attacks occupational licensing with great force:

Geographic mobility has been declining for thirty years in the US. Workers are less likely to move between states and metropolitan areas than they were in the past. There are several plausible explanations for this trend. One of them is the steady increase in the number of workers whose occupations require some sort of license or certification... Licensing is always “officially” motivated by concerns for health, safety, and consumer protection. And sometimes it is legitimate. Often, however, it is the perfect way for incumbents to protect their rents.

Indeed, they actively lobby for the extension of lobbying requirements because they understand that these are efficient barriers to entry. (p. 283)

Attempts to restrict entry range far beyond licensing:

Entry in finance is also limited by heavy—and sometimes biased—regulations...Why did we get the bloated financial industry of today instead of the lean and efficient Walmart? As it turns out, Walmart applied for a banking license in 2005, but it was denied under—who would have guessed—heavy lobbying by bankers. (p. 216)

*The Great Reversal* should thus be read with caution. Philippon likes competition but, like many other technocrats, he thinks he can do better than the unhampered market economy. He cannot.

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## BOOK REVIEW

# SOCIALISM SUCKS: TWO ECONOMISTS DRINK THEIR WAY THROUGH THE UNFREE WORLD

ROBERT LAWSON AND BENJAMIN POWELL  
WASHINGTON, DC: REGNERY PUBLISHING, 2019, 192 PP.

DAVID GORDON\*

Robert Lawson and Benjamin Powell are well-known free market economists, and they do not look with favor on a disturbing trend among American young people. “In the spring of 2016,” they explain, “a Harvard survey found that a third of eighteen-to twenty-nine year olds supported socialism. Another survey, from the Victims of Communism Memorial Foundation, reported that millennials supported socialism over any other economic system” (p. 8).

Unfortunately, the young people in question have little idea of the nature of socialism. Lawson and Powell would like to remedy this situation, but they confront a problem. Ordinarily, one would urge students to read Hazlitt’s *Economics in One Lesson*, Mises’s “Economic Calculation in the Socialist Commonwealth,” and

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similar classic works, in order to understand the basic facts about the free market and socialism, but the millennials are unlikely to do so. One must attract their attention. What can be done?

Lawson and Powell have had the happy idea of presenting elementary economics in a humorous way that will appeal to those “turned off” by serious and sober scholarship. In the latter adjective lies the key to their approach. Both of the authors enjoy drinking beer, and they travel around the world to various socialist countries in pursuit of their beloved beverage, making incisive comments about the economy of each country as they do so. They write in a salty style that will make millennials laugh, though some readers will find it jarring.

For the young, “socialism” means no more than vague ideas about “fairness,” but, the authors note, the term has a precise meaning: “To separate the state from socialism in any large society is like trying to separate private property from capitalism. It can’t be done. I’ll say it once more for the people in the back: socialism, in practice, means that *the state owns and controls the means of production*” (p. 128). No country is completely socialist, but some are more socialist than others. How can the degree of socialism be evaluated? Lawson has, along with James Gwartney, produced an annual economic freedom index for the Fraser Institute, which the authors use to answer this question, sometimes with surprising results.

Many professed socialists look to Sweden for inspiration, but according to the freedom index “Sweden gets a 7.54 rating, which is good enough for twenty-seventh place out of the 159 countries in the study...Bottom line: Sweden is a prosperous, mostly capitalist country” (pp. 10–11).

The authors must now confront an objection. Why should we not prefer welfare-state capitalism to the straightforward free market economy the authors want? They reply that Sweden prospered under freedom but that the increased taxation needed to finance the welfare state has brought about stagnation. “Sweden grew most when it was freer than it is today” (p. 13).

If some people admire Sweden, few except fanatics have good words for the economy of Cuba. Nevertheless, must we not recognize the wonders accomplished by the Cuban socialized medicine? We must give the devil his due. Lawson and Powell are not convinced.

Official Cuban health statistics are impressive... Yet, we also know that the hospitals most Cubans use are so poorly equipped that people often have to bring their own sheets. What gives? The silence [on the streets] is part of the answer. The lack of automobiles means a lack of traffic fatalities. Since automobile accidents are a leading cause of death among younger people, the lack of automobiles has a disproportionate impact on life expectancy statistics for reasons that have nothing to do with health care. The low rate of infant mortality is a product of data manipulation. (p. 53)

Why has Cuban socialism, like all other centralized socialist economies, failed? The authors present with great clarity the essential point:

almost a hundred years ago, the Austrian economist Ludwig von Mises explained that socialism, even if run by benevolent despots and populated with workers willing to work for the common good, could still not match capitalism's performance. Socialism requires abolishing private property in the means of production. But private property is necessary to have the free exchange of labor, capital, and goods that establish proper prices. Without proper prices, socialist planners could not know which consumer goods were needed or how best to produce them... Socialism also gives tremendous power to government officials and bureaucrats who are the system's planners—and with that power comes corruption, abuse, and tyranny. (p. 37)

Socialist tyrants were the greatest mass murderers in history, and the young must be apprised of this melancholy fact. "Stalin ranks just behind Mao as history's second greatest mass murderer, with Hitler coming in third—and all three dictators were, of course, committed socialists of one sort or another." (p. 115)

Some millennial socialists respond with a distinction: the despotic governments mentioned were not genuinely socialist. The authors answer with appropriate severity:

This is the same dirty trick socialists have played for decades. Whenever things go south, as they inevitably do, they claim that it wasn't "real" socialism. I [Lawson] find the whole thing more than a little disingenuous and very irritating. When socialists, democratic and otherwise, held up Venezuela as a great socialist experiment in the 2000s, the message was, "See, we told you so; socialism works!" But when the failure happened, the message changed to, "No, wait—that's not real socialism!" They want to claim socialism during the good times but disavow it during the bad. (pp. 127–28)



A related gross error, the famous “nirvana fallacy,” is to compare an ideal state of affairs conjured up by socialists with the difficulties of real-world capitalism.

If the authors are ready to rebuke the errors of misguided youth, they look with sympathy on some of their hopes. Many young people condemn the drug war with its rampant racism and mass incarcerations, and they are right to do so:

The U.S. government’s war on drugs is unwinnable because, in the language of economists, it is a supply-side war, where demand isn’t very price-sensitive. This means when the U.S. government scores a “win” in the war, the price of the remaining drugs goes up more than the usage falls. As a result, net revenue to drug cartels increases, which increases their ability to corrupt law enforcement and buy weapons and other smuggling equipment. The result has been an endless cycle of increasing violence along the entire supply chain in Central and South America. (p. 135)

It is not only the drug war but also the war on terror that ought to be condemned, and here once more the many millennials who protested against the war are in the right:

We feel the same about the war on terror. The wars and violence associated with it in the Middle East are a major reason for Europe’s immigration wave....advocates for capitalism can be against war precisely because war undermines capitalist institutions and freedoms....Chris Coyne wrote a book entitled *After War: The Political Economy of Exporting Democracy*, in which he shows that when the U.S. engages in foreign intervention, it rarely creates the kind of lasting institutional change that supports what some might call a “neoliberal” society. Economist Robert Higgs’s classic book, *Crisis and Leviathan*, shows how crises in the United States, especially wars, have led to expanded government at the expense of markets. Chris’s latest book, *Tyranny Come Home: The Domestic Fate of U.S. Militarism*, co-authored with another friend of ours, Abby Hall, has shown how U.S. military interventions abroad “boomerang” back to the United States in ways that decrease our freedoms at home. See, anti-war isn’t a uniquely leftist position. Capitalists should be anti-war too. (pp. 136–37)

The use of “neoliberal” as a term of praise and the solecism “advocates for” are regrettable.

I confess that I approached the authors’ project of a drinking tour of the socialist countries with skepticism. Would it be more

than a *jeu d'esprit*? Reading the book has laid my skepticism to rest. *Socialism Sucks* has the potential to do great good if it gets into the right hands, and its impressive sales suggest that it will do so.

## BOOK REVIEW

# BANKING AND MONETARY POLICY FROM THE PERSPECTIVE OF AUSTRIAN ECONOMICS

ANNETTE GODART-VAN DER KROON AND PATRIK VONLANTHEN, EDS.  
CHAM, SWITZERLAND: SPRINGER, 2018, 280 PP.

JOSEPH T. SALERNO\*

The editors are to be heartily congratulated for putting together this book, which covers an impressive range of topics in monetary economics from an explicitly Austrian perspective. Most of the twelve essays are of a very high quality and one will learn much about money and related topics by a careful reading of them. The chapters range from an insightful interpretation of Austrian monetary theory as a rehabilitation and development of classical monetary theory to novel applications of the theory to current issues such as inflation targeting, the consequences of unconventional European Central Bank (ECB) policies, and cryptocurrencies. In addition to its ambitious scope, this book stands out because most essays take an unabashedly Austrian approach to their topic. It is a great pleasure to read a volume on money and banking that so liberally cites Mises, Hayek, and Rothbard. Ironically, the one

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minor drawback of the book is that it does not contain an index for someone interested in the number and location of text references to these and other Austrian monetary theorists.

Guido Hülsmann presents an excellent overview of Mises's monetary theory that emphasizes its deep roots in the classical approach to money formulated by Ricardo and the British Currency school. As Hülsmann (p. 26) demonstrates in his essay, Mises "rebuilds classical monetary theory on a completely new and more solid foundation [i.e., the subjective theory of value], thus awakening it out of the slumber into which it had sunken after 1844 and making it relevant again for political decision-making." Now, this story has been told before, but the subtlety and clarity of Hülsmann's presentation mark it as an indispensable introduction to Mises's monetary theory and perfectly suit its position as the opening essay of the book.

The merits of this essay are not purely expositional, however, for Hülsmann makes an important doctrinal discovery. Standard accounts of the transition from the views of the sound money Currency school to what Hülsmann labels the "New Orthodoxy," based on the previously discredited Banking school, have always focused on the alleged policy failures of the "currency principle" but have been hazy or mute regarding its doctrinal aspects. Who, exactly, was the central figure (or figures) in the recrudescence of the "banking principle"? The latter principle asserts that issuance of fractional reserve bank notes and deposits convertible into specie are indispensable to ensuring economic stability and accommodating economic growth. Hülsmann fills this gap in the literature by identifying the prolific Scottish banker and economist Henry Dunning McLeod as the pioneer of this movement. He argues that Schumpeter, Keynes, and the early L. Albert Hahn all accepted the New Orthodoxy and developed their respective theories of money under McLeod's influence. Hülsmann makes a very plausible case for McLeod's key role in overturning classical monetary theory. But his case would be more compelling if he offered textual evidence from Schumpeter, Keynes, et al. to support his argument, because McLeod was lightly regarded by his contemporaries and dismissed as a monetary crank by later writers. In any event, Hülsmann has uncovered a lacuna in the history of monetary thought that at least needs to be addressed by further research.

Brendan Brown's essay "What Is Wrong with the 2% Inflation Target" presents what I consider the definitive refutation of inflation targeting. Brown approaches his topic by upholding the classical gold standard as the standard by which to evaluate the nature and performance of modern fiat money regimes. In doing so, Brown provides an excellent analysis of the merits of the gold standard. Brown eschews the artificial constructs of aggregate spending flows that contemporary macroeconomists fixate on. Instead, following Mises, Hayek, and Rothbard, he focuses his comparative analysis of monetary regimes on general movements of concrete money prices, which naturally emerge in an economy in which money and goods are inextricably entwined in individual exchanges.

According to Brown, under the gold standard, gold served as high-powered money and was the "pivot" of the monetary system, because it enjoyed a "large stable demand" for use as transactions media, bank reserves, and as an industrial input. Since the supply of gold was determined by market forces, it tended to be relatively fixed and inelastic in the short and medium runs while in the long run responding elastically to changes in its real price (i.e., in terms of the quantity of commodities a gold unit could purchase). Thus, although the "well-pivoted" gold standard confined the movement of overall prices within definite bounds, it provided the necessary flexibility for the scale of money prices to move upward or downward naturally and spontaneously in response to changes in real conditions over short or medium periods. Indeed, it is precisely the accommodation of these natural price fluctuations that for Brown constitutes the essence of sound money and sharply distinguishes it from modern fiat money regimes, which "target" stability of statistical constructs such as the price level, inflation rate, or nominal income. As Brown (p. 87) incisively states:

Under a system where a high-powered money is at the pivot, as in a gold money regime, there is considerable scope for prices to fluctuate under real influences, and in a way, which aids the invisible hands in their job of steering the capitalist economy in an efficient manner. Indeed stable prices over the short and medium-term would indicate a defect in the price-signalling mechanisms of a capitalist economy under sound money.

Brown (pp. 87–88) gives three instances in which sound money facilitates the "natural rhythm of prices." During a recession,

sound money promotes rapid recovery by facilitating the natural tendency of prices to fall below the perceived norm “for the cycle on average[,] caus[ing] consumers and businesses to bring forward spending (so contributing to the business recovery).” Likewise, sound money poses no obstacle to price declines that reflect increases in real incomes caused by spurts of productivity growth. Lastly, a sound-money regime would not conceal and exacerbate the effects of severe (negative) supply shocks emanating from an interruption of energy supplies or crop failures, because prices would rise rapidly above anticipated levels, revealing and smoothly rationing the scarcer commodity supplies in the short run and encouraging consumers to postpone their purchases until prices return to perceived normal levels in the longer run. In all these cases, inflation targeting, if rigidly followed, would suppress the natural rhythm of prices and thereby disrupt the economy by either initiating asset bubbles (the first two cases) or by exacerbating real scarcities (the third case).

Furthermore, Brown (p. 90) argues, under a regime in which the price level or the inflation rate is targeted by the central bank, “the link between money and prices or nominal incomes [becomes] loose and unpredictable.” The monetary pivot is thus “dislodged” and the natural rhythm of prices gives way to price inertia and institutionalism. This means that, at least in the short and medium runs, inflationary expectations become unmoored from monetary fundamentals and a tendency develops for the inflation rate to persist at the level expected. In addition, expectations themselves come to be dominated by real side institutional factors such as the behavior of labor unions or the state of the national budget or trade balance, etc. Of course, in the long run, monetary forces reassert themselves, but in the meantime resources are misallocated, financial markets distorted, and asset bubbles begin to form.

Brown’s essay is also instructive in explaining the historical origins and dissemination of the 2 percent inflation standard. Brown (pp. 99–100) concludes by presenting a bold, populist program—and the challenges thereto—for demolishing the inflation-targeting regime and reestablishing sound money short of the restoration of the classical gold standard:

Reserves at the central bank, like gold, must not pay interest. Obstacles to a vibrant use of cash in the economy should be demolished (...)

[including] issuance of high denomination notes to satisfy demand for these as medium of exchange). Bank demand for reserves (which would be held voluntarily not as a legal reserve requirement) would be boosted by the curtailing and ideally the abolition of too big to fail, lender of last resort and deposit insurance....The vast balance sheets of the central banks accumulated during the Grand Monetary Experiment would have to be shrunk such that the monetary base would be freely demanded at zero interest rates at the start.

Arkadiusz Sieroń's "Hayek and Mises on Neutrality of Money: Implications for Monetary Policy" outlines the uniquely Austrian understanding of the nonneutrality of money, which emphasizes the role of Cantillon effects. In particular Sieroń (p. 153) focuses on Mises's and Hayek's writings, "as these two authors presented the most far-reaching criticisms of the neutrality of money." Mainstream macroeconomists, in contrast, argue that although money is nonneutral in the short run, a proportional adjustment of nominal variables to a change in the money supply ensures that the effects on real variables vanish and neutrality of money prevails in the long run. For Mises and Hayek, Cantillon effects, also known as "first-round" or "injection" effects, refer to the fact that the emission of new money into the economy under any monetary regime is inevitably distributed unevenly among economic agents. This initial redistribution of monetary assets among households and firms causes an alteration in the structure of relative demands for different kinds of goods and a consequent change in the pattern of relative prices and the allocation of resources. Furthermore, the prices of some goods—those purchased by the first recipients of the new money—naturally rise before those of others, causing further changes in the relative price structure and, therefore, in the distribution of money incomes and cash balances. By the time this step-by-step process of adjustment to a change in the money supply comes to an end, the entire system of relative prices has been revolutionized, resulting in a permanent change in resource allocation and the distribution of wealth and income. The sequential and time-consuming operation of the monetary adjustment process, during which the array of money prices changes at different times in different proportions (and even directions), is thus an inherent feature of a money economy. As Sieroń (p. 159) trenchantly puts it:

For Hayek, changes in relative prices in response to monetary disturbances are not frictions, lags, or market failures occurring due to price rigidity, incomplete information, or irrational expectations, but the natural and inevitable consequence of monetary impulses. This is because new money enters circulation only through specific channels and some people receive the additional money earlier than others.

In comparing Mises's and Hayek's views on neutral money, Sieroń (p. 161) makes another important observation. Mises went "much further than Hayek" in his critique of neutral money, for Mises pointed out that money is nonneutral even if it is supposed that Cantillon effects are absent because every agent's cash balance is somehow increased in equal proportion. In fact, although Sieroń does not note this, Mises (1971, pp. 140–41) went even further than this and supposed a situation in which the new money is distributed among individual cash balances in such a way that the relative (monetary plus nonmonetary) wealth of all remains unchanged. Mises insisted that in this case the nonneutrality of money also holds. The reason is that as the wealth of individuals increases, their subjective marginal utility rankings of different goods and money will change and alter their relative demands for goods and cash balances. The outcome of this mental experiment is a permanent reconfiguration of relative prices and resource allocation and a lack of proportionality between the change in the money stock and the scale of money prices—the long-run nonneutrality of money, in short.

Sieroń concludes that the Cantillon effect, as conceived by Mises and Hayek, has momentous implications for the ongoing discussion of the efficacy of monetary policy, which has intensified since the financial crisis. In particular, once the injection effect is recognized, monetary policy is exposed as an important cause of business cycles and asset bubbles and their international transmission, as well as a contributing factor to greater income inequality.

Jesús Huerta de Soto brilliantly debunks the fallacious arguments against deflation in his chapter "Anti-deflationist Paranoia." He recognizes three distinct kinds of deflation and perceptively analyzes their consequences. He points out that one type of deflation stems from an "error of institutional design" in the form of fractional reserve banking. This "institutional deflation" is part of the regular recurrence of expansion and contraction of the money supply that is an inherent feature of a fractional reserve banking system. It is



the inevitable outcome of an inflationary boom fueled by previous bank credit expansion that falsifies the interest rate and causes malinvestments and distortion of the production structure. Indeed, this built-in tendency toward deflation is so powerful that the fractional reserve banking system's "survival depends on a lender of last resort (or central banker)." Beyond preventing a wholesale collapse of the banking system, Huerta de Soto (p. 198) argues,

there is relatively little central banks can do. At most they can keep private banks from failing by providing them with all sorts of loans and assistance. And that is about it. However a process of monetary contraction (i.e., a process of deflation) is inevitable.

Now this assertion that institutional deflation in the sense of an actual contraction of the money supply is an inevitable outcome of a fractional reserve banking system appears to be in conflict with the facts, at least since World War II. Certainly the Fed and other central banks successfully prevented their money supplies from contracting during the 2008 financial crisis with resort to unconventional methods of printing base money, such as zero interest rate policy (ZIRP), quantitative easing (QE), forward guidance, credit easing, etc. Nor did the money supply contract in the US after the dot-com bubble burst in 2000, or even during the severe "double-dip" recession of 1980–82. I may misunderstand the author on this point, and he may be referring to a powerful deflationary *tendency* that is present in fractional reserve banking and that actually manifested itself when central banks operated only as lenders of last resort. But if this is the case, it would have been instructive for the author to indicate how modern central banks, focused on stabilizing prices or targeting inflation, routinely neutralize institutional deflation and what the consequences of their doing so are.

Huerta de Soto also engages and demolishes the main arguments against the kind of deflation that is caused by increases in productivity induced by capital accumulation and advances in technology. I do, however, have one minor reservation with respect to his rebuttal of the contention that a fall in prices due to an increase in real output that outstrips the increase in the money supply constrains economic growth and leads to a cumulative economic contraction. Huerta de Soto counters the argument by pointing out that a fall in prices will spur entrepreneurs to reduce costs by: 1. renegotiating

input prices downward and 2. substituting at the margin relatively cheaper capital goods for laborers, who are now receiving higher real wages, thereby increasing the demand for capital goods and causing laid-off laborers to migrate to capital goods industries (i.e., the Ricardo effect).

If I have understood the argument correctly, it puts the cart before the horse, for it is the increase in saving and investment in capital goods that *initiates* the process of productivity growth. Increased investment causes workers to shift from the consumer goods to capital goods industries. Eventually this movement increases the supply and lowers the prices of capital goods, making it profitable to implement new and more productive technical methods in the consumer goods industries. Thus, even with nominal wage rates unchanged, costs of production decline as labor productivity increases. The prospective profit margins on consumer goods therefore expand. This stimulates consumer goods firms to increase their supply and the increased competition causes prices naturally to fall. In short, during the process of economic growth initiated by net saving and investment, labor productivity and costs of production fall *in advance of or in step with* the decline in product prices. Furthermore, laborers shift from industries closer in time to consumers to ones more temporally remote from consumers at the very beginning of the growth process rather than at its end, as Huerta de Soto contends. Thus there is no need to renegotiate nominal wage rates or to lay off workers in response to deflation due to real output growth. But this is a minor emendation to a fine essay.

Due to space constraints I can only give brief notice to several other excellent essays in the book. Two of these essays focus on the nature and consequences of errors in ECB monetary policy. These are “Unintended Consequences of ECB Monetary Policies in Europe,” by Andreas Hoffman and Nicolas Cachanosky, and “The Failure of ECB Monetary Policy from a Mises-Hayek Perspective,” by Gunther Schnabl. The authors of these essays have been pioneers in the application of Austrian business cycle theory to analyzing the international dimensions and transmission of asset bubbles and the ensuing financial crisis. Their essays in this book display deep scholarship and a familiarity with an enormous range of theoretical and empirical literature, both Austrian and mainstream. The significance of their essays lies not merely in identifying the flaws in ECB

monetary policy leading up to the financial crisis, but in utilizing innovative theoretical models and masterfully employing data to explain how ECB policy in the aftermath of the crisis has led to a weak and protracted recovery in the euro area. These essays also serve as exemplars for future research on the global transmission of national or supranational central banks' monetary policy errors.

Two of the essays addressing the Austrian view of cryptocurrency are "The Reconsideration of Hayek's Idea on the Denationalization of Money: Taking the Growing Tendency of Digital Currency in Consideration" and "Cryptocurrencies from an Austrian Perspective," by Chikako Nakayama and Alistair Milne, respectively. These essays are not as tightly formulated as other essays in the book and tend to be wide-ranging reflections upon the linkages between Austrian monetary theory and cryptocurrencies in their various aspects. But they are extremely valuable nonetheless, because they stimulate thought about the problems and potentialities of a radical approach to denationalizing money and implementing a sound, market-based money regime.

This book is indispensable reading for anyone who has a professional or vocational interest in the Austrian approach to money, finance, and business cycles.

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## REMEMBERING OSKAR MORGANSTERN

RICHARD EBELING\*

In this article in our “Remembering” series, we commemorate the well-known economist Oskar Morgenstern. Born on January 24, 1902 in Görlitz, on the modern border of Germany and Poland, he died on July 26, 1977, at the age of 75. He is best known as the co-developer of modern game theory with John von Neumann in their 1944 book, “The Theory of Games and Economic Behavior.”

Morgenstern had been educated at the University of Vienna, studying with one of the early leaders of the Austrian School of Economics, Friedrich von Wieser. But his main “Austrian” mentor was Hans Mayer, who replaced Wieser at the time of the latter’s retirement in 1923. (Hans Mayer was the author in 1932 of a 100-page monograph offering an “Austrian” critique of mathematical general equilibrium theory.)

Morgenstern’s first book was on economic forecasting (1928), in which he argued that precise predictions in the realm of economics was inherently impossible due to the unique qualities of the social sciences arising from human beings as intentional, thinking men whose very expectations about the future can frustrate the projections the forecaster attempts to make about their anticipated

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This article in the QJAE’s “Remembering” series is adapted from <https://mises.org/wire/remembering-oskar-morgenstern>.



conduct. In addition, the events in the human arena have sufficiently distinct and unique characteristics that many of the assumptions underlying probability theory could not be easily applied to economic and market processes.

His 1934 book, *The Limits of Economics*, was meant to bring out the difficulties inherent in policy making because of the complexity in the interactive events of the market, which are wrapped up in time and causal sequences that hampers what the economic policy maker could successfully manage and control. He also warned of those who approach policy issues with predetermined ideological biases that could influence the logic of the policy maker's analyses and conclusions.

Shortly after the founding of the Austrian Institute for Business Cycle Research in 1928 under the directorship of a young Friedrich A. Hayek, Morgenstern was hired as his assistant. Morgenstern replaced Hayek as the Institute's director when Hayek accepted an appointment at the London School of Economics in the autumn of 1931. He held this position until March 1938. Morgenstern was on a lecture tour in the United States when Austria was invaded and annexed by Nazi Germany. Exiled in America, he ended up with a position at Princeton University, until his retirement, at which point he took up a professorship at New York University.

It was in this capacity at NYU that I came to know Morgenstern. Indeed, I (and Don Lavoie and Jack High) took Morgenstern for his last class at NYU on the History of Economic Thought before his death from cancer.

A few years ago, I wrote a review of Robert Leonard's excellent book, "Von Neumann, Morgenstern and the Creation of Game Theory" (2010). The book presented a different side of Morgenstern, based on Leonard's researches, including the entries in Morgenstern's private diary. We find someone partly envious and resentful of other members of the Austrian School in that interwar period of the 1920s and 1930s, and willing to collaborate with the fascist-type government that ruled Austria before the annexation of the country in March 1938 by the Nazis. And he was certainly very much the "junior partner" in the development of game theory, often finding it hard to keep up with von Neumann's mathematical formulations and demonstrations.

One aspect of his “Austrian” roots that Morgenstern retained was his healthy suspicions about the limits of macroeconomic aggregates and averages as a meaningful approach for understanding the dynamics of money’s influence on the market process. Indeed, he always emphasized the need for microeconomic process analyses of money’s “non-neutrality” on the structure of relative prices and wages, profit margins, and resulting potential misallocations of capital and labor.

Thus, for instance, in his 1972 article, “Thirteen Critical Points in Contemporary Economic Theory,” he insisted:

The concentration on undifferentiated aggregates as, say, that of the total quantity of money, is a step backward into a more primitive world of thought. It runs counter to what must be done....

Consider an inflationary, or as a matter of fact, any increase in the total quantity of money. If no account is given where this additional money originates from, where it is injected, with what different magnitudes and how it penetrates (through which paths and channels, and with what speed), into the body economic, very little information is given.

The same total addition will have very different consequences if it is injected via consumers’ loans, or via producers’ borrowing, via the Defense Department, or via unemployment subsidies, etc. Depending on the existing condition of the economy, each point of injection will produce different consequences for the same aggregate amount of money, so that the monetary analysis will have to be combined with an equally detailed analysis of changing flows of commodities and services.

I found Morganstern to be a most approachable and friendly person, who happily spent time with me answering my questions about the “old Vienna days” in the years between the wars and his interactions with Wieser, Mayer, Hayek, and other Austrians. Though he had an unflattering, dark side, he was a fascinating economist having early connections with some of the brightest lights in the Austrian School.

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