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Session 1

The State as an Intervention

- **Power and Market**
  Chapter 1: Defense Services on the Free Market

- **For a New Liberty**
  Part I: The Libertarian Creed

- **For a New Liberty**
  The Public Sector, III: Police, Law, and the Courts
PROPERTY AND EXCHANGE

THE NONAGGRESSION AXIOM

The libertarian creed rests upon one central axiom: that no man or group of men may aggress against the person or property of anyone else. This may be called the “nonaggression axiom.” “Aggression” is defined as the initiation of the use or threat of physical violence against the person or property of anyone else. Aggression is therefore synonymous with invasion.

If no man may aggress against another; if, in short, everyone has the absolute right to be “free” from aggression, then this at once implies that the libertarian stands foursquare for what are generally known as “civil liberties”: the freedom to speak, publish, assemble, and to engage in such “victimless crimes” as pornography, sexual deviation, and prostitution (which the libertarian does not regard as “crimes” at all, since he defines a “crime” as violent invasion of someone else’s person or property). Furthermore, he regards conscription as slavery on a massive scale. And since war, especially modern war, entails the mass slaughter of civilians, the libertarian regards such conflicts as mass murder and therefore totally illegitimate.

All of these positions are now considered “leftist” on the contemporary ideological scale. On the other hand, since the libertarian also opposes invasion of the rights of private
property, this also means that he just as emphatically opposes government interference with property rights or with the free-market economy through controls, regulations, subsidies, or prohibitions. For if every individual has the right to his own property without having to suffer aggressive depredation, then he also has the right to give away his property (bequest and inheritance) and to exchange it for the property of others (free contract and the free market economy) without interference. The libertarian favors the right to unrestricted private property and free exchange; hence, a system of “laissez-faire capitalism.”

In current terminology again, the libertarian position on property and economics would be called “extreme right wing.” But the libertarian sees no inconsistency in being “leftist” on some issues and “rightist” on others. On the contrary, he sees his own position as virtually the only consistent one, consistent on behalf of the liberty of every individual. For how can the leftist be opposed to the violence of war and conscription while at the same time supporting the violence of taxation and government control? And how can the rightist trumpet his devotion to private property and free enterprise while at the same time favoring war, conscription, and the outlawing of noninvasive activities and practices that he deems immoral? And how can the rightist favor a free market while seeing nothing amiss in the vast subsidies, distortions, and unproductive inefficiencies involved in the military-industrial complex?

While opposing any and all private or group aggression against the rights of person and property, the libertarian sees that throughout history and into the present day, there has been one central, dominant, and overriding aggressor upon all of these rights: the State. In contrast to all other thinkers, left, right, or in-between, the libertarian refuses to give the State the moral sanction to commit actions that almost everyone agrees would be immoral, illegal, and criminal if committed by any person or group in society. The libertarian, in short, insists on applying the general moral law to everyone, and makes no special exemptions for any person or group. But if we look at the State naked, as it were, we see that it is universally allowed, and even encouraged, to commit all the acts
which even non-libertarians concede are reprehensible crimes. The State habitually commits mass murder, which it calls “war,” or sometimes “suppression of subversion”; the State engages in enslavement into its military forces, which it calls “conscription”; and it lives and has its being in the practice of forcible theft, which it calls “taxation.” The libertarian insists that whether or not such practices are supported by the majority of the population is not germane to their nature: that, regardless of popular sanction, War is Mass Murder, Conscription is Slavery, and Taxation is Robbery. The libertarian, in short, is almost completely the child in the fable, pointing out insistently that the emperor has no clothes.

Throughout the ages, the emperor has had a series of pseudo-clothes provided for him by the nation’s intellectual caste. In past centuries, the intellectuals informed the public that the State or its rulers were divine, or at least clothed in divine authority, and therefore what might look to the naive and untutored eye as despotism, mass murder, and theft on a grand scale was only the divine working its benign and mysterious ways in the body politic. In recent decades, as the divine sanction has worn a bit threadbare, the emperor’s “court intellectuals” have spun ever more sophisticated apologia: informing the public that what the government does is for the “common good” and the “public welfare,” that the process of taxation-and-spending works through the mysterious process of the “multiplier” to keep the economy on an even keel, and that, in any case, a wide variety of governmental “services” could not possibly be performed by citizens acting voluntarily on the market or in society. All of this the libertarian denies: he sees the various apologia as fraudulent means of obtaining public support for the State’s rule, and he insists that whatever services the government actually performs could be supplied far more efficiently and far more morally by private and cooperative enterprise.

The libertarian therefore considers one of his prime educational tasks is to spread the demystification and desanctification of the State among its hapless subjects. His task is to demonstrate repeatedly and in depth that not only the emperor but even the “democratic” State has no clothes; that
all governments subsist by exploitive rule over the public; and that such rule is the reverse of objective necessity. He strives to show that the very existence of taxation and the State necessarily sets up a class division between the exploiting rulers and the exploited ruled. He seeks to show that the task of the court intellectuals who have always supported the State has ever been to weave mystification in order to induce the public to accept State rule, and that these intellectuals obtain, in return, a share in the power and pelf extracted by the rulers from their deluded subjects.

Take, for example, the institution of taxation, which statisticians have claimed is in some sense really “voluntary.” Anyone who truly believes in the “voluntary” nature of taxation is invited to refuse to pay taxes and to see what then happens to him. If we analyze taxation, we find that, among all the persons and institutions in society, only the government acquires its revenues through coercive violence. Everyone else in society acquires income either through voluntary gift (lodge, charitable society, chess club) or through the sale of goods or services voluntarily purchased by consumers. If anyone but the government proceeded to “tax,” this would clearly be considered coercion and thinly disguised banditry. Yet the mystical trappings of “sovereignty” have so veiled the process that only libertarians are prepared to call taxation what it is: legalized and organized theft on a grand scale.

PROPERTY RIGHTS

If the central axiom of the libertarian creed is nonaggression against anyone’s person and property, how is this axiom arrived at? What is its groundwork or support? Here, libertarians, past and present, have differed considerably. Roughly, there are three broad types of foundation for the libertarian axiom, corresponding to three kinds of ethical philosophy: the emotivist, the utilitarian, and the natural rights viewpoint. The emotivists assert that they take liberty or nonaggression as their premise purely on subjective, emotional grounds. While their own intense emotion might seem a valid basis for
their own political philosophy, this can scarcely serve to convince anyone else. By ultimately taking themselves outside the realm of rational discourse, the emotivists thereby insure the lack of general success of their own cherished doctrine.

The utilitarians declare, from their study of the consequences of liberty as opposed to alternative systems, that liberty will lead more surely to widely approved goals: harmony, peace, prosperity, etc. Now no one disputes that relative consequences should be studied in assessing the merits or demerits of respective creeds. But there are many problems in confining ourselves to a utilitarian ethic. For one thing, utilitarianism assumes that we can weigh alternatives, and decide upon policies, on the basis of their good or bad consequences. But if it is legitimate to apply value judgments to the consequences of X, why is it not equally legitimate to apply such judgments to X itself? May there not be something about an act itself which, in its very nature, can be considered good or evil?

Another problem with the utilitarian is that he will rarely adopt a principle as an absolute and consistent yardstick to apply to the varied concrete situations of the real world. He will only use a principle, at best, as a vague guideline or aspiration, as a tendency which he may choose to override at any time. This was the major defect of the nineteenth-century English Radicals, who had adopted the laissez-faire view of the eighteenth-century liberals but had substituted a supposedly “scientific” utilitarianism for the supposedly “mystical” concept of natural rights as the groundwork for that philosophy. Hence the nineteenth-century laissez-faire liberals came to use laissez-faire as a vague tendency rather than as an unblemished yardstick, and therefore increasingly and fatally compromised the libertarian creed. To say that a utilitarian cannot be “trusted” to maintain libertarian principle in every specific application may sound harsh, but it puts the case fairly. A notable contemporary example is the free-market economist Professor Milton Friedman who, like his classical economist forebears, holds to freedom as against State intervention as a general tendency, but in practice allows a myriad of damaging exceptions, exceptions which serve to vitiate the principle
almost completely, notably in the fields of police and military affairs, education, taxation, welfare, “neighborhood effects,” antitrust laws, and money and banking.

Let us consider a stark example: Suppose a society which fervently considers all redheads to be agents of the Devil and therefore to be executed whenever found. Let us further assume that only a small number of redheads exist in any generation—so few as to be statistically insignificant. The utilitarian-libertarian might well reason: “While the murder of isolated redheads is deplorable, the executions are small in number; the vast majority of the public, as non-redheads, achieves enormous psychic satisfaction from the public execution of redheads. The social cost is negligible, the social, psychic benefit to the rest of society is great; therefore, it is right and proper for society to execute the redheads.” The natural-rights libertarian, overwhelmingly concerned as he is for the justice of the act, will react in horror and staunchly and unequivocally oppose the executions as totally unjustified murder and aggression upon nonaggressive persons. The consequence of stopping the murders—depriving the bulk of society of great psychic pleasure—would not influence such a libertarian, the “absolutist” libertarian, in the slightest. Dedicated to justice and to logical consistency, the natural-rights libertarian cheerfully admits to being “doctrinaire,” to being, in short, an unabashed follower of his own doctrines.

Let us turn then to the natural-rights basis for the libertarian creed, a basis which, in one form or another, has been adopted by most of the libertarians, past and present. “Natural rights” is the cornerstone of a political philosophy which, in turn, is embedded in a greater structure of “natural law.” Natural law theory rests on the insight that we live in a world of more than one—in fact, a vast number—of entities, and that each entity has distinct and specific properties, a distinct “nature,” which can be investigated by man’s reason, by his sense perception and mental faculties. Copper has a distinct nature and behaves in a certain way, and so do iron, salt, etc. The species man, therefore, has a specifiable nature, as does the world around him and the ways of interaction between them. To put it with undue brevity, the activity of each inorganic and
organic entity is determined by its own nature and by the nature of the other entities with which it comes in contact. Specifically, while the behavior of plants and at least the lower animals is determined by their biological nature or perhaps by their “instincts,” the nature of man is such that each individual person must, in order to act, choose his own ends and employ his own means in order to attain them. Possessing no automatic instincts, each man must learn about himself and the world, use his mind to select values, learn about cause and effect, and act purposively to maintain himself and advance his life. Since men can think, feel, evaluate, and act only as individuals, it becomes vitally necessary for each man’s survival and prosperity that he be free to learn, choose, develop his faculties, and act upon his knowledge and values. This is the necessary path of human nature; to interfere with and cripple this process by using violence goes profoundly against what is necessary by man’s nature for his life and prosperity. Violent interference with a man’s learning and choices is therefore profoundly “antihuman”; it violates the natural law of man’s needs.

Individualists have always been accused by their enemies of being “atomistic”—of postulating that each individual lives in a kind of vacuum, thinking and choosing without relation to anyone else in society. This, however, is an authoritarian straw man; few, if any, individualists have ever been “atomists.” On the contrary, it is evident that individuals always learn from each other, cooperate and interact with each other; and that this, too, is required for man’s survival. But the point is that each individual makes the final choice of which influences to adopt and which to reject, or of which to adopt first and which afterwards. The libertarian welcomes the process of voluntary exchange and cooperation between freely acting individuals; what he abhors is the use of violence to cripple such voluntary cooperation and force someone to choose and act in ways different from what his own mind dictates.

The most viable method of elaborating the natural-rights statement of the libertarian position is to divide it into parts, and to begin with the basic axiom of the “right to self-ownership.” The right to self-ownership asserts the absolute right of
each man, by virtue of his (or her) being a human being, to “own” his or her own body; that is, to control that body free of coercive interference. Since each individual must think, learn, value, and choose his or her ends and means in order to survive and flourish, the right to self-ownership gives man the right to perform these vital activities without being hampered and restricted by coercive molestation.

Consider, too, the consequences of denying each man the right to own his own person. There are then only two alternatives: either (1) a certain class of people, $A$, have the right to own another class, $B$; or (2) everyone has the right to own his own equal quotal share of everyone else. The first alternative implies that while Class $A$ deserves the rights of being human, Class $B$ is in reality subhuman and therefore deserves no such rights. But since they are indeed human beings, the first alternative contradicts itself in denying natural human rights to one set of humans. Moreover, as we shall see, allowing Class $A$ to own Class $B$ means that the former is allowed to exploit, and therefore to live parasitically, at the expense of the latter. But this parasitism itself violates the basic economic requirement for life: production and exchange.

The second alternative, what we might call “participatory communalism” or “communism,” holds that every man should have the right to own his equal quotal share of everyone else. If there are two billion people in the world, then everyone has the right to own one two-billionth of every other person. In the first place, we can state that this ideal rests on an absurdity: proclaiming that every man is entitled to own a part of everyone else, yet is not entitled to own himself. Secondly, we can picture the viability of such a world: a world in which no man is free to take any action whatever without prior approval or indeed command by everyone else in society. It should be clear that in that sort of “communist” world, no one would be able to do anything, and the human race would quickly perish. But if a world of zero self-ownership and one hundred percent other ownership spells death for the human race, then any steps in that direction also contravene the natural law of what is best for man and his life on earth.
Finally, however, the participatory communist world *cannot* be put into practice. For it is physically impossible for everyone to keep continual tabs on everyone else, and thereby to exercise his equal quotal share of partial ownership over every other man. In practice, then, the concept of universal and equal other-ownership is utopian and impossible, and supervision and therefore control and ownership of others necessarily devolves upon a specialized group of people, who thereby become a ruling class. Hence, in practice, any attempt at communist rule will automatically become class rule, and we would be back at our first alternative.

The libertarian therefore rejects these alternatives and concludes by adopting as his primary axiom the universal right of self-ownership, a right held by everyone by virtue of being a human being. A more difficult task is to settle on a theory of property in nonhuman objects, in the things of this earth. It is comparatively easy to recognize the practice when someone is aggressing against the property right of another’s person: If A assaults B, he is violating the property right of B in his own body. But with nonhuman objects the problem is more complex. If, for example, we see X seizing a watch in the possession of Y we cannot automatically assume that X is aggressing against Y’s right of property in the watch; for may not X have been the original, “true” owner of the watch who can therefore be said to be repossessing his own legitimate property? In order to decide, we need a theory of justice in property, a theory that will tell us whether X or Y or indeed someone else is the legitimate owner.

Some libertarians attempt to resolve the problem by asserting that whoever the existing government decrees has the property title should be considered the just owner of the property. At this point, we have not yet delved deeply into the nature of government, but the anomaly here should be glaring enough: it is surely odd to find a group eternally suspicious of virtually any and all functions of government suddenly leaving it to government to define and apply the precious concept of property, the base and groundwork of the entire social order. It is particularly the utilitarian laissez-fairists who believe it most feasible to begin the new libertarian world by
confirming all existing property titles; that is, property titles and rights as decreed by the very government that is condemned as a chronic aggressor.

Let us illustrate with a hypothetical example. Suppose that libertarian agitation and pressure has escalated to such a point that the government and its various branches are ready to abdicate. But they engineer a cunning ruse. Just before the government of New York state abdicates it passes a law turning over the entire territorial area of New York to become the private property of the Rockefeller family. The Massachusetts legislature does the same for the Kennedy family. And so on for each state. The government could then abdicate and decree the abolition of taxes and coercive legislation, but the victorious libertarians would now be confronted with a dilemma. Do they recognize the new property titles as legitimately private property? The utilitarians, who have no theory of justice in property rights, would, if they were consistent with their acceptance of given property titles as decreed by government, have to accept a new social order in which fifty new satraps would be collecting taxes in the form of unilaterally imposed “rent.” The point is that only natural-rights libertarians, only those libertarians who have a theory of justice in property titles that does not depend on government decree, could be in a position to scoff at the new rulers’ claims to have private property in the territory of the country, and to rebuff these claims as invalid. As the great nineteenth-century liberal Lord Acton saw clearly, the natural law provides the only sure ground for a continuing critique of governmental laws and decrees.¹ What, specifically, the natural-rights position on property titles may be is the question to which we now turn.

We have established each individual’s right to self-ownership, to a property right in his own body and person. But people are not floating wraiths; they are not self-subsistent entities;

they can only survive and flourish by grappling with the earth around them. They must, for example, stand on land areas; they must also, in order to survive and maintain themselves, transform the resources given by nature into “consumer goods,” into objects more suitable for their use and consumption. Food must be grown and eaten; minerals must be mined and then transformed into capital and then useful consumer goods, etc. Man, in other words, must own not only his own person, but also material objects for his control and use. How, then, should the property titles in these objects be allocated?

Let us take, as our first example, a sculptor fashioning a work of art out of clay and other materials; and let us waive, for the moment, the question of original property rights in the clay and the sculptor’s tools. The question then becomes: Who owns the work of art as it emerges from the sculptor’s fashioning? It is, in fact, the sculptor’s “creation,” not in the sense that he has created matter, but in the sense that he has transformed nature-given matter—the clay—into another form dictated by his own ideas and fashioned by his own hands and energy. Surely, it is a rare person who, with the case put thus, would say that the sculptor does not have the property right in his own product. Surely, if every man has the right to own his own body, and if he must grapple with the material objects of the world in order to survive, then the sculptor has the right to own the product he has made, by his energy and effort, a veritable extension of his own personality. He has placed the stamp of his person upon the raw material, by “mixing his labor” with the clay, in the phrase of the great property theorist John Locke. And the product transformed by his own energy has become the material embodiment of the sculptor’s ideas and vision. John Locke put the case this way:

. . . every man has a property in his own person. This nobody has any right to but himself. The labour of his body and the work of his hands, we may say, are properly his. WHATSOEVER, then, he removes out of the state that nature hath provided and left it in, he hath mixed his labour with it, and joined it to something that is his own, and thereby makes it his property. It being by him removed from the common state nature placed it in, it hath by this labour something annexed to it
that excludes the common right of other men. For this labour being the unquestionable property of the labourer, no man but he can have a right to what that is once joined to.2

As in the case of the ownership of people’s bodies, we again have three logical alternatives: (1) either the transformer, or “creator” has the property right in his creation; or (2) another man or set of men have the right in that creation, i.e., have the right to appropriate it by force without the sculptor’s consent; or (3) every individual in the world has an equal, quotal share in the ownership of the sculpture—the “communal” solution. Again, put baldly, there are very few who would not concede the monstrous injustice of confiscating the sculptor’s property, either by one or more others, or on behalf of the world as a whole. By what right do they do so? By what right do they appropriate to themselves the product of the creator’s mind and energy? In this clear-cut case, the right of the creator to own what he has mixed his person and labor with would be generally conceded. (Once again, as in the case of communal ownership of persons, the world communal solution would, in practice, be reduced to an oligarchy of a few others expropriating the creator’s work in the name of “world public” ownership.)

The main point, however, is that the case of the sculptor is not qualitatively different from all cases of “production.” The man or men who had extracted the clay from the ground and had sold it to the sculptor may not be as “creative” as the sculptor, but they too are “producers,” they too have mixed their ideas and their technological know-how with the nature-given soil to emerge with a useful product. They, too, are “producers,” and they too have mixed their labor with natural materials to transform those materials into more useful goods and services. These persons, too, are entitled to the

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ownership of their products. Where then does the process begin? Again, let us turn to Locke:

He that is nourished by the acorns he picked up under an oak, or the apples he gathered from the trees in the wood, has certainly appropriated them to himself. Nobody can deny but the nourishment is his. I ask then, when did they begin to be his? When he digested? or when he ate? or when he boiled? or when he brought them home? or when he picked them up? And 'tis plain, if the first gathering made them not his, nothing else could. That labour put a distinction between them and common. That added something to them more than Nature, the common mother of all, had done, and so they became his private right. And will any one say he had no right to those acorns or apples he thus appropriated because he had not the consent of all mankind to make them his? Was it a robbery thus to assume to himself what belonged to all in common? If such a consent as that was necessary, man had starved, notwithstanding the plenty God had given him. . . . Thus, the grass my horse has bit, the turfs my servant has cut, and the ore I have digged in my place, where I have a right to them in common with others, become my property without the assignation or consent of any body. The labour that was mine, removing them out of that common state they were in, hath fixed my property in them.

By making an explicit consent of every commoner necessary to any one's appropriating to himself any part of what is given in common, children or servants could not cut the meat which their father or master had provided for them in common without assigning to every one his peculiar part. Though the water running in the fountain be every one's, yet who can doubt but that in the pitcher is his only who drew it out? His labour hath taken it out of the hands of Nature where it was common . . . and hath thereby appropriated it to himself.

Thus the law of reason makes the deer that Indian's who killed it; 'tis allowed to be his goods who hath bestowed his labour upon it, though, before, it was the common right of every one. And amongst those who are counted the civilized part of mankind . . . this original law of nature for the
beginning of property, in what was before common, still takes place, and by virtue thereof, what fish any one catches in the ocean, that great and still remaining common of mankind; or what ambergris any one takes up here is by the labour that removes it out of that common state nature left it in, made his property who takes that pains about it.  

If every man owns his own person and therefore his own labor, and if by extension he owns whatever property he has “created” or gathered out of the previously unused, unowned, “state of nature,” then what of the last great question: the right to own or control the earth itself? In short, if the gatherer has the right to own the acorns or berries he picks, or the farmer the right to own his crop of wheat or peaches, who has the right to own the land on which these things have grown? It is at this point that Henry George and his followers, who have gone all the way so far with the libertarians, leave the track and deny the individual’s right to own the piece of land itself, the ground on which these activities have taken place. The Georgists argue that, while every man should own the goods which he produces or creates, since Nature or God created the land itself, no individual has the right to assume ownership of that land. Yet, if the land is to be used at all as a resource in any sort of efficient manner, it must be owned or controlled by someone or some group, and we are again faced with our three alternatives: either the land belongs to the first user, the man who first brings it into production; or it belongs to a group of others; or it belongs to the world as a whole, with every individual owning a quotable part of every acre of land. George’s option for the last solution hardly solves his moral problem: If the land itself should belong to God or Nature, then why as it more moral for every acre in the world to be owned by the world as a whole, than to concede individual ownership? In practice, again, it is obviously impossible for every person in the world to exercise effective ownership of his four-billionth

3Locke, Civil Government, pp. 18–49. While Locke was a brilliant property theorist, we are not claiming that he developed and applied his theory with anything like complete consistency.
portion (if the world population is, say, four billion) of every piece of the world’s land surface. In practice, of course, a small oligarchy would do the controlling and owning, and not the world as a whole.

But apart from these difficulties in the Georgist position, the natural-rights justification for the ownership of ground land is the same as the justification for the original ownership of all other property. For, as we have seen, no producer really “creates” matter; he takes nature-given matter and transforms it by his labor energy in accordance with his ideas and vision. But this is precisely what the pioneer—the “homesteader”—does when he brings previously unused land into his own private ownership. Just as the man who makes steel out of iron ore transforms that ore out of his know-how and with his energy, and just as the man who takes the iron out of the ground does the same, so does the homesteader who clears, fences, cultivates, or builds upon the land. The homesteader, too, has transformed the character of the nature-given soil by his labor and his personality. The homesteader is just as legitimately the owner of the property as the sculptor or the manufacturer; he is just as much a “producer” as the others.

Furthermore, if the original land is nature- or God-given then so are the people’s talents, health, and beauty. And just as all these attributes are given to specific individuals and not to “society,” so then are land and natural resources. All of these resources are given to individuals and not to “society,” which is an abstraction that does not actually exist. There is no existing entity called “society”; there are only interacting individuals. To say that “society” should own land or any other property in common, then, must mean that a group of oligarchs—in practice, government bureaucrats—should own the property, and at the expense of expropriating the creator or the homesteader who had originally brought this product into existence.

Moreover, no one can produce anything without the cooperation of original land, if only as standing room. No man can produce or create anything by his labor alone; he must have the cooperation of land and other natural raw materials.
Man comes into the world with just himself and the world around him—the land and natural resources given him by nature. He takes these resources and transforms them by his labor and mind and energy into goods more useful to man. Therefore, if an individual cannot own original land, neither can he in the full sense own any of the fruits of his labor. The farmer cannot own his wheat crop if he cannot own the land on which the wheat grows. Now that his labor has been inextricably mixed with the land, he cannot be deprived of one without being deprived of the other.

Moreover, if a producer is not entitled to the fruits of his labor, who is? It is difficult to see why a newborn Pakistani baby should have a moral claim to a quotable share of ownership of a piece of Iowa land that someone has just transformed into a wheatfield—and vice versa of course for an Iowan baby and a Pakistani farm. Land in its original state is unused and unowned. Georgists and other land communalists may claim that the whole world population really “owns” it, but if no one has yet used it, it is in the real sense owned and controlled by no one. The pioneer, the homesteader, the first user and transformer of this land, is the man who first brings this simple valueless thing into production and social use. It is difficult to see the morality of depriving him of ownership in favor of people who have never gotten within a thousand miles of the land, and who may not even know of the existence of the property over which they are supposed to have a claim.

The moral, natural-rights issue involved here is even clearer if we consider the case of animals. Animals are “economic land,” since they are original nature-given resources. Yet will anyone deny full title to a horse to the man who finds and domesticates it—is this any different from the acorns and berries that are generally conceded to the gatherer? Yet in land, too, some homesteader takes the previously “wild,” undomesticated land, and “tames” it by putting it to productive use. Mixing his labor with land sites should give him just as clear a title as in the case of animals. As Locke declared: “As much land as a man tills, plants, improves, cultivates, and can
use the product of, so much is his property. He by his labour
does, as it were, enclose it from the common.”\textsuperscript{4}

The libertarian theory of property was eloquently
summed up by two nineteenth-century laissez-faire French
economists:

If man acquires rights over things, it is because he is at once
active, intelligent and free; by his activity he spreads over
external nature; by his intelligence he governs it, and bends it
to his use; by his liberty, he establishes between himself and
it the relation of cause and effect and makes it his own. . . .

Where is there, in a civilized country, a clod of earth, a leaf,
which does not bear this impress of the personality of man?
In the town, we are surrounded by the works of man; we
walk upon a level pavement or a beaten road; it is man who
made healthy the formerly muddy soil, who took from the
side of a far-away hill the flint or stone which covers it. We
live in houses; it is man who has dug the stone from the
quarry, who has hewn it, who has planed the woods; it is the
thought of man which has arranged the materials properly
and made a building of what was before rock and wood.
And in the country, the action of man is still everywhere
present; men have cultivated the soil and generations of
laborers have mellowed and enriched it; the works of man
have dammed the rivers and created fertility where the
waters had brought only desolation. . . . Everywhere a pow-
nerful hand is divined which has moulded matter, and an
intelligent will which has adapted it . . . to the satisfaction of
the wants of one same being. Nature has recognized her
master, and man feels that he is at home in nature. Nature
has been \textit{appropriated} by him for his use; she has become his \textit{own}; she is his \textit{property}. This property is legitimate; it con-
stitutes a right as sacred for man as is the free exercise of his
faculties. It is his because it has come entirely from himself,
and is in no way anything but an emanation from his being.
Before him, there was scarcely anything but matter; since
him, and by him, there is interchangeable wealth, that is to

\textsuperscript{4}Locke, \textit{Civil Government}, p. 20.
say, articles having acquired a value by some industry, by manufacture, by handling, by extraction, or simply by transportation. From the picture of a great master, which is perhaps of all material production that in which matter plays the smallest part, to the pail of water which the carrier draws from the river and takes to the consumer, wealth, whatever it may be, acquires its value only by communicated qualities, and these qualities are part of human activity, intelligence, strength. The producer has left a fragment of his own person in the thing which has thus become valuable, and may hence be regarded as a prolongation of the faculties of man acting upon external nature. As a free being he belongs to himself; now the cause, that is to say, the productive force, is himself; the effect, that is to say, the wealth produced, is still himself. Who shall dare contest his title of ownership so clearly marked by the seal of his personality? . . .

It is then, to the human being, the creator of all wealth, that we must come back . . . it is by labor that man impresses his personality on matter. It is labor which cultivates the earth and makes of an unoccupied waste an appropriated field; it is labor which makes of an untrodden forest a regularly ordered wood; it is labor, or rather, a series of labors often executed by a very numerous succession of workmen, which brings hemp from seed, thread from hemp, cloth from thread, clothing from cloth; which transforms the shapeless pyrite, picked up in the mine, into an elegant bronze which adorns some public place, and repeats to an entire people the thought of an artist. . . .

Property, made manifest by labor, participates in the rights of the person whose emanation it is; like him, it is inviolable so long as it does not extend so far as to come into collision with another right; like him, it is individual, because it has origin in the independence of the individual, and because, when several persons have cooperated in its formation, the latest possessor has purchased with a value, the fruit of his personal labor, the work of all the fellow-laborers who have preceded him: this is what is usually the case with manufactured articles. When property has passed, by sale or by inheritance, from one hand to another, its conditions have not changed; it is still the fruit of human liberty manifested
by labor, and the holder has the rights as the producer who took possession of it by right.5

**SOCIETY AND THE INDIVIDUAL**

We have talked at length of individual rights; but what, it may be asked, of the “rights of society”? Don’t they supersede the rights of the mere individual? The libertarian, however, is an individualist; he believes that one of the prime errors in social theory is to treat “society” as if it were an actually existing entity. “Society” is sometimes treated as a superior or quasi-divine figure with overriding “rights” of its own; at other times as an existing evil which can be blamed for all the ills of the world. The individualist holds that only individuals exist, think, feel, choose, and act; and that “society” is not a living entity but simply a label for a set of interacting individuals. Treating society as a thing that chooses and acts, then, serves to obscure the real forces at work. If, in a small community, ten people band together to rob and expropriate three others then this is clearly and evidently a case of a group of individuals acting in concert against another group. In this situation, if the ten people presumed to refer to themselves as “society” acting in “its” interest, the rationale would be laughed out of court; even the ten robbers would probably be too shamefaced to use this sort of argument. But let their size increase, and this kind of obfuscation becomes rife and succeeds in duping the public.

The fallacious use of a collective noun like “nation,” similar in this respect to “society,” has been trenchantly pointed out by the historian Parker T. Moon:

> When one uses the simple monosyllable “France” one thinks of France as a unit, an entity. When . . . we say “France sent her troops to conquer Tunis”—we impute not only unit but personality to the country. The very words

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conceal the facts and make international relations a glamorous drama in which personalized nations are the actors, and all too easily we forget the flesh-and-blood men and women who are the true actors . . . if we had no such word as “France” . . . then we should more accurately describe the Tunis expedition in some such way as this: “A few of these thirty-eight million persons sent thirty thousand others to conquer Tunis.” This way of putting the fact immediately suggests a question, or rather a series of questions. Who were the “few”? Why did they send the thirty thousand to Tunis? And why did these obey? Empire-building is done not by “nations,” but by men. The problem before us is to discover the men, the active, interested minorities in each nation, who are directly interested in imperialism and then to analyze the reasons why the majorities pay the expense and fight the war necessitated by imperialist expansion.

The individualist view of “society” has been summed up in the phrase: “Society” is everyone but yourself. Put thus bluntly, this analysis can be used to consider those cases where “society” is treated, not only as a superhero with super-rights, but as a supervillain on whose shoulders massive blame is placed. Consider the typical view that not the individual criminal, but “society,” is responsible for his crime. Take, for example, the case where Smith robs or murders Jones. The “old-fashioned” view is that Smith is responsible for his act. The modern liberal counters that “society” is responsible. This sounds both sophisticated and humanitarian, until we apply the individualist perspective. Then we see that what liberals are really saying is that everyone but Smith, including of course the victim Jones, is responsible for the crime. Put this baldly, almost everyone would recognize the absurdity of this position. But conjuring up the fictive entity “society” obfuscates this process. As the sociologist Arnold W. Green puts it: “It would follow, then, that if society is responsible for crime, and criminals are not responsible for crime,

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only those members of society who do not commit crime can be held responsible for crime. Nonsense this obvious can be circumvented only by conjuring up society as devil, as evil being apart from people and what they do.”

The great American libertarian writer Frank Chodorov stressed this view of society when he wrote that “Society Are People.”

Society is a collective concept and nothing else; it is a convenience for designating a number of people. So, too, is family or crowd or gang, or any other name we give to an agglomeration of persons. Society . . . is not an extra “person”; if the census totals a hundred million, that’s all there are, not one more, for there cannot be any accretion to Society except by procreation. The concept of Society as a metaphysical person falls flat when we observe that Society disappears when the component parts disperse; as in the case of a “ghost town” or of a civilization we learn about by the artifacts they left behind. When the individuals disappear so does the whole. The whole has no separate existence. Using the collective noun with a singular verb leads us into a trap of the imagination; we are prone to personalize the collectivity and to think of it as having a body and a psyche of its own.

**Free Exchange and Free Contract**

The central core of the libertarian creed, then, is to establish the absolute right to private property of every man: first, in his own body, and second, in the previously unused natural resources which he first transforms by his labor. These two axioms, the right of self-ownership and the right to

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“homestead,” establish the complete set of principles of the libertarian system. The entire libertarian doctrine then becomes the spinning out and the application of all the implications of this central doctrine. For example, a man, X, owns his own person and labor and the farm he clears on which he grows wheat. Another man, Y, owns the fish he catches; a third man, Z, owns the cabbages he has grown and the land under it. But if a man owns anything, he then has the right to give away or exchange these property titles to someone else, after which point the other person also has absolute property title. From this corollary right to private property stems the basic justification for free contract and for the free-market economy. Thus, if X grows wheat, he may and probably will agree to exchange some of that wheat for some of the fish caught by Y or for some of the cabbages grown by Z. With both X and Y making voluntary agreements to exchange property titles (or Y and Z, or X and Z) the property then becomes with equal legitimacy the property of the other person. If X exchanges wheat for Y’s fish, then that fish becomes X’s property to do with as he wishes, and the wheat becomes Y’s property in precisely the same way.

Further, a man may exchange not only the tangible objects he owns but also his own labor, which of course he owns as well. Thus, Z may sell his labor services of teaching farmer X’s children in return for some of the farmer’s produce.

It so happens that the free-market economy, and the specialization and division of labor it implies, is by far the most productive form of economy known to man, and has been responsible for industrialization and for the modern economy on which civilization has been built. This is a fortunate utilitarian result of the free market, but it is not, to the libertarian, the prime reason for his support of this system. That prime reason is moral and is rooted in the natural-rights defense of private property we have developed above. Even if a society of despotism and systematic invasion of rights could be shown to be more productive than what Adam Smith called “the system of natural liberty,” the libertarian would support this system. Fortunately, as in so many other areas, the utilitarian and
the moral, natural rights and general prosperity, go hand in hand.

The developed-market economy, as complex as the system appears to be on the surface, is nothing more than a vast network of voluntary and mutually agreed-upon two-person exchanges such as we have shown to occur between wheat and cabbage farmers, or between the farmer and the teacher. Thus, when I buy a newspaper for a dime, a mutually beneficial two-person exchange takes place: I transfer my ownership of the dime to the newsdealer and he transfers ownership of the paper to me. We do this because, under the division of labor, I calculate that the paper is worth more to me than the dime, while the newsdealer prefers the dime to keeping the paper. Or, when I teach at a university, I estimate that I prefer my salary to not expending my labor of teaching, while the university authorities calculate that they prefer gaining my teaching services to not paying me the money. If the newsdealer insisted on charging 50¢ for the paper, I might well decide that it isn’t worth the price; similarly, if I should insist on triple my present salary, the university might well decide to dispense with my services.

Many people are willing to concede the justice and propriety of property rights and the free-market economy, to concede that the farmer should be able to charge whatever his wheat will bring from consumers or the worker to reap whatever others are willing to pay for his services. But they balk at one point: inheritance. If Willie Stargell is ten times as good and “productive” a ball player as Joe Jack, they are willing to concede the justice of Stargell’s earning ten times the amount; but what, they ask, is the justification for someone whose only merit is being born a Rockefeller inheriting far more wealth than someone born a Rothbard? The libertarian answer is to concentrate not on the recipient, the child Rockefeller or the child Rothbard, but to concentrate on the giver, the man who bestows the inheritance. For if Smith and Jones and Stargell have the right to their labor and property and to exchange the titles to this property for the similar property of others, they also have the right to give their property to whomever they wish. And of course most such gifts consist of the gifts of the
property owners to their children—in short, inheritance. If Willie Stargell owns his labor and the money he earns from it, then he has the right to give that money to the baby Stargell.

In the developed free-market economy, then, the farmer exchanges the wheat for money; the wheat is bought by the miller who processes and transforms the wheat into flour; the miller sells the flour to the baker who produces bread; the baker sells the bread to the wholesaler, who in turn sells it to the retailer, who finally sells it to the consumer. And at each step of the way, the producer may hire the labor services of the workers in exchange for money. How “money” enters the equation is a complex process; but it should be clear that conceptually the use of money is equivalent to any single or group of useful commodities that are exchanged for the wheat, flour, etc. Instead of money, the commodity exchanged could be cloth, iron, or whatever. At each step of the way, mutually beneficial exchanges of property titles are agreed upon and transacted.

We are now in a position to see how the libertarian defines the concept of “freedom” or “liberty.” Freedom is a condition in which a person’s ownership rights in his own body and his legitimate material property are not invaded, are not aggressed against. A man who steals another man’s property is invading and restricting the victim’s freedom, as does the man who beats another over the head. Freedom and unrestricted property right go hand in hand. On the other hand, to the libertarian, “crime” is an act of aggression against a man’s property right, either in his own person or his materially owned objects. Crime is an invasion, by the use of violence, against a man’s property and therefore against his liberty. “Slavery”—the opposite of freedom—is a condition in which the slave has little or no right of self-ownership; his person and his produce are systematically expropriated by his master by the use of violence.

The libertarian, then, is clearly an individualist but not an egalitarian. The only “equality” he would advocate is the equal right of every man to the property in his own person, to the property in the unused resources he “homesteads,” and to
the property of others he has acquired either through voluntary exchange or gift.

**PROPERTY RIGHTS AND “HUMAN RIGHTS”**

Liberals will generally concede the right of every individual to his “personal liberty,” to his freedom to think, speak, write, and engage in such personal “exchanges” as sexual activity between “consenting adults.” In short, the liberal attempts to uphold the individual’s right to the ownership of his own body, but then denies his right to “property,” i.e., to the ownership of material objects. Hence, the typical liberal dichotomy between “human rights,” which he upholds, and “property rights,” which he rejects. Yet the two, according to the libertarian, are inextricably intertwined; they stand or fall together.

Take, for example, the liberal socialist who advocates government ownership of all the “means of production” while upholding the “human” right of freedom of speech or press. How is this “human” right to be exercised if the individuals constituting the public are denied their right to ownership of property? If, for example, the government owns all the newsprint and all the printing shops, how is the right to a free press to be exercised? If the government owns all the newsprint, it then necessarily has the right and the power to allocate that newsprint, and someone’s “right to a free press” becomes a mockery if the government decides not to allocate newsprint in his direction. And since the government must allocate scarce newsprint in *some* way, the right to a free press of, say, minorities or “subversive” antisocialists will get short shrift indeed. The same is true for the “right to free speech” if the government owns all the assembly halls, and therefore allocates those halls as it sees fit. Or, for example, if the government of Soviet Russia, being atheistic, decides not to allocate many scarce resources to the production of matzohs, for Orthodox Jews the “freedom of religion” becomes a mockery; but again, the Soviet government can always rebut that Orthodox Jews
are a small minority and that capital equipment should not be diverted to matzoh production.

The basic flaw in the liberal separation of “human rights” and “property rights” is that people are treated as ethereal abstractions. If a man has the right to self-ownership, to the control of his life, then in the real world he must also have the right to sustain his life by grappling with and transforming resources; he must be able to own the ground and the resources on which he stands and which he must use. In short, to sustain his “human right”—or his property rights in his own person—he must also have the property right in the material world, in the objects which he produces. Property rights are human rights, and are essential to the human rights which liberals attempt to maintain. The human right of a free press depends upon the human right of private property in newsprint.

In fact, there are no human rights that are separable from property rights. The human right of free speech is simply the property right to hire an assembly hall from the owners, or to own one oneself; the human right of a free press is the property right to buy materials and then print leaflets or books and to sell them to those who are willing to buy. There is no extra “right of free speech” or free press beyond the property rights we can enumerate in any given case. And furthermore, discovering and identifying the property rights involved will resolve any apparent conflicts of rights that may crop up.

Consider, for example, the classic example where liberals generally concede that a person’s “right of freedom of speech” must be curbed in the name of the “public interest”: Justice Holmes’ famous dictum that no one has the right to cry “fire” falsely in a crowded theater. Holmes and his followers have used this illustration again and again to prove the supposed necessity for all rights to be relative and tentative rather than precise and absolute.

But the problem here is not that rights cannot be pushed too far but that the whole case is discussed in terms of a vague and wooly “freedom of speech” rather than in terms of the rights of private property. Suppose we analyze the problem
under the aspect of property rights. The fellow who brings on a riot by falsely shouting “fire” in a crowded theater is, necessarily, either the owner of the theater (or the owner’s agent) or a paying patron. If he is the owner, then he has committed fraud on his customers. He has taken their money in exchange for a promise to put on a movie or play, and now, instead, he disrupts the show by falsely shouting “fire” and breaking up the performance. He has thus welshed on his contractual obligation, and has thereby stolen the property—the money—of his patrons and has violated their property rights.

Suppose, on the other hand, that the shouter is a patron and not the owner. In that case, he is violating the property right of the owner—as well as of the other guests to their paid-for performance. As a guest, he has gained access to the property on certain terms, including an obligation not to violate the owner’s property or to disrupt the performance the owner is putting on. His malicious act, therefore, violates the property rights of the theater owner and of all the other patrons.

There is no need, therefore, for individual rights to be restricted in the case of the false shouter of “fire.” The rights of the individual are still absolute; but they are property rights. The fellow who maliciously cried “fire” in a crowded theater is indeed a criminal, but not because his so-called “right of free speech” must be pragmatically restricted on behalf of the “public good”; he is a criminal because he has clearly and obviously violated the property rights of another person.
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THE STATE

THE STATE AS AGRESSOR

The central thrust of libertarian thought, then, is to oppose any and all aggression against the property rights of individuals in their own persons and in the material objects they have voluntarily acquired. While individual and gangs of criminals are of course opposed, there is nothing unique here to the libertarian creed, since almost all persons and schools of thought oppose the exercise of random violence against persons and property.

There is, however, a difference of emphasis on the part of libertarians even in this universally accepted area of defending people against crime. In the libertarian society there would be no “district attorney” who prosecutes criminals in the name of a nonexistent “society,” even against the wishes of the victim of crime. The victim would himself decide whether to press charges. Furthermore, as another side to the same coin, in a libertarian world the victim would be able to press suit against a wrongdoer without having to convince the same district attorney that he should proceed. Moreover, in the system of criminal punishment in the libertarian world, the emphasis would never be, as it is now, on “society’s” jailing the criminal; the emphasis would necessarily be on compelling the criminal to make restitution to the victim of his crime. The present system, in which the victim is not recompensed but instead has to pay taxes to support the incarceration of his
own attacker—would be evident nonsense in a world that focuses on the defense of property rights and therefore on the victim of crime.

Furthermore, while most libertarians are not pacifists, they would not join the present system in interfering with people’s right to be pacifists. Thus, suppose that Jones, a pacifist, is aggressed against by Smith, a criminal. If Jones, as the result of his beliefs, is against defending himself by the use of violence and is therefore opposed to any prosecution of crime, then Jones will simply fail to prosecute, and that will be the end of it. There will be no governmental machinery that pursues and tries criminals even against the wishes of the victim.

But the critical difference between libertarians and other people is not in the area of private crime; the critical difference is their view of the role of the State—the government. For libertarians regard the State as the supreme, the eternal, the best organized aggressor against the persons and property of the mass of the public. All States everywhere, whether democratic, dictatorial, or monarchical, whether red, white, blue, or brown.

The State! Always and ever the government and its rulers and operators have been considered above the general moral law. The “Pentagon Papers” are only one recent instance among innumerable instances in history of men, most of whom are perfectly honorable in their private lives, who lie in their teeth before the public. Why? For “reasons of State.” Service to the State is supposed to excuse all actions that would be considered immoral or criminal if committed by “private” citizens. The distinctive feature of libertarians is that they coolly and uncompromisingly apply the general moral law to people acting in their roles as members of the State apparatus. Libertarians make no exceptions. For centuries, the State (or more strictly, individuals acting in their roles as “members of the government”) has cloaked its criminal activity in high-sounding rhetoric. For centuries the State has committed mass murder and called it “war”; then ennobled the mass slaughter that “war” involves. For centuries the State has enslaved people into its armed battalions and called it “conscription” in the “national service.” For centuries the State has robbed people
at bayonet point and called it “taxation.” In fact, if you wish to know how libertarians regard the State and any of its acts, simply think of the State as a criminal band, and all of the libertarian attitudes will logically fall into place.

Let us consider, for example, what it is that sharply distinguishes government from all other organizations in society. Many political scientists and sociologists have blurred this vital distinction, and refer to all organizations and groups as hierarchical, structured, “governmental,” etc. Left-wing anarchists, for example, will oppose equally government and private organizations such as corporations on the ground that each is equally “elitist” and “coercive.” But the “rightist” libertarian is not opposed to inequality, and his concept of “coercion” applies only to the use of violence. The libertarian sees a crucial distinction between government, whether central, state, or local, and all other institutions in society. Or rather, two crucial distinctions. First, every other person or group receives its income by voluntary payment: either by voluntary contribution or gift (such as the local community chest or bridge club), or by voluntary purchase of its goods or services on the market (i.e., grocery store owner, baseball player, steel manufacturer, etc.). Only the government obtains its income by coercion and violence—i.e., by the direct threat of confiscation or imprisonment if payment is not forthcoming. This coerced levy is “taxation.” A second distinction is that, apart from criminal outlaws, only the government can use its funds to commit violence against its own or any other subjects; only the government can prohibit pornography, compel a religious observance, or put people in jail for selling goods at a higher price than the government deems fit. Both distinctions, of course, can be summed up as: only the government, in society, is empowered to aggress against the property rights of its subjects, whether to extract revenue, to impose its moral code, or to kill those with whom it disagrees. Furthermore, any and all governments, even the least despotic, have always obtained the bulk of their income from the coercive taxing power. And historically, by far the overwhelming portion of all enslavement and murder in the history of the world has come from the hands of government. And since we have seen that the
central thrust of the libertarian is to oppose all aggression against the rights of person and property, the libertarian necessarily opposes the institution of the State as the inherent and overwhelmingly the most important enemy of those precious rights.

There is another reason why State aggression has been far more important than private, a reason apart from the greater organization and central mobilizing of resources that the rulers of the State can impose. The reason is the absence of any check upon State depredation, a check that does exist when we have to worry about muggers or the Mafia. To guard against private criminals we have been able to turn to the State and its police; but who can guard us against the State itself? No one. For another critical distinction of the State is that it compels the monopolization of the service of protection; the State arrogates to itself a virtual monopoly of violence and of ultimate decision-making in society. If we don’t like the decisions of the State courts, for example, there are no other agencies of protection to which we may turn.

It is true that, in the United States, at least, we have a constitution that imposes strict limits on some powers of government. But, as we have discovered in the past century, no constitution can interpret or enforce itself; it must be interpreted by men. And if the ultimate power to interpret a constitution is given to the government’s own Supreme Court, then the inevitable tendency is for the Court to continue to place its imprimatur on ever-broader powers for its own government. Furthermore, the highly touted “checks and balances” and “separation of powers” in the American government are flimsy indeed, since in the final analysis all of these divisions are part of the same government and are governed by the same set of rulers.

One of America’s most brilliant political theorists, John C. Calhoun, wrote prophetically of the inherent tendency of a State to break through the limits of its written constitution:

A written constitution certainly has many and considerable advantages, but it is a great mistake to suppose that the mere insertion of provisions to restrict and limit the powers
of the government, without investing those for whose protection they are inserted with the means of enforcing their observance, will be sufficient to prevent the major and dominant party from abusing its powers. Being the party in possession of the government, they will . . . be in favor of the powers granted by the constitution and opposed to the restrictions intended to limit them. As the major and dominant parties, they will have no need of these restrictions for their protection . . . .

The minor or weaker party on the contrary, would take the opposite direction and regard them as essential to their protection against the dominant party . . . . But where there are no means by which they could compel the major party to observe the restrictions, the only resort left them would be a strict construction of the constitution . . . . To this the major party would oppose a liberal construction—one which would give to the words of the grant the broadest meaning of which they were susceptible. It would then be construction against construction—the one to contract and the other to enlarge the powers of the government to the utmost. But of what possible avail could the strict construction of the minor party be, against the liberal interpretation of the major, when the one would have all the powers of the government to carry its construction into effect and the other be deprived of all means of enforcing its construction? In a contest so unequal, the result would not be doubtful. The party in favor of the restrictions would be overpowered . . . . The end of the contest would be the subversion of the constitution . . . . the restrictions would ultimately be annulled and the government be converted into one of unlimited powers.

Nor would the division of government into separate and, as it regards each other, independent departments prevent this result . . . . as each and all the departments—and, of course, the entire government—would be under the control of the numerical majority, it is too clear to require explanation that a mere distribution of its powers among its agents or representatives could do little or nothing to counteract its tendency to oppression and abuse of power.1

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But why worry about the weakness of limits on governmental power? Especially in a “democracy,” in the phrase so often used by American liberals in their heyday before the mid-1960s when doubts began to creep into the liberal utopia: “Are we not the government?” In the phrase “we are the government,” the useful collective term “we” has enabled an ideological camouflage to be thrown over the naked exploitative reality of political life. For if we truly are the government, then anything a government does to an individual is not only just and not tyrannical; it is also “voluntary” on the part of the individual concerned. If the government has incurred a huge public debt which must be paid by taxing one group on behalf of another, this reality of burden is conveniently obscured by blithely saying that “we owe it to ourselves” (but who are the “we” and who the “ourselves”?). If the government drafts a man, or even throws him into jail for dissident opinions, then he is only “doing it to himself” and therefore nothing improper has occurred. Under this reasoning, then, Jews murdered by the Nazi government were not murdered; they must have “committed suicide,” since they were the government (which was democratically chosen), and therefore anything the government did to them was only voluntary on their part. But there is no way out of such grotesqueries for those supporters of government who see the State merely as a benevolent and voluntary agent of the public.

And so we must conclude that “we” are not the government; the government is not “us.” The government does not in any accurate sense “represent” the majority of the people, but even if it did, even if 90 percent of the people decided to murder or enslave the other 10 percent, this would still be murder and slavery, and would not be voluntary suicide or enslavement on the part of the oppressed minority. Crime is crime, aggression against rights is aggression, no matter how many citizens agree to the oppression. There is nothing sacrosanct about the majority; the lynch mob, too, is the majority in its own domain.

But while, as in the lynch mob, the majority can become actively tyrannical and aggressive, the normal and continuing condition of the State is oligarchic rule: rule by a coercive elite
which has managed to gain control of the State machinery. There are two basic reasons for this: one is the inequality and division of labor inherent in the nature of man, which gives rise to an "Iron Law of Oligarchy" in all of man’s activities; and second is the parasitic nature of the State enterprise itself.

We have said that the individualist is not an egalitarian. Part of the reason for this is the individualist’s insight into the vast diversity and individuality within mankind, a diversity that has the chance to flower and expand as civilization and living standards progress. Individuals differ in ability and in interest both within and between occupations; and hence, in all occupations and walks of life, whether it be steel production or the organization of a bridge club, leadership in the activity will inevitably be assumed by a relative handful of the most able and energetic, while the remaining majority will form themselves into rank-and-file followers. This truth applies to all activities, whether they are beneficial or malevolent (as in criminal organizations). Indeed, the discovery of the Iron Law of Oligarchy was made by the Italian sociologist Robert Michels, who found that the Social Democratic Party of Germany, despite its rhetorical commitment to egalitarianism, was rigidly oligarchical and hierarchical in its actual functioning.

A second basic reason for the oligarchic rule of the State is its parasitic nature—the fact that it lives coercively off the production of the citizenry. To be successful to its practitioners, the fruits of parasitic exploitation must be confined to a relative minority, otherwise a meaningless plunder of all by all would result in no gains for anyone. Nowhere has the coercive and parasitic nature of the State been more clearly limned than by the great late nineteenth-century German sociologist, Franz Oppenheimer. Oppenheimer pointed out that there are two and only two mutually exclusive means for man to obtain wealth. One, the method of production and voluntary exchange, the method of the free market, Oppenheimer termed the "economic means"; the other, the method of robbery by the use of violence, he called the "political means." The political means is clearly parasitic, for it requires previous production for the exploiters to confiscate, and it subtracts from instead of adding to the total production in society.
Oppenheimer then proceeded to define the State as the "organization of the political means"—the systematization of the predatory process over a given territorial area.2

In short, private crime is, at best, sporadic and uncertain; the parasitism is ephemeral, and the coercive, parasitic lifeline can be cut at any time by the resistance of the victims. The State provides a legal, orderly, systematic channel for predation on the property of the producers; it makes certain, secure, and relatively "peaceful" the lifeline of the parasitic caste in society. The great libertarian writer Albert Jay Nock wrote vividly that "the State claims and exercises the monopoly of crime. . . . It forbids private murder, but itself organizes murder on a colossal scale. It punishes private theft, but itself lays unscrupulous hands on anything it wants, whether the property of citizen or of alien."3

At first, of course, it is startling for someone to consider taxation as robbery, and therefore government as a band of robbers. But anyone who persists in thinking of taxation as in some sense a "voluntary" payment can see what happens if he chooses not to pay. The great economist Joseph Schumpeter, himself by no means a libertarian, wrote that "the state has been living on a revenue which was being produced in the private sphere for private purposes and had to be deflected from these purposes by political force. The theory which construes taxes on the analogy of club dues or of the purchase of the services of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind."4

The eminent Viennese "legal positivist" Hans Kelsen attempted, in his treatise, The General Theory of Law and the State, to establish a political theory and justification of the

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State, on a strictly “scientific” and value-free basis. What happened is that early in the book, he came to the crucial sticking-point, the pons asinorum of political philosophy: What distinguishes the edicts of the State from the commands of a bandit gang? Kelsen’s answer was simply to say that the decrees of the State are “valid,” and to proceed happily from there, without bothering to define or explain this concept of “validity.” Indeed, it would be a useful exercise for nonlibertarians to ponder this question: How can you define taxation in a way which makes it different from robbery?

To the great nineteenth-century individualist anarchist—and constitutional lawyer—Lysander Spooner, there was no problem in finding the answer. Spooner’s analysis of the State as robber group is perhaps the most devastating ever written:

It is true that the theory of our Constitution is, that all taxes are paid voluntarily; that our government is a mutual insurance company, voluntarily entered into by the people with each other. . . .

But this theory of our government is wholly different from the practical fact. The fact is that the government, like a highwayman, say to a man: “Your money, or your life.” And many, if not most, taxes are paid under the compulsion of that threat.

The government does not, indeed, waylay a man in a lonely place, spring upon him from the roadside, and holding a pistol to his head, proceed to rifle his pockets. But the robbery is none the less a robbery on that account; and it is far more dastardly and shameful.

The highwayman takes solely upon himself the responsibility, danger, and crime of his own act. He does not pretend that he has any rightful claim to your money, or that he intends to use it for your own benefit. He does not pretend to be anything but a robber. He has not acquired impudence enough to profess to be merely a “protector,” and that he takes men’s money against their will, merely to enable him to “protect” those infatuated travellers, who feel perfectly able to protect themselves, or do not appreciate his peculiar system of protection. He is too sensible a man to make such
professions as these. Furthermore, having taken your money, he leaves you, as you wish him to do. He does not persist in following you on the road, against your will; assuming to be your rightful “sovereign,” on account of the “protection” he affords you. He does not keep “protecting” you, by commanding you to bow down and serve him; by requiring you to do this, and forbidding you to do that; by robbing you of more money as often as he finds it for his interest or pleasure to do so; and by branding you as a rebel, a traitor, and an enemy to your country, and shooting you down without mercy, if you dispute his authority, or resist his demands. He is too much of a gentleman to be guilty of such impostures, and insults, and villainies as these. In short, he does not, in addition to robbing you, attempt to make you either his dupe or his slave.5

If the State is a group of plunderers, who then constitutes the State? Clearly, the ruling elite consists at any time of (a) the full-time apparatus—the kings, politicians, and bureaucrats who man and operate the State; and (b) the groups who have maneuvered to gain privileges, subsidies, and benefices from the State. The remainder of society constitutes the ruled. It was, again, John C. Calhoun who saw with crystal clarity that, no matter how small the power of government, no matter how low the tax burden or how equal its distribution, the very nature of government creates two unequal and inherently conflicting classes in society: those who, on net, pay the taxes (the “tax-payers”), and those who, on net, live off taxes (the “tax-consumers”). Suppose that the government imposes a low and seemingly equally distributed tax to pay for building a dam. This very act takes money from most of the public to pay it out to net “tax-consumers”: the bureaucrats who run the operation, the contractors and workers who build the dam, etc. And the greater the scope of government decision-making, the greater its fiscal burdens, Calhoun went on, the

greater the burden and the artificial inequality it imposes between these two classes:

Few, comparatively, as they are, the agents and employees of the government constitute that portion of the community who are the exclusive recipients of the proceeds of the taxes. Whatever amount is taken from the community in the form of taxes, if not lost, goes to them in the shape of expenditures or disbursements. The two—disbursement and taxation—constitute the fiscal action of the government. They are correlatives. What the one takes from the community under the name of taxes is transferred to the portion of the community who are the recipients under that of disbursements. But as the recipients constitute only a portion of the community, it follows, taking the two parts of the fiscal process together, that its action must be unequal between the payers of the taxes and the recipients of their proceeds. Nor can it be otherwise; unless what is collected from each individual in the shape of taxes shall be returned to him in that of disbursements, which would make the process nugatory and absurd. . . .

The necessary result, then, of the unequal fiscal action of the government is to divide the community into two great classes: one consisting of those who, in reality, pay the taxes and, of course, bear exclusively the burden of supporting the government; and the other, of those who are the recipients of their proceeds through disbursements, and who are, in fact, supported by the government; or, in fewer words, to divide it into tax-payers and tax-consumers.

But the effect of this is to place them in antagonistic relations in reference to the fiscal action of the government—and the entire course of policy therewith connected. For the greater the taxes and disbursements, the greater the gain of the one and the loss of the other, and vice versa. . . . The effect, then, of every increase is to enrich and strengthen the one, and impoverish and weaken the other.6

If states have everywhere been run by an oligarchic group of predators, how have they been able to maintain their rule over the mass of the population? The answer, as the philosopher David Hume pointed out over two centuries ago, is that in the long run every government, no matter how dictatorial, rests on the support of the majority of its subjects. Now this does not of course render these governments “voluntary,” since the very existence of the tax and other coercive powers shows how much compulsion the State must exercise. Nor does the majority support have to be eager and enthusiastic approval; it could well be mere passive acquiescence and resignation. The conjunction in the famous phrase “death and taxes” implies a passive and resigned acceptance to the assumed inevitability of the State and its taxation.

The tax-consumers, the groups that benefit from the operations of the State, will of course be eager rather than passive followers of the State mechanism. But these are only a minority. How is the compliance and acquiescence of the mass of the population to be secured? Here we come to the central problem of political philosophy—that branch of philosophy that deals with politics, the exercise of regularized violence: the mystery of civil obedience. Why do people obey the edicts and depredations of the ruling elite? Conservative writer James Burnham, who is the reverse of libertarian, put the problem very clearly, admitting that there is no rational justification for civil obedience: “Neither the source nor the justification of government can be put in wholly rational terms . . . why should I accept the hereditary or democratic or any other principle of legitimacy? Why should a principle justify the rule of that man over me?” His own answer is hardly calculated to convince many others: “I accept the principle, well . . . because I do, because that is the way it is and has been.” But suppose that one does not accept the principle; what will the “way” be then? And why have the bulk of subjects agreed to accept it?

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THE STATE AND THE INTELLECTUALS

The answer is that, since the early origins of the State, its rulers have always turned, as a necessary bolster to their rule, to an alliance with society’s class of intellectuals. The masses do not create their own abstract ideas, or indeed think through these ideas independently; they follow passively the ideas adopted and promulgated by the body of intellectuals, who become the effective “opinion moulders” in society. And since it is precisely a moulding of opinion on behalf of the rulers that the State almost desperately needs, this forms a firm basis for the age-old alliance of the intellectuals and the ruling classes of the State. The alliance is based on a *quid pro quo*: on the one hand, the intellectuals spread among the masses the idea that the State and its rulers are wise, good, sometimes divine, and at the very least inevitable and better than any conceivable alternatives. In return for this panoply of ideology, the State incorporates the intellectuals as part of the ruling elite, granting them power, status, prestige, and material security. Furthermore, intellectuals are needed to staff the bureaucracy and to “plan” the economy and society.

Before the modern era, particularly potent among the intellectual handmaidens of the State was the priestly caste, cementing the powerful and terrible alliance of warrior chief and medicine man, of Throne and Altar. The State “established” the Church and conferred upon it power, prestige, and wealth extracted from its subjects. In return, the Church anointed the State with divine sanction and inculcated this sanction into the populace. In the modern era, when theocratic arguments have lost much of their lustre among the public, the intellectuals have posed as the scientific cadre of “experts” and have been busy informing the hapless public that political affairs, foreign and domestic, are much too complex for the average person to bother his head about. Only the State and its corps of intellectual experts, planners, scientists, economists, and “national security managers” can possibly hope to deal with these problems. The role of the masses, even in “democracies,” is to ratify and assent to the decisions of their knowledgeable rulers.
Historically, the union of Church and State, of Throne and Altar, has been the most effective device for inducing obedience and support among the subjects. Burnham attests to the power of myth and mystery in inducing support when he writes that, “In ancient times, before the illusions of science had corrupted traditional wisdom, the founders of Cities were known to be gods or demi-gods.” To the established priestcraft, the ruler was either anointed by God or, in the case of the absolute rule of many Oriental despotisms, was even himself God; hence, any questioning or resistance to his rule would be blasphemy.

Many and subtle are the ideological weapons the State and its intellectuals have used over the centuries to induce their subjects to accept their rule. One excellent weapon has been the power of tradition. The longer lasting the rule of any given State, the more powerful this weapon; for then the X-Dynasty or the Y-State has the seeming weight of centuries of tradition behind it. Worship of one’s ancestors then becomes a none-too-subtle means of cultivating worship of one’s ancestral rulers. The force of tradition is, of course, bolstered by ancient habit, which confirms the subjects in the seeming propriety and legitimacy of the rule under which they live. Thus, the political theorist Bertrand De Jouvenel has written:

The essential reason for obedience is that it has become a habit of the species. . . . Power is for us a fact of nature. From the earliest days of recorded history it has always presided over human destinies . . . the authorities which ruled . . . in former times did not disappear without bequeathing to their successors their privilege nor without leaving in men’s minds imprints which are cumulative in their effect. The succession of governments which, in the course of centuries, rule the same society may be looked on as one underlying government which takes on continuous accretions.9

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8Burnham, Congress and the American Tradition, p. 3.
Another potent ideological force is for the State to deprecate the *individual* and exalt either the past or the present collectivity of society. Any isolated voice, any raiser of new doubts, can then be attacked as a profane violator of the wisdom of his ancestors. Moreover, any new idea, much less any new *critical* idea, must necessarily *begin* as a small minority opinion. Therefore, in order to ward off any potentially dangerous idea from threatening majority acceptance of its rule, the State will try to nip the new idea in the bud by ridiculing any view that sets itself against mass opinion. The ways in which the State rulers in ancient Chinese despotisms used religion as a method of binding the individual to the State-run society were summarized by Norman Jacobs:

Chinese religion is a social religion, seeking to solve the problems of social interests, not individual interests. . . . Religion is essentially a force of impersonal social adjustment and control—rather than a medium for the personal solutions of the individual—and social adjustment and control are effected through education and reverence for superiors. . . . Reverence for superiors—superior in age and hence in education and experience—is the ethical foundation of social adjustment and control. . . . In China, the interrelationship of political authority with orthodox religion equated heterodoxy with political error. The orthodox religion was particularly active in persecuting and destroying heterodox sects; in this it was backed by the secular power.10

The general tendency of government to seek out and thwart any heterodox views was outlined, in typically witty and delightful style, by the libertarian writer H.L. Mencken:

All [that government] can see in an original idea is potential change, and hence an invasion of its prerogatives. The most

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dangerous man, to any government, is the man who is able to think things out for himself, without regard to the prevailing superstitions and taboos. Almost inevitably he comes to the conclusion that the government he lives under is dishonest, insane and intolerable, and so, if he is romantic, he tries to change it. And even if he is not romantic personally he is very apt to spread discontent among those who are.\textsuperscript{11}

It is also particularly important for the State to make its rule seem \textit{inevitable}: even if its reign is disliked, as it often is, it will then be met with the passive resignation expressed in the familiar coupling of “death and taxes.” One method is to bring to its side historical determinism: if X-State rules us, then this has been inevitably decreed for us by the Inexorable Laws of History (or the Divine Will, or the Absolute, or the Material Productive Forces), and nothing that any puny individuals may do can change the inevitable. It is also important for the State to inculcate in its subjects an aversion to any outcropping of what is now called “a conspiracy theory of history.” For a search for “conspiracies,” as misguided as the results often are, means a search for motives, and an attribution of individual responsibility for the historical misdeeds of ruling elites. If, however, any tyranny or venality or aggressive war imposed by the State was brought about \textit{not} by particular State rulers but by mysterious and arcane “social forces,” or by the imperfect state of the world—or if, in some way, \textit{everyone} was guilty (“We are all murderers,” proclaims a common slogan), then there is no point in anyone’s becoming indignant or rising up against such misdeeds. Furthermore, a discrediting of “conspiracy theories”—or indeed, of anything smacking of “economic determinism”—will make the subjects more likely to believe the “general welfare” reasons that are invariably put forth by the modern State for engaging in any aggressive actions.

The rule of the State is thus made to seem inevitable. Furthermore, any alternative to the existing State is encased in an aura of fear. Neglecting its own monopoly of theft and predation, the State raises the spectre among its subjects of the chaos that would supposedly ensue if the State should disappear. The people on their own, it is maintained, could not possibly supply their own protection against sporadic criminals and marauders. Furthermore, each State has been particularly successful over the centuries in instilling fear among its subjects of other State rulers. With the land area of the globe now parcelled out among particular States, one of the basic doctrines and tactics of the rulers of each State has been to identify itself with the territory it governs. Since most men tend to love their homeland, the identification of that land and its population with the State is a means of making natural patriotism work to the State’s advantage. If, then, “Ruritania” is attacked by “Walldavia,” the first task of the Ruritania State and its intellectuals is to convince the people of Ruritania that the attack is really upon them, and not simply upon their ruling class. In this way, a war between rulers is converted into a war between peoples, with each people rushing to the defense of their rulers in the mistaken belief that the rulers are busily defending them. This device of nationalism has been particularly successful in recent centuries; it was not very long ago, at least in Western Europe, when the mass of subjects regarded wars as irrelevant battles between various sets of nobles and their retinues.

Another tried and true method for bending subjects to one’s will is the infusion of guilt. Any increase in private well-being can be attacked as “unconscionable greed,” “materialism,” or “excessive affluence”; and mutually beneficial exchanges in the market can be denounced as “selfish.” Somehow the conclusion always drawn is that more resources should be expropriated from the private sector and siphoned into the parasitic “public,” or State, sector. Often the call upon the public to yield more resources is couched in a stern call by the ruling elite for more “sacrifices” for the national or the common weal. Somehow, however, while the public is supposed to sacrifice and curtail its “materialistic greed,” the
sacrifices are always one way. The State does not sacrifice; the State eagerly grabs more and more of the public’s material resources. Indeed, it is a useful rule of thumb: when your ruler calls aloud for “sacrifices,” look to your own life and pocketbook!

This sort of argumentation reflects a general double standard of morality that is always applied to State rulers but not to anyone else. No one, for example, is surprised or horrified to learn that businessmen are seeking higher profits. No one is horrified if workers leave lower-paying for higher-paying jobs. All this is considered proper and normal behavior. But if anyone should dare assert that politicians and bureaucrats are motivated by the desire to maximize their incomes, the hue and cry of “conspiracy theorist” or “economic determinist” spreads throughout the land. The general opinion—carefully cultivated, of course, by the State itself—is that men enter politics or government purely out of devoted concern for the common good and the public weal. What gives the gentlemen of the State apparatus their superior moral patina? Perhaps it is the dim and instinctive knowledge of the populace that the State is engaged in systematic theft and predation, and they may feel that only a dedication to altruism on the part of the State makes these actions tolerable. To consider politicians and bureaucrats subject to the same monetary aims as everyone else would strip the Robin Hood veil from State predation. For it would then be clear that, in the Oppenheimer phrasing, ordinary citizens were pursuing the peaceful, productive “economic means” to wealth, while the State apparatus was devoting itself to the coercive and exploitative organized “political means.” The emperor’s clothes of supposed altruistic concern for the common weal would then be stripped from him.

The intellectual arguments used by the State throughout history to “engineer consent” by the public can be classified into two parts: (1) that rule by the existing government is inevitable, absolutely necessary, and far better than the indescribable evils that would ensue upon its downfall; and (2) that the State rulers are especially great, wise, and altruistic men—far greater, wiser, and better than their simple subjects.
In former times, the latter argument took the form of rule by “divine right” or by the “divine ruler” himself, or by an “aristocracy” of men. In modern times, as we indicated earlier, this argument stresses not so much divine approval as rule by a wise guild of “scientific experts” especially endowed in knowledge of statesmanship and the arcane facts of the world. The increasing use of scientific jargon, especially in the social sciences, has permitted intellectuals to weave apologia for State rule which rival the ancient priestcraft in obscurantism. For example, a thief who presumed to justify his theft by saying that he was really helping his victims by his spending, thus giving retail trade a needed boost, would be hooted down without delay. But when this same theory is clothed in Keynesian mathematical equations and impressive references to the “multiplier effect,” it carries far more conviction with a bamboozled public.

In recent years, we have seen the development in the United States of a profession of “national security managers,” of bureaucrats who never face electoral procedures, but who continue, through administration after administration, secretly using their supposed special expertise to plan wars, interventions, and military adventures. Only their egregious blunders in the Vietnam war have called their activities into any sort of public question; before that, they were able to ride high, wide, and handsome over the public they saw mostly as cannon fodder for their own purposes.

A public debate between “isolationist” Senator Robert A. Taft and one of the leading national security intellectuals, McGeorge Bundy, was instructive in demarking both the issues at stake and the attitude of the intellectual ruling elite. Bundy attacked Taft in early 1951 for opening a public debate on the waging of the Korean war. Bundy insisted that only the executive policy leaders were equipped to manipulate diplomatic and military force in a lengthy decades-long period of limited war against the communist nations. It was important, Bundy maintained, that public opinion and public debate be excluded from promulgating any policy role in this area. For, he warned, the public was unfortunately not committed to the rigid national purposes discerned by the policy managers; it
merely responded to the *ad hoc* realities of given situations. Bundy also maintained that there should be no recriminations or even examinations of the decisions of the policy managers, because it was important that the public accept their decisions without question. Taft, in contrast, denounced the secret decision-making by military advisers and specialists in the executive branch, decisions effectively sealed off from public scrutiny. Furthermore, he complained, “If anyone dared to suggest criticism or even a thorough debate, he was at once branded as an isolationist and a saboteur of unity and the bipartisan foreign policy.”

Similarly, at a time when President Eisenhower and Secretary of State Dulles were privately contemplating going to war in Indochina, another prominent national security manager, George F. Kennan, was advising the public that “There are times when, having elected a government, we will be best advised to let it govern and let it speak for us as it will in the councils of the nations.”

We see clearly why the State needs the intellectuals; but why do the intellectuals need the State? Put simply, the intellectual’s livelihood in the free market is generally none too secure; for the intellectual, like everyone else on the market, must depend on the values and choices of the masses of his fellow men, and it is characteristic of these masses that they are generally uninterested in intellectual concerns. The State, on the other hand, is willing to offer the intellectuals a warm, secure, and permanent berth in its apparatus, a secure income, and the panoply of prestige.

The eager alliance between the State and the intellectuals was symbolized by the avid desire of the professors at the University of Berlin, in the nineteenth century, to form themselves into what they themselves proclaimed as the “intellectual

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bodyguard of the House of Hohenzollern.” From a superficially different ideological perspective, it can be seen in the revealingly outraged reaction of the eminent Marxist scholar of ancient China, Joseph Needham, to Karl Wittfogel’s acidulous critique of ancient Chinese despotism. Wittfogel had shown the importance for bolstering the system of the Confucian glorification of the gentleman-scholar officials who manned the ruling bureaucracy of despotic China. Needham charged indignantly that the “civilization which Professor Wittfogel is so bitterly attacking was one which could make poets and scholars into officials.” What matter the totalitarianism so long as the ruling class is abundantly staffed by certified intellectuals!

The worshipful and fawning attitude of intellectuals toward their rulers has been illustrated many times throughout history. A contemporary American counterpart to the “intellectual bodyguard of the House of Hohenzollern” is the attitude of so many liberal intellectuals toward the office and person of the President. Thus, to political scientist Professor Richard Neustadt, the President is the “sole crown-like symbol of the Union.” And policy manager Townsend Hoopes, in the winter of 1960, wrote that “under our system the people can look only to the President to define the nature of our foreign policy problem and the national programs and sacrifices required to meet it with effectiveness.” After generations of such rhetoric, it is no wonder that Richard Nixon, on the eve of his election as President, should thus describe his role: “He


[the President] must articulate the nation’s values, define its goals and marshall its will.” Nixon’s conception of his role is hauntingly similar to Ernst Huber’s articulation, in the Germany of the 1930s, of the Constitutional Law of the Greater German Reich. Huber wrote that the head of State “sets up the great ends which are to be attained and draws up the plans for the utilization of all national powers in the achievement of the common goals . . . he gives the national life its true purpose and value.”16

The attitude and motivation of the contemporary national security intellectual bodyguard of the State has been caustically described by Marcus Raskin, who was a staff member of the National Security Council during the Kennedy administration. Calling them “megadeath intellectuals,” Raskin writes that:

their most important function is to justify and extend the existence of their employers. . . . In order to justify the continued large-scale production of these [thermonuclear] bombs and missiles, military and industrial leaders needed some kind of theory to rationalize their use. . . . This became particularly urgent during the late 1950’s, when economy-minded members of the Eisenhower Administration began to wonder why so much money, thought, and resources were being spent on weapons if their use could not be justified. And so began a series of rationalizations by the “defense intellectuals” in and out of the universities. . . . Military procurement will continue to flourish, and they will continue to demonstrate why it must. In this respect they are no different from the great majority of modern specialists who accept the assumptions of the organizations which employ them because of the rewards in money and power and prestige. . . . They know enough not to question their employers’ right to exist.17


This is not to say that all intellectuals everywhere have been “court intellectuals,” servitors and junior partners of power. But this has been the ruling condition in the history of civilizations—generally in the form of a priestcraft—just as the ruling condition in those civilizations has been one or another form of despotism. There have been glorious exceptions, however, particularly in the history of Western civilization, where intellectuals have often been trenchant critics and opponents of State power, and have used their intellectual gifts to fashion theoretical systems which could be used in the struggle for liberation from that power. But invariably, these intellectuals have only been able to arise as a significant force when they have been able to operate from an independent power base—an independent property base—separate from the apparatus of the State. For wherever the State controls all property, wealth, and employment, everyone is economically dependent on it, and it becomes difficult, if not impossible, for such independent criticism to arise. It has been in the West, with its decentralized foci of power, its independent sources of property and employment, and therefore of bases from which to criticize the State, where a body of intellectual critics has been able to flourish. In the Middle Ages, the Roman Catholic Church, which was at least separate if not independent from the State, and the new free towns were able to serve as centers of intellectual and also of substantive opposition. In later centuries, teachers, ministers, and pamphleteers in a relatively free society were able to use their independence from the State to agitate for further expansion of freedom. In contrast, one of the first libertarian philosophers, Lao-tse, living in the midst of ancient Chinese despotism, saw no hope for achieving liberty in that totalitarian society except by counseling quietism, to the point of the individual’s dropping out of social life altogether.

With decentralized power, with a Church separate from the State, with flourishing towns and cities able to develop

outside the feudal power structure, and with freedom in society, the economy was able to develop in Western Europe in a way that transcended all previous civilizations. Furthermore, the Germanic—and particularly the Celtic—tribal structure which succeeded the disintegrating Roman Empire had strong libertarian elements. Instead of a mighty State apparatus exerting a monopoly of violence, disputes were solved by contending tribesmen consulting the elders of the tribe on the nature and application of the tribe’s customary and common law. The “chief” was generally merely a war leader who was only called into his warrior role whenever war with other tribes was under way. There was no permanent war or military bureaucracy in the tribes. In Western Europe, as in many other civilizations, the typical model of the origin of the State was not via a voluntary “social contract” but by the conquest of one tribe by another. The original liberty of the tribe or the peasantry thus falls victim to the conquerors. At first, the conquering tribe killed and looted the victims and rode on. But at some time the conquerors decided that it would be more profitable to settle down among the conquered peasantry and rule and loot them on a permanent and systematic basis. The periodic tribute exacted from the conquered subjects eventually came to be called “taxation.” And, with equal generality, the conquering chieftains parcelled out the land of the peasantry to the various warlords, who were then able to settle down and collect feudal “rent” from the peasantry. The peasants were often enslaved, or rather enserfed, to the land itself to provide a continuing source of exploited labor for the feudal lords.18

18On the typical genesis of the State, see Oppenheimer, The State, chap. II. While scholars such as Lowie and Wittfogel (Oriental Despotism, pp. 324–25) dispute the Gumplowicz-Oppenheimer-Rüstow thesis that the State always originated in conquest, they concede that conquest often entered into the alleged internal development of States. Furthermore, there is evidence that in the first great civilization, Sumer, a prosperous, free and Stateless society existed until military defense against conquest induced the development of a permanent military and State bureaucracy. Cf. Samuel Noah Kramer, The Sumerians (Chicago: University of Chicago Press, 1963), pp. 73ff.
We may note a few prominent instances of the birth of a modern State through conquest. One was the military conquest of the Indian peasantry in Latin America by the Spaniards. The conquering Spanish not only established a new State over the Indians, but the land of the peasantry was parcelled out among the conquering warlords, who were ever after to collect rent from the tillers of the land. Another instance was the new political form imposed upon the Saxons of England after their conquest by the Normans in 1066. The land of England was parcelled out among the Norman warrior lords, who thereby formed a State and feudal-land apparatus of rule over the subject population. For the libertarian, the most interesting and certainly the most poignant example of the creation of a State through conquest was the destruction of the libertarian society of ancient Ireland by England in the seventeenth century, a conquest which established an imperial State and ejected numerous Irish from their cherished land. The libertarian society of Ireland, which lasted for a thousand years—and which will be described further below—was able to resist English conquest for hundreds of years because of the absence of a State which could be conquered easily and then used by the conquerors to rule over the native population.

But while throughout Western history, intellectuals have formulated theories designed to check and limit State power, each State has been able to use its own intellectuals to turn those ideas around into further legitimations of its own advance of power. Thus, originally, in Western Europe the concept of the “divine right of kings” was a doctrine promoted by the Church to limit State power. The idea was that the king could not just impose his arbitrary will. His edicts were limited to conforming with the divine law. As absolute monarchy advanced, however, the kings were able to turn the concept around to the idea that God put his stamp of approval on any of the king’s actions; that he ruled by “divine right.”

Similarly, the concept of parliamentary democracy began as a popular check on the absolute rule of the monarch. The king was limited by the power of parliament to grant him tax revenues. Gradually, however, as parliament displaced the king as head of State, the parliament itself became the...
unchecked State sovereign. In the early nineteenth century, English utilitarians, who advocated additional individual liberty in the name of social utility and the general welfare, were to see these concepts turned into sanctions for expanding the power of the State.

As De Jouvenel writes:

Many writers on theories of sovereignty have worked out one or the other of these restrictive devices. But in the end every single such theory has, sooner or later, lost its original purpose, and come to act merely as a springboard to Power, by providing it with the powerful aid of an invisible sovereign with whom it could in time successfully identify itself.19

Certainly, the most ambitious attempt in history to impose limits on the State was the Bill of Rights and other restrictive parts of the United States Constitution. Here, written limits on government became the fundamental law, to be interpreted by a judiciary supposedly independent of the other branches of government. All Americans are familiar with the process by which John C. Calhoun’s prophetic analysis has been vindicated; the State’s own monopoly judiciary has inexorably broadened the construction of State power over the last century and a half. But few have been as keen as liberal Professor Charles Black—who hails the process—in seeing that the State has been able to transform judicial review itself from a limiting device into a powerful instrument for gaining legitimacy for its actions in the minds of the public. If a judicial decree of “unconstitutional” is a mighty check on governmental power, so too a verdict of “constitutional” is an equally mighty weapon for fostering public acceptance of ever greater governmental power.

Professor Black begins his analysis by pointing out the crucial necessity for “legitimacy” of any government in order to endure; that is, basic majority acceptance of the government and its actions. Acceptance of legitimacy, however, becomes a

19De Jouvenel, On Power, p. 27.
real problem in a country like the United States, where “substantive limitations are built into the theory on which the government rests.” What is needed, adds Black, is a method by which the government can assure the public that its expanding powers are indeed “constitutional.” And this, he concludes, has been the major historic function of judicial review. Let Black illustrate the problem:

The supreme risk [to the government] is that of disaffection and a feeling of outrage widely disseminated throughout the population, and loss of moral authority by the government as such, however long it may be propped up by force or inertia or the lack of an appealing and immediately available alternative. Almost everybody living under a government of limited powers, must sooner or later be subjected to some governmental action which as a matter of private opinion he regards as outside the power of government or positively forbidden to government. A man is drafted, though he finds nothing in the Constitution about being drafted. . . A farmer is told how much wheat he can raise; he believes, and he discovers that some respectable lawyers believe with him, that the government has no more right to tell him how much wheat he can grow than it has to tell his daughter whom she can marry. A man goes to the federal penitentiary for saying what he wants to, and he paces his cell reciting. . . “Congress shall make no laws abridging the freedom of speech.” . . A businessman is told what he can ask, and must ask, for buttermilk.

The danger is real enough that each of these people (and who is not of their number?) will confront the concept of governmental limitation with the reality (as he sees it) of the flagrant overstepping of actual limits, and draw the obvious conclusion as to the status of his government with respect to legitimacy.20

This danger is averted, Black adds, by the State’s propounding the doctrine that some one agency must have the ultimate decision on constitutionality, and that this agency

must be part of the federal government itself. For while the seeming independence of the federal judiciary has played a vital role in making its actions virtual Holy Writ for the bulk of the population, it is also true that the judiciary is part and parcel of the government apparatus and is appointed by the executive and legislative branches. Professor Black concedes that the government has thereby set itself up as a judge in its own case, and has thus violated a basic juridical principle for arriving at any kind of just decision. But Black is remarkably lighthearted about this fundamental breach: “The final power of the State . . . must stop where the law stops it. And who shall set the limit, and who shall enforce the stopping, against the mightiest power? Why, the State itself, of course, through its judges and its laws. Who controls the temperate? Who teaches the wise?”\(^2^1\) And so Black admits that when we have a State, we hand over all our weapons and means of coercion to the State apparatus, we turn over all of our powers of ultimate decision-making to this deified group, and then we must jolly well sit back quietly and await the unending stream of justice that will pour forth from these institutions—even though they are basically judging their own case. Black sees no conceivable alternative to this coercive monopoly of judicial decisions enforced by the State, but here is precisely where our new movement challenges this conventional view and asserts that there is a viable alternative: libertarianism.

Seeing no such alternative, Professor Black falls back on mysticism in his defense of the State, for in the final analysis he finds the achievement of justice and legitimacy from the State’s perpetual judging of its own cause to be “something of a miracle.” In this way, the liberal Black joins the conservative Burnham in falling back on the miraculous and thereby admitting that there is no satisfactory rational argument in support of the State.\(^2^2\)

\(^2^1\)Ibid., pp. 32–33.

\(^2^2\)In contrast to the complacency of Black was the trenchant critique of the Constitution and the powers of the Supreme Court by the political
Applying his realistic view of the Supreme Court to the famous conflict between the Court and the New Deal in the 1930s, Professor Black chides his liberal colleagues for their shortsightedness in denouncing judicial obstructionism:

the standard version of the story of the New Deal and the Court, though accurate in its way, displaces the emphasis. . . . It concentrates on the difficulties; it almost forgets how the whole thing turned out. The upshot of the matter was (and this is what I like to emphasize) that after some twenty-four months of balking . . . the Supreme Court, without a single change in the law of its composition, or, indeed, in its actual manning, placed the affirmative stamp of legitimacy on the New Deal, and on the whole new conception of government in America. [Italics the author’s]23

In this way, the Supreme Court was able to put the quietus to the large body of Americans who had strong constitutional objections to the expanded powers of the New Deal:

Of course, not everyone was satisfied. The Bonnie Prince Charlie of constitutionally commanded laissez-faire still stirs the hearts of a few zealots in the Highlands of choleric unreality. But there is no longer any significant or dangerous public doubt as to the constitutional power of Congress to deal as it does with the national economy. . . . We had no means, other than the Supreme Court, for imparting legitimacy to the New Deal.24

Thus, even in the United States, unique among governments in having a constitution, parts of which at least were meant to impose strict and solemn limits upon its actions,


23Ibid., p. 64.
24Ibid., p. 65.
even here the Constitution has proved to be an instrument for ratifying the expansion of State power rather than the opposite. As Calhoun saw, any written limits that leave it to government to interpret its own powers are bound to be interpreted as sanctions for expanding and not binding those powers. In a profound sense, the idea of binding down power with the chains of a written constitution has proved to be a noble experiment that failed. The idea of a strictly limited government has proved to be utopian; some other, more radical means must be found to prevent the growth of the aggressive State. The libertarian system would meet this problem by scrapping the entire notion of creating a government—an institution with a coercive monopoly of force over a given territory—and then hoping to find ways to keep that government from expanding. The libertarian alternative is to abstain from such a monopoly government to begin with.

We will explore the entire notion of a State-less society, a society without formal government, in later chapters. But one instructive exercise is to try to abandon the habitual ways of seeing things, and to consider the argument for the State de novo. Let us try to transcend the fact that for as long as we can remember, the State has monopolized police and judicial services in society. Suppose that we were all starting completely from scratch, and that millions of us had been dropped down upon the earth, fully grown and developed, from some other planet. Debate begins as to how protection (police and judicial services) will be provided. Someone says: “Let’s all give all of our weapons to Joe Jones over there, and to his relatives. And let Jones and his family decide all disputes among us. In that way, the Joneses will be able to protect all of us from any aggression or fraud that anyone else may commit. With all the power and all the ability to make ultimate decisions on disputes in the hands of Jones, we will all be protected from one another. And then let us allow the Joneses to obtain their income from this great service by using their weapons, and by exacting as much revenue by coercion as they shall desire.” Surely in that sort of situation, no one would treat this proposal with anything but ridicule. For it would be starkly evident that there would be no way, in that case, for
any of us to protect ourselves from the aggressions, or the depredations, of the Joneses themselves. No one would then have the total folly to respond to that long-standing and most perceptive query: “Who shall guard the guardians?” by answering with Professor Black’s blithe: “Who controls the temperate?” It is only because we have become accustomed over thousands of years to the existence of the State that we now give precisely this kind of absurd answer to the problem of social protection and defense.

And, of course, the State never really did begin with this sort of “social contract.” As Oppenheimer pointed out, the State generally began in violence and conquest; even if at times internal processes gave rise to the State, it was certainly never by general consensus or contract.

The libertarian creed can now be summed up as (1) the absolute right of every man to the ownership of his own body; (2) the equally absolute right to own and therefore to control the material resources he has found and transformed; and (3) therefore, the absolute right to exchange or give away the ownership to such titles to whoever is willing to exchange or receive them. As we have seen, each of these steps involves property rights, but even if we call step (1) “personal” rights, we shall see that problems about “personal liberty” inextricably involve the rights of material property or free exchange. Or, briefly, the rights of personal liberty and “freedom of enterprise” almost invariably intertwine and cannot really be separated.

We have seen that the exercise of personal “freedom of speech,” for example, almost invariably involves the exercise of “economic freedom”—i.e., freedom to own and exchange material property. The holding of a meeting to exercise freedom of speech involves the hiring of a hall, traveling to the hall over roads, and using some form of transportation, etc. The closely related “freedom of the press” even more evidently involves the cost of printing and of using a press, the sale of leaflets to willing buyers—in short, all the ingredients of “economic freedom.” Furthermore, our example of “shouting ‘fire’ in a crowded theater” provides us with the clear guideline for deciding whose rights must be defended in any
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given situation—the guidelines being provided by our criterion: the rights of property.
The market and private enterprise do exist, and so most people can readily envision a free market in most goods and services. Probably the most difficult single area to grasp, however, is the abolition of government operations in the service of protection: police, the courts, etc.—the area encompassing defense of person and property against attack or invasion. How could private enterprise and the free market possibly provide such service? How could police, legal systems, judicial services, law enforcement, prisons—how could these be provided in a free market? We have already seen how a great deal of police protection, at the least, could be supplied by the various owners of streets and land areas. But we now need to examine this entire area systematically.

In the first place, there is a common fallacy, held even by most advocates of laissez-faire, that the government must supply “police protection,” as if police protection were a single, absolute entity, a fixed quantity of something which the government supplies to all. But in actual fact there is no absolute commodity called “police protection” any more than there is an absolute single commodity called “food” or “shelter.” It is true that everyone pays taxes for a seemingly fixed quantity of protection, but this is a myth. In actual fact, there
are almost infinite degrees of all sorts of protection. For any
given person or business, the police can provide everything
from a policeman on the beat who patrols once a night, to two
policemen patrolling constantly on each block, to cruising
patrol cars, to one or even several round-the-clock personal
bodyguards. Furthermore, there are many other decisions the
police must make, the complexity of which becomes evident
as soon as we look beneath the veil of the myth of absolute
“protection.” How shall the police allocate their funds which
are, of course, always limited as are the funds of all other indi-
viduals, organizations, and agencies? How much shall the
police invest in electronic equipment? fingerprinting equip-
ment? detectives as against uniformed police? patrol cars as
against foot police, etc.?

The point is that the government has no rational way to
make these allocations. The government only knows that it
has a limited budget. Its allocations of funds are then subject
to the full play of politics, boondoggling, and bureaucratic
inefficiency, with no indication at all as to whether the police
department is serving the consumers in a way responsive to
their desires or whether it is doing so efficiently. The situation
would be different if police services were supplied on a free,
competitive market. In that case, consumers would pay for
whatever degree of protection they wish to purchase. The con-
sumers who just want to see a policeman once in a while
would pay less than those who want continuous patrolling,
and far less than those who demand 24-hour bodyguard serv-
ice. On the free market, protection would be supplied in pro-
portion and in whatever way that the consumers wish to pay
for it. A drive for efficiency would be insured, as it always is
on the market, by the compulsion to make profits and avoid
losses, and thereby to keep costs low and to serve the highest
demands of the consumers. Any police firm that suffers from
gross inefficiency would soon go bankrupt and disappear.

One big problem a government police force must always
face is: what laws really to enforce? Police departments are the-
oretically faced with the absolute injunction, “enforce all
laws,” but in practice a limited budget forces them to allocate
their personnel and equipment to the most urgent crimes. But
the absolute dictum pursues them and works against a rational allocation of resources. On the free market, what would be enforced is whatever the customers are willing to pay for. Suppose, for example, that Mr. Jones has a precious gem he believes might soon be stolen. He can ask, and pay for, round-the-clock police protection at whatever strength he may wish to work out with the police company. He might, on the other hand, also have a private road on his estate he doesn’t want many people to travel on—but he might not care very much about trespassers on that road. In that case, he won’t devote any police resources to protecting the road. As on the market in general, it is up to the consumer—and since all of us are consumers this means each person individually decides how much and what kind of protection he wants and is willing to buy.

All that we have said about landowners’ police applies to private police in general. Free-market police would not only be efficient, they would have a strong incentive to be courteous and to refrain from brutality against either their clients or their clients’ friends or customers. A private Central Park would be guarded efficiently in order to maximize park revenue, rather than have a prohibitive curfew imposed on innocent—and paying—customers. A free market in police would reward efficient and courteous police protection to customers and penalize any falling off from this standard. No longer would there be the current disjunction between service and payment inherent in all government operations, a disjunction which means that police, like all other government agencies, acquire their revenue, not voluntarily and competitively from consumers, but from the taxpayers coercively.

In fact, as government police have become increasingly inefficient, consumers have been turning more and more to private forms of protection. We have already mentioned block or neighborhood protection. There are also private guards, insurance companies, private detectives, and such increasingly sophisticated equipment as safes, locks, and closed-circuit TV and burglar alarms. The President’s Commission on Law Enforcement and the Administration of Justice estimated in 1969 that government police cost the American public $2.8
billion a year, while it spends $1.35 billion on private protection service and another $200 million on equipment, so that private protection expenses amounted to over half the outlay on government police. These figures should give pause to those credulous folk who believe that police protection is somehow, by some mystic right or power, necessarily and forevermore an attribute of State sovereignty.¹

Every reader of detective fiction knows that private insurance detectives are far more efficient than the police in recovering stolen property. Not only is the insurance company impelled by economics to serve the consumer—and thereby try to avoid paying benefits—but the major focus of the insurance company is very different from that of the police. The police, standing as they do for a mythical “society,” are primarily interested in catching and punishing the criminal; restoring the stolen loot to the victim is strictly secondary. To the insurance company and its detectives, on the other hand, the prime concern is recovery of the loot, and apprehension and punishment of the criminal is secondary to the prime purpose of aiding the victim of crime. Here we see again the difference between a private firm impelled to serve the customer-victim of crime and the public police, which is under no such economic compulsion.

We cannot blueprint a market that exists only as an hypothesis, but it is reasonable to believe that police service in the libertarian society would be supplied by the landowners or by insurance companies. Since insurance companies would be paying benefits to victims of crime, it is highly likely that they would supply police service as a means of keeping down crime and hence their payment of benefits. It is certainly likely in any case that police service would be paid for in regular monthly premiums, with the police agency—whether insurance company or not—called on whenever needed.

This supplies what should be the first simple answer to a typical nightmare question of people who first hear about the idea of a totally private police: “Why, that means that if you’re

¹See Wooldridge, Uncle Sam the Monopoly Man, pp. 111ff.
attacked or robbed you have to rush over to a policeman and start dickering on how much it will cost to defend you.” A moment’s reflection should show that no service is supplied in this way on the free market. Obviously, the person who wants to be protected by Agency A or Insurance Company B will pay regular premiums rather than wait to be attacked before buying protection. “But suppose an emergency occurs and a Company A policeman sees someone being mugged; will he stop to ask if the victim has bought insurance from Company A?” In the first place, this sort of street crime will be taken care of, as we noted above, by the police hired by whoever owns the street in question. But what of the unlikely case that a neighborhood does not have street police, and a policeman of Company A happens to see someone being attacked? Will he rush to the victim’s defense? That, of course, would be up to Company A, but it is scarcely conceivable that private police companies would not cultivate goodwill by making it a policy to give free aid to victims in emergency situations and perhaps ask the rescued victim for a voluntary donation afterward. In the case of a homeowner being robbed or attacked, then of course he will call on whichever police company he has been using. He will call Police Company A rather than “the police” he calls upon now.

Competition insures efficiency, low price, and high quality, and there is no reason to assume a priori, as many people do, that there is something divinely ordained about having only one police agency in a given geographical area. Economists have often claimed that the production of certain goods or services is a “natural monopoly,” so that more than one private agency could not long survive in a given area. Perhaps, although only a totally free market could decide the matter once and for all. Only the market can decide what and how many firms, and of what size and quality, can survive in active competition. But there is no reason to suppose in advance that police protection is a “natural monopoly.” After all, insurance companies are not; and if we can have Metropolitan, Equitable, Prudential, etc., insurance companies coexisting side by side, why not Metropolitan, Equitable, and Prudential police protection companies? Gustave de Molinari, the nineteenth-century
French free-market economist, was the first person in history to contemplate and advocate a free market for police protection.\(^2\) Molinari estimated that there would eventually turn out to be several private police agencies side by side in the cities, and one private agency in each rural area. Perhaps—but we must realize that modern technology makes much more feasible branch offices of large urban firms in even the most remote rural areas. A person living in a small village in Wyoming, therefore, could employ the services of a local protection company, or he might use a nearby branch office of the Metropolitan Protection Company.

“But how could a poor person afford private protection he would have to pay for instead of getting free protection, as he does now?” There are several answers to this question, one of the most common criticisms of the idea of totally private police protection. One is: that this problem of course applies to any commodity or service in the libertarian society, not just the police. But isn’t protection necessary? Perhaps, but then so is food of many different kinds, clothing, shelter, etc. Surely these are at least as vital if not more so than police protection, and yet almost nobody says that therefore the government must nationalize food, clothing, shelter, etc., and supply these free as a compulsory monopoly. Very poor people would be supplied, in general, by private charity, as we saw in our chapter on welfare. Furthermore, in the specific case of police there would undoubtedly be ways of voluntarily supplying free police protection to the indigent—either by the police companies themselves for goodwill (as hospitals and doctors do now) or by special “police aid” societies that would do work similar to “legal aid” societies today. (Legal aid societies voluntarily supply free legal counsel to the indigent in trouble with the authorities.)

There are important supplementary considerations. As we have seen, police service is not “free”; it is paid for by the

taxpayer, and the taxpayer is very often the poor person himself. He may very well be paying more in taxes for police now than he would in fees to private, and far more efficient, police companies. Furthermore, the police companies would be tapping a mass market; with the economies of such a large-scale market, police protection would undoubtedly be much cheaper. No police company would wish to price itself out of a large chunk of its market, and the cost of protection would be no more prohibitively expensive than, say, the cost of insurance today. (In fact, it would tend to be much cheaper than current insurance, because the insurance industry today is heavily regulated by government to keep out low-cost competition.)

There is a final nightmare which most people who have contemplated private protection agencies consider to be decisive in rejecting such a concept. Wouldn’t the agencies always be clashing? Wouldn’t “anarchy” break out, with perpetual conflicts between police forces as one person calls in “his” police while a rival calls in “his”?

There are several levels of answers to this crucial question. In the first place, since there would be no overall State, no central or even single local government, we would at least be spared the horror of inter-State wars, with their plethora of massive, superdestructive, and now nuclear, weapons. As we look back through history, isn’t it painfully clear that the number of people killed in isolated neighborhood “rumbles” or conflicts is as nothing to the total mass devastation of inter-State wars? There are good reasons for this. To avoid emotionalism let us take two hypothetical countries: “Ruritania” and “Walldavia.” If both Ruritania and Walldavia were dissolved into a libertarian society, with no government and innumerable private individuals, firms, and police agencies, the only clashes that could break out would be local, and the weaponry would necessarily be strictly limited in scope and devastation. Suppose that in a Ruritanian city two police agencies clash and start shooting it out. At worst, they could not use mass bombing or nuclear destruction or germ warfare, since they themselves would be blown up in the holocaust. It is the slicing off of territorial areas into single, governmental
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monopolies that leads to mass destruction—for then if the single monopoly government of Walldavia confronts its ancient rival, the government of Ruritania, each can wield weapons of mass destruction and even nuclear warfare because it will be the “other guy” and the “other country” they will hurt. Furthermore, now that every person is a subject of a monopoly government, in the eyes of every other government he becomes irretrievably identified with “his” government. The citizen of France is identified with “his” government, and therefore if another government attacks France, it will attack the citizenry as well as the government of France. But if Company A battles with Company B, the most that can happen is that the respective customers of each company may be dragged into the battle—but no one else. It should be evident, then, that even if the worst happened, and a libertarian world would indeed become a world of “anarchy,” we would still be much better off than we are now, at the mercy of rampant, “anarchic” nation-states, each possessing a fearsome monopoly of weapons of mass destruction. We must never forget that we are all living, and always have lived, in a world of “international anarchy,” in a world of coercive nation-states unchecked by any overall world government, and there is no prospect of this situation changing.

A libertarian world, then, even if anarchic, would still not suffer the brutal wars, the mass devastation, the A-bombing, that our State-ridden world has suffered for centuries. Even if local police clash continually, there would be no more Dresdens, no more Hiroshimas.

But there is far more to be said. We should never concede that this local “anarchy” would be likely to occur. Let us separate the problem of police clashes into distinct and different parts: honest disagreements, and the attempt of one or more police forces to become “outlaws” and to extract funds or impose their rule by coercion. Let us assume for a moment that the police forces will be honest, and that they are only driven by honest clashes of opinion; we will set aside for a while the problem of outlaw police. Surely one of the very important aspects of protection service the police can offer their respective customers is quiet protection. Every consumer,
every buyer of police protection, would wish above all for protection that is efficient and quiet, with no conflicts or disturbances. Every police agency would be fully aware of this vital fact. To assume that police would continually clash and battle with each other is absurd, for it ignores the devastating effect that this chaotic “anarchy” would have on the business of all the police companies. To put it bluntly, such wars and conflicts would be bad—very bad—for business. Therefore, on the free market, the police agencies would all see to it that there would be no clashes between them, and that all conflicts of opinion would be ironed out in private courts, decided by private judges or arbitrators.

To get more specific: in the first place, as we have said, clashes would be minimal because the street owner would have his guards, the storekeeper his, the landlord his, and the homeowner his own police company. Realistically, in the everyday world there would be little room for direct clashes between police agencies. But suppose, as will sometimes occur two neighboring homeowners get into a fight, each accuses the other of initiating assault or violence, and each calls on his own police company, should they happen to subscribe to different companies. What then? Again, it would be pointless and economically as well as physically self-destructive for the two police companies to start shooting it out. Instead, every police company, to remain in business at all, would announce as a vital part of its service, the use of private courts or arbitrators to decide who is in the wrong.

THE COURTS

Suppose, then, that the judge or arbitrator decides Smith was in the wrong in a dispute, and that he aggressed against Jones. If Smith accepts the verdict, then, whatever damages or punishment is levied, there is no problem for the theory of libertarian protection. But what if he does not accept it? Or suppose another example: Jones is robbed. He sets his police company to do detective work in trying to track down the criminal. The company decides that a certain Brown is the
criminal. Then what? If Brown acknowledges his guilt, then again there is no problem and judicial punishment proceeds, centering on forcing the criminal to make restitution to the victim. But, again, what if Brown denies his guilt?

These cases take us out of the realm of police protection and into another vital area of protection: judicial service, i.e., the provision, in accordance with generally accepted procedures, of a method of trying as best as one can to determine who is the criminal, or who is the breaker of contracts, in any sort of crime or dispute. Many people, even those who acknowledge that there could be privately competitive police service supplied on a free market, balk at the idea of totally private courts. How in the world could courts be private? How would courts employ force in a world without government? Wouldn’t eternal conflicts and “anarchy” then ensue?

In the first place, the monopoly courts of government are subject to the same grievous problems, inefficiencies, and contempt for the consumer as any other government operation. We all know that judges, for example, are not selected according to their wisdom, probity, or efficiency in serving the consumer, but are political hacks chosen by the political process. Furthermore, the courts are monopolies; if, for example, the courts in some town or city should become corrupt, venal, oppressive, or inefficient, the citizen at present has no recourse. The aggrieved citizen of Deep Falls, Wyoming, must be governed by the local Wyoming court or not at all. In a libertarian society, there would be many courts, many judges to whom he could turn. Again, there is no reason to assume a “natural monopoly” of judicial wisdom. The Deep Falls citizen could, for example, call upon the local branch of the Prudential Judicial Company.

How would courts be financed in a free society? There are many possibilities. Possibly, each individual would subscribe to a court service, paying a monthly premium, and then calling upon the court if he is in need. Or, since courts will probably be needed much less frequently than policemen, he may pay a fee whenever he chooses to use the court, with the criminal or contract-breaker eventually recompensing the victim or plaintiff. Or, in still a third possibility, the courts may be
hired by the police agencies to settle disputes, or there may even be “vertically integrated” firms supplying both police and judicial service: the Prudential Judicial Company might have a police and a judicial division. Only the market will be able to decide which of these methods will be most appropriate.

We should all be more familiar with the increasing use of private arbitration, even in our present society. The government courts have become so clogged, inefficient, and wasteful that more and more parties to disputes are turning to private arbitrators as a cheaper and far less time-consuming way of settling their disputes. In recent years, private arbitration has become a growing and highly successful profession. Being voluntary, furthermore, the rules of arbitration can be decided rapidly by the parties themselves, without the need for a ponderous, complex legal framework applicable to all citizens. Arbitration therefore permits judgments to be made by people expert in the trade or occupation concerned. Currently, the American Arbitration Association, whose motto is “The Handclasp is Mightier than the Fist,” has 25 regional offices throughout the country, with 23,000 arbitrators. In 1969, the Association conducted over 22,000 arbitrations. In addition, the insurance companies adjust over 50,000 claims a year through voluntary arbitration. There is also a growing and successful use of private arbitrators in automobile accident claim cases.

It might be protested that, while performing an ever greater proportion of judicial functions, the private arbitrators’ decisions are still enforced by the courts, so that once the disputing parties agree on an arbitrator, his decision becomes legally binding. This is true, but it was not the case before 1920, and the arbitration profession grew at as rapid a rate from 1900 to 1920 as it has since. In fact, the modern arbitration movement began in full force in England during the time of the American Civil War, with merchants increasingly using the “private courts” provided by voluntary arbitrators, even though the decisions were not legally binding. By 1900, voluntary arbitration began to take hold in the United States. In fact, in medieval England, the entire structure of merchant law, which was handled clumsily and inefficiently by the government’s courts, grew up in private merchants’ courts. The
merchants’ courts were purely voluntary arbitrators, and the decisions were not legally binding. How, then, were they successful?

The answer is that the merchants, in the Middle Ages and down to 1920, relied solely on ostracism and boycott by the other merchants in the area. In other words, should a merchant refuse to submit to arbitration or ignore a decision, the other merchants would publish this fact in the trade, and would refuse to deal with the recalcitrant merchant, bringing him quickly to heel. Wooldridge mentions one medieval example:

Merchants made their courts work simply by agreeing to abide by the results. The merchant who broke the understanding would not be sent to jail, to be sure, but neither would he long continue to be a merchant, for the compliance exacted by his fellows, and their power over his goods, proved if anything more effective than physical coercion. Take John of Homing, who made his living marketing wholesale quantities of fish. When John sold a lot of herring on the representation that it conformed to a three-barrel sample, but which, his fellow merchants found, was actually mixed with “sticklebacks and putrid herring,” he made good the deficiency on pain of economic ostracism.3

In modern times, ostracism became even more effective, and it included the knowledge that anyone who ignored an arbitrator’s award could never again avail himself of an arbitrator’s services. Industrialist Owen D. Young, head of General Electric, concluded that the moral censure of other businessmen was a far more effective sanction than legal enforcement. Nowadays, modern technology, computers, and credit ratings would make such nationwide ostracism even more effective than it has ever been in the past.

Even if purely voluntary arbitration is sufficient for commercial disputes, however, what of frankly criminal activities:

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3Wooldridge, Uncle Sam the Monopoly Man, p. 96. Also see pp. 94–110.
the mugger, the rapist, the bank robber? In these cases, it must be admitted that ostracism would probably not be sufficient—even though it would also include, we must remember, refusal of private street owners to allow such criminals in their areas. For the criminal cases, then, courts and legal enforcement become necessary.

How, then, would the courts operate in the libertarian society? In particular, how could they enforce their decisions? In all their operations, furthermore, they must observe the critical libertarian rule that no physical force may be used against anyone who has not been convicted as a criminal—otherwise, the users of such force, whether police or courts, would be themselves liable to be convicted as aggressors if it turned out that the person they had used force against was innocent of crime. In contrast to statist systems, no policeman or judge could be granted special immunity to use coercion beyond what anyone else in society could use.

Let us now take the case we mentioned before. Mr. Jones is robbed, his hired detective agency decides that one Brown committed the crime, and Brown refuses to concede his guilt. What then? In the first place, we must recognize that there is at present no overall world court or world government enforcing its decrees; yet while we live in a state of “international anarchy” there is little or no problem in disputes between private citizens of two countries. Suppose that right now, for example, a citizen of Uruguay claims that he has been swindled by a citizen of Argentina. Which court does he go to? He goes to his own, i.e., the victim’s or the plaintiff’s court. The case proceeds in the Uruguayan court, and its decision is honored by the Argentinian court. The same is true if an American feels he has been swindled by a Canadian, and so on. In Europe after the Roman Empire, when German tribes lived side by side and in the same areas, if a Visigoth felt that he had been injured by a Frank, he took the case to his own court, and the decision was generally accepted by the Franks. Going to the plaintiff’s court is the rational libertarian procedure as well, since the victim or plaintiff is the one who is aggrieved, and who naturally takes the case to his own court. So, in our
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case, Jones would go to the Prudential Court Company to charge Brown with theft.

It is possible, of course, that Brown is also a client of the Prudential Court, in which case there is no problem. The Prudential’s decision covers both parties, and becomes binding. But one important stipulation is that no coercive subpoena power can be used against Brown, because he must be considered innocent until he is convicted. But Brown would be served with a voluntary subpoena, a notice that he is being tried on such and such a charge and inviting him or his legal representative to appear. If he does not appear, then he will be tried in absentia, and this will obviously be less favorable for Brown since his side of the case will not be pleaded in court. If Brown is declared guilty, then the court and its marshals will employ force to seize Brown and exact whatever punishment is decided upon—a punishment which obviously will focus first on restitution to the victim.

What, however, if Brown does not recognize the Prudential Court? What if he is a client of the Metropolitan Court Company? Here the case becomes more difficult. What will happen then? First, victim Jones pleads his case in the Prudential Court. If Brown is found innocent, this ends the controversy. Suppose, however, that defendant Brown is found guilty. If he does nothing, the court’s judgment proceeds against him. Suppose, however, Brown then takes the case to the Metropolitan Court Company, pleading inefficiency or venality by Prudential. The case will then be heard by Metropolitan. If Metropolitan also finds Brown guilty, this too ends the controversy and Prudential will proceed against Brown with dispatch. Suppose, however, that Metropolitan finds Brown innocent of the charge. Then what? Will the two courts and their arms-wielding marshals shoot it out in the streets?

Once again, this would clearly be irrational and self-destructive behavior on the part of the courts. An essential part of their judicial service to their clients is the provision of just, objective, and peacefully functioning decisions—the best and most objective way of arriving at the truth of who committed the crime. Arriving at a decision and then allowing chaotic gunplay would scarcely be considered valuable
judicial service by their customers. Thus, an essential part of any court’s service to its clients would be an appeals procedure. In short, every court would agree to abide by an appeals trial, as decided by a voluntary arbitrator to whom Metropolitan and Prudential would now turn. The appeals judge would make his decision, and the result of this third trial would be treated as binding on the guilty. The Prudential court would then proceed to enforcement.

An appeals court! But isn’t this setting up a compulsory monopoly government once again? No, because there is nothing in the system that requires any one person or court to be the court of appeal. In short, in the United States at present the Supreme Court is established as *the* court of final appeal, so the Supreme Court judges become the final arbiters regardless of the wishes of plaintiff or defendant alike. In contrast, in the libertarian society the various competing private courts could go to *any* appeals judge they think fair, expert, and objective. No single appeals judge or set of judges would be foisted upon society by coercion.

How would the appeals judges be financed? There are many possible ways, but the most likely is that they will be paid by the various original courts who would charge their customers for appeals services in their premiums or fees.

But suppose Brown insists on another appeals judge, and yet another? Couldn’t he escape judgment by appealing *ad infinitum*? Obviously, in *any* society legal proceedings cannot continue indefinitely; there must be *some* cutoff point. In the present statist society, where government monopolizes the judicial function, the Supreme Court is arbitrarily designated as the cutoff point. In the libertarian society, there would also have to be an agreed-upon cutoff point, and since there are only two parties to any crime or dispute—the plaintiff and the defendant—it seems most sensible for the legal code to declare that *a decision arrived at by any two courts shall be binding*. This will cover the situation when both the plaintiff’s and the defendant’s courts come to the same decision, as well as the situation when an appeals court decides on a disagreement between the two original courts.
For a New Liberty

THE LAW AND THE COURTS

It is now clear that there will have to be a legal code in the libertarian society. How? How can there be a legal code, a system of law without a government to promulgate it, an appointed system of judges, or a legislature to vote on statutes? To begin with, is a legal code consistent with libertarian principles?

To answer the last question first, it should be clear that a legal code is necessary to lay down precise guidelines for the private courts. If, for example, Court A decides that all redheads are inherently evil and must be punished, it is clear that such decisions are the reverse of libertarian, that such a law would constitute an invasion of the rights of redheads. Hence, any such decision would be illegal in terms of libertarian principle, and could not be upheld by the rest of society. It then becomes necessary to have a legal code which would be generally accepted, and which the courts would pledge themselves to follow. The legal code, simply, would insist on the libertarian principle of no aggression against person or property, define property rights in accordance with libertarian principle, set up rules of evidence (such as currently apply) in deciding who are the wrongdoers in any dispute, and set up a code of maximum punishment for any particular crime. Within the framework of such a code, the particular courts would compete on the most efficient procedures, and the market would then decide whether judges, juries, etc., are the most efficient methods of providing judicial services.

Are such stable and consistent law codes possible, with only competing judges to develop and apply them, and without government or legislature? Not only are they possible, but over the years the best and most successful parts of our legal system were developed precisely in this manner. Legislatures, as well as kings, have been capricious, invasive, and inconsistent. They have only introduced anomalies and despotism into the legal system. In fact, the government is no more qualified to develop and apply law than it is to provide any other service; and just as religion has been separated from the State,
and the economy can be separated from the State, so can every other State function, including police, courts, and the law itself!

As indicated above, for example, the entire law merchant was developed, not by the State or in State courts, but by private merchant courts. It was only much later that government took over mercantile law from its development in merchants’ courts. The same occurred with admiralty law, the entire structure of the law of the sea, shipping, salvages, etc. Here again, the State was not interested, and its jurisdiction did not apply to the high seas; so the shippers themselves took on the task of not only applying, but working out the whole structure of admiralty law in their own private courts. Again, it was only later that the government appropriated admiralty law into its own courts.

Finally, the major body of Anglo-Saxon law, the justly celebrated common law, was developed over the centuries by competing judges applying time-honored principles rather than the shifting decrees of the State. These principles were not decided upon arbitrarily by any king or legislature; they grew up over centuries by applying rational—and very often libertarian—principles to the cases before them. The idea of following precedent was developed, not as a blind service to the past, but because all the judges of the past had made their decisions in applying the generally accepted common law principles to specific cases and problems. For it was universally held that the judge did not make law (as he often does today); the judge’s task, his expertise, was in finding the law in accepted common law principles, and then applying that law to specific cases or to new technological or institutional conditions. The glory of the centuries-long development of the common law is testimony to their success.

The common law judges, furthermore, functioned very much like private arbitrators, as experts in the law to whom private parties went with their disputes. There was no arbitrarily imposed “supreme court” whose decision would be binding, nor was precedent, though honored, considered as automatically binding either. Thus, the libertarian Italian jurist Bruno Leoni has written:
courts of judicature could not easily enact arbitrary rules of their own in England, as they were never in a position to do so directly, that is to say, in the usual, sudden, widely ranging and imperious manner of legislators. Moreover, there were so many courts of justice in England and they were so jealous of one another that even the famous principle of the binding precedent was not openly recognized as valid by them until comparatively recent times. Besides, they could never decide anything that had not been previously brought before them by private persons. Finally, comparatively few people used to go before the courts to ask from them the rules deciding their cases.4

And on the absence of “supreme courts”:

it cannot be denied that the lawyers’ law or the judiciary law may tend to acquire the characteristics of legislation, including its undesirable ones, whenever jurists or judges are entitled to decide ultimately on a case. . . . In our time the mechanism of the judiciary in certain countries where “supreme courts” are established results in the imposition of the personal views of the members of these courts, or of a majority of them, on all the other people concerned whenever there is a great deal of disagreement between the opinion of the former and the convictions of the latter. But . . . this possibility, far from being necessarily implied in the nature of lawyers’ law or of judiciary law, is rather a deviation from it.5

Apart from such aberrations, the imposed personal views of the judges were kept to a minimum: (a) by the fact that judges could only make decisions when private citizens brought cases to them; (b) each judge’s decisions applied only to the particular case; and (c) because the decisions of the common-law judges and lawyers always considered the precedents of the centuries. Furthermore, as Leoni points out, in

5Ibid., pp. 23–24.
contrast to legislatures or the executive, where dominant majorities or pressure groups ride roughshod over minorities, judges, by their very position, are constrained to hear and weigh the arguments of the two contending parties in each dispute. “Parties are equal as regards the judge, in the sense that they are free to produce arguments and evidence. They do not constitute a group in which dissenting minorities give way to triumphant majorities.” And Leoni points out the analogy between this process and the free-market economy: “Of course, arguments may be stronger or weaker, but the fact that every party can produce them is comparable to the fact that everybody can individually compete with everybody else in the market in order to buy and sell.”

Professor Leoni found that, in the private law area, the ancient Roman judges operated in the same way as the English common law courts:

The Roman jurist was a sort of scientist; the objects of his research were the solutions to cases that citizens submitted to him for study, just as industrialists might today submit to a physicist or to an engineer a technical problem concerning their plants or their production. Hence, private Roman law was something to be described or to be discovered, not something to be enacted—a world of things that were there, forming part of the common heritage of all Roman citizens. Nobody enacted that law; nobody could change it by any exercise of his personal will. . . . This is the long-run concept or, if you prefer, the Roman concept, of the certainty of the law.

Finally, Professor Leoni was able to use his knowledge of the operations of ancient and common law to answer the vital question: In a libertarian society, “who will appoint the judges . . . to let them perform the task of defining the law?” His answer is: the people themselves, people who would go to the judges with the greatest reputation of expertise and wisdom

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6Ibid., p. 188.

7Ibid., pp. 84–85.
in knowing and applying the basic common legal principles of the society:

In fact, it is rather immaterial to establish in advance who will appoint the judges, for, in a sense, everybody could do so, as happens to a certain extent when people resort to private arbiters to settle their own quarrels. . . . For the appointment of judges is not such a special problem as would be, for example, that of “appointing” physicists or doctors or other kinds of learned and experienced people. The emergence of good professional people in any society is only apparently due to official appointments, if any. It is, in fact, based on a widespread consent on the part of clients, colleagues, and the public at large—a consent without which no appointment is really effective. Of course, people can be wrong about the true value chosen as being worthy, but these difficulties in their choice are inescapable in any kind of choice.8

Of course, in the future libertarian society, the basic legal code would not rely on blind custom, much of which could well be antilibertarian. The code would have to be established on the basis of acknowledged libertarian principle, of nonaggression against the person or property of others; in short, on the basis of reason rather than on mere tradition, however sound its general outlines. Since we have a body of common law principles to draw on, however, the task of reason in correcting and amending the common law would be far easier than trying to construct a body of systematic legal principles de novo out of the thin air.

The most remarkable historical example of a society of libertarian law and courts, however, has been neglected by historians until very recently. And this was also a society where not only the courts and the law were largely libertarian, but where they operated within a purely state-less and libertarian society. This was ancient Ireland—an Ireland which persisted in this libertarian path for roughly a thousand years until its

8Ibid., p. 183.
brutal conquest by England in the seventeenth century. And, in contrast to many similarly functioning primitive tribes (such as the Ibos in West Africa, and many European tribes), preconquest Ireland was not in any sense a “primitive” society: it was a highly complex society that was, for centuries, the most advanced, most scholarly, and most civilized in all of Western Europe.

For a thousand years, then, ancient Celtic Ireland had no State or anything like it. As the leading authority on ancient Irish law has written: “There was no legislature, no bailiffs, no police, no public enforcement of justice. . . . There was no trace of State-administered justice.”

How then was justice secured? The basic political unit of ancient Ireland was the *tuath*. All “freemen” who owned land, all professionals, and all craftsmen, were entitled to become members of a *tuath*. Each *tuath*’s members formed an annual assembly which decided all common policies, declared war or peace on other *tuatha*, and elected or deposed their “kings.” An important point is that, in contrast to primitive tribes, no one was stuck or bound to a given *tuath*, either because of kinship or of geographical location. Individual members were free to, and often did, secede from a *tuath* and join a competing *tuath*. Often, two or more *tuatha* decided to merge into a single, more efficient unit. As Professor Peden states, “the *tuath* is thus a body of persons voluntarily united for socially beneficial purposes and the sum total of the landed properties of its members constituted its territorial dimension.” In short, they did not have the modern State with its claim to sovereignty over a given (usually expanding) territorial area, divorced from the landed property rights of its subjects; on the

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contrary, _tuatha_ were voluntary associations which only comprised the landed properties of its voluntary members. Historically, about 80 to 100 _tuatha_ coexisted at any time throughout Ireland.

But what of the elected “king”? Did _he_ constitute a form of State ruler? Chiefly, the king functioned as a religious high priest, presiding over the worship rites of the _tuath_, which functioned as a voluntary religious, as well as a social and political, organization. As in pagan, pre-Christian, priesthoods, the kingly function was hereditary, this practice carrying over to Christian times. The king was elected by the _tuath_ from within a royal kin-group (the _derbfine_), which carried the hereditary priestly function. *Politically*, however, the king had strictly limited functions: he was the military leader of the _tuath_, and he presided over the _tuath_ assemblies. But he could only conduct war or peace negotiations as agent of the assemblies; and he was in no sense sovereign and had no rights of administering justice over _tuath_ members. He could not legislate, and when he himself was party to a lawsuit, he had to submit his case to an independent judicial arbiter.

Again, how, then, was law developed and justice maintained? In the first place, the law itself was based on a body of ancient and immemorial custom, passed down as oral and then written tradition through a class of professional jurists called the _brehons_. The brehons were in no sense public, or governmental, officials; they were simply selected by parties to disputes on the basis of their reputations for wisdom, knowledge of the customary law, and the integrity of their decisions. As Professor Peden states:

> the professional jurists were consulted by parties to disputes for advice as to what the law was in particular cases, and these same men often acted as arbitrators between suitors. They remained at all times private persons, not public officials; their functioning depended upon their knowledge of the law and the integrity of their judicial reputations.\(^\text{11}\)

\(^{11}\)Ibid.
Furthermore, the brehons had no connection whatsoever with the individual tuatha or with their kings. They were completely private, national in scope, and were used by disputants throughout Ireland. Moreover, and this is a vital point, in contrast to the system of private Roman lawyers, the brehon was all there was; there were no other judges, no “public” judges of any kind, in ancient Ireland.

It was the brehons who were schooled in the law, and who added glosses and applications to the law to fit changing conditions. Furthermore, there was no monopoly, in any sense, of the brehon jurists; instead, several competing schools of jurisprudence existed and competed for the custom of the Irish people.

How were the decisions of the brehons enforced? Through an elaborate, voluntarily developed system of “insurance,” or sureties. Men were linked together by a variety of surety relationships by which they guaranteed one another for the righting of wrongs, and for the enforcement of justice and the decisions of the brehons. In short, the brehons themselves were not involved in the enforcement of decisions, which rested again with private individuals linked through sureties. There were various types of surety. For example, the surety would guarantee with his own property the payment of a debt, and then join the plaintiff in enforcing a debt judgment if the debtor refused to pay. In that case, the debtor would have to pay double damages: one to the original creditor, and another as compensation to his surety. And this system applied to all offences, aggressions and assaults as well as commercial contracts; in short, it applied to all cases of what we would call “civil” and “criminal” law. All criminals were considered to be “debtors” who owed restitution and compensation to their victims, who thus became their “creditors.” The victim would gather his sureties around him and proceed to apprehend the criminal or to proclaim his suit publicly and demand that the defendant submit to adjudication of their dispute with the brehons. The criminal might then send his own sureties to negotiate a settlement or agree to submit the dispute to the brehons. If he did not do so, he was considered an “outlaw” by the entire community; he could no longer enforce any
claim of his own in the courts, and he was treated to the opprobrium of the entire community.\textsuperscript{12}

There were occasional “wars,” to be sure, in the thousand years of Celtic Ireland, but they were minor brawls, negligible compared to the devastating wars that racked the rest of Europe. As Professor Peden points out,

without the coercive apparatus of the State which can through taxation and conscription mobilize large amounts of arms and manpower, the Irish were unable to sustain any large scale military force in the field for any length of time. Irish wars . . . were pitiful brawls and cattle raids by European standards.\textsuperscript{13}

Thus, we have indicated that it is perfectly possible, in theory and historically, to have efficient and courteous police, competent and learned judges, and a body of systematic and socially accepted law—and none of these things being furnished by a coercive government. Government—claiming a compulsory monopoly of protection over a geographical area, and extracting its revenues by force—can be separated from the entire field of protection. Government is no more necessary for providing vital protection service than it is necessary for providing anything else. And we have not stressed a crucial fact about government: that its compulsory monopoly over the weapons of coercion has led it, over the centuries, to infinitely more butcheries and infinitely greater tyranny and oppression than any decentralized, private agencies could possibly have done. If we look at the black record of mass murder, exploitation, and tyranny levied on society by governments over the ages, we need not be loath to abandon the Leviathan State and . . . try freedom.

\textsuperscript{12}Professor Charles Donahue of Fordham University has maintained that the secular part of ancient Irish law was not simply haphazard tradition; that it was consciously rooted in the Stoic conception of natural law, discoverable by man’s reason. Charles Donahue, “Early Celtic Laws” (unpublished paper, delivered at the Columbia University Seminar in the History of Legal and Political Thought, Autumn, 1964), pp. 13ff.

\textsuperscript{13}Peden, “Stateless Societies,” p. 4.
OUTLAW PROTECTORS

We have saved for the last this problem: What if police or judges and courts should be venal and biased—what if they should bias their decisions, for example, in favor of particularly wealthy clients? We have shown how a libertarian legal and judicial system could work on the purely free market, assuming honest differences of opinion—but what if one or more police or courts should become, in effect, outlaws? What then?

In the first place, libertarians do not flinch from such a question. In contrast to such utopians as Marxists or left-wing anarchists (anarchocommunists or anarcho-syndicalists), libertarians do not assume that the ushering in of the purely free society of their dreams will also bring with it a new, magically transformed Libertarian Man. We do not assume that the lion will lie down with the lamb, or that no one will have criminal or fraudulent designs upon his neighbor. The “better” that people will be, of course, the better any social system will work, in particular the less work any police or courts will have to do. But no such assumption is made by libertarians. What we assert is that, given any particular degree of “goodness” or “badness” among men, the purely libertarian society will be at once the most moral and the most efficient, the least criminal and the most secure of person or property.

Let us first consider the problem of the venal or crooked judge or court. What of the court which favors its own wealthy client in trouble? In the first place, any such favoritism will be highly unlikely, given the rewards and sanctions of the free market economy. The very life of the court, the very livelihood of a judge, will depend on his reputation for integrity, fair-mindedness, objectivity, and the quest for truth in every case. This is his “brand name.” Should word of any venality leak out, he will immediately lose clients and the courts will no longer have customers; for even those clients who may be criminally inclined will scarcely sponsor a court whose decisions are no longer taken seriously by the rest of society, or who themselves may well be in jail for dishonest and fraudulent dealings. If, for example, Joe Zilch is accused
of a crime or breach of contract, and he goes to a “court” headed by his brother-in-law, no one, least of all other, honest courts will take this “court’s” decision seriously. It will no longer be considered a “court” in the eyes of anyone but Joe Zilch and his family.

Contrast this built-in corrective mechanism to the present-day government courts. Judges are appointed or elected for long terms, up to life, and they are accorded a monopoly of decision-making in their particular area. It is almost impossible, except in cases of gross corruption, to do anything about venal decisions of judges. Their power to make and to enforce their decisions continues unchecked year after year. Their salaries continue to be paid, furnished under coercion by the hapless taxpayer. But in the totally free society, any suspicion of a judge or court will cause their customers to melt away and their “decisions” to be ignored. This is a far more efficient system of keeping judges honest than the mechanism of government.

Furthermore, the temptation for venality and bias would be far less for another reason: business firms in the free market earn their keep, not from wealthy customers, but from a mass market by consumers. Macy’s earns its income from the mass of the population, not from a few wealthy customers. The same is true of Metropolitan Life Insurance today, and the same would be true of any “Metropolitan” court system tomorrow. It would be folly indeed for the courts to risk the loss of favor by the bulk of its customers for the favors of a few wealthy clients. But contrast the present system, where judges, like all other politicians, may be beholden to wealthy contributors who finance the campaigns of their political parties.

There is a myth that the “American System” provides a superb set of “checks and balances,” with the executive, the legislature, and the courts all balancing and checking one against the other, so that power cannot unduly accumulate in one set of hands. But the American “checks and balances” system is largely a fraud. For each one of these institutions is a coercive monopoly in its area, and all of them are part of one government, headed by one political party at any given time.
Furthermore, at best there are only two parties, each one close to the other in ideology and personnel, often colluding, and the actual day-to-day business of government headed by a civil service bureaucracy that cannot be displaced by the voters. Contrast to these mythical checks and balances the real checks and balances provided by the free-market economy! What keeps A&P honest is the competition, actual and potential, of Safeway, Pioneer, and countless other grocery stores. What keeps them honest is the ability of the consumers to cut off their patronage. What would keep the free-market judges and courts honest is the lively possibility of heading down the block or down the road to another judge or court if suspicion should descend on any particular one. What would keep them honest is the lively possibility of their customers cutting off their business. These are the real, active checks and balances of the free-market economy and the free society.

The same analysis applies to the possibility of a private police force becoming outlaw, of using their coercive powers to exact tribute, set up a “protection racket” to shake down their victims, etc. Of course, such a thing could happen. But, in contrast to present-day society, there would be immediate checks and balances available; there would be other police forces who could use their weapons to band together to put down the aggressors against their clientele. If the Metropolitan Police Force should become gangsters and exact tribute, then the rest of society could flock to the Prudential, Equitable, etc., police forces who could band together to put them down. And this contrasts vividly with the State. If a group of gangsters should capture the State apparatus, with its monopoly of coercive weapons, there is nothing at present that can stop them—short of the immensely difficult process of revolution. In a libertarian society there would be no need for a massive revolution to stop the depredation of gangster-States; there would be a swift turning to the honest police forces to check and put down the force that had turned bandit.

And, indeed, what is the State anyway but organized banditry? What is taxation but theft on a gigantic, unchecked, scale? What is war but mass murder on a scale impossible by private police forces? What is conscription but mass
enslavement? Can anyone envision a private police force getting away with a tiny fraction of what States get away with, and do habitually, year after year, century after century?

There is another vital consideration that would make it almost impossible for an outlaw police force to commit anything like the banditry that modern governments practice. One of the crucial factors that permits governments to do the monstrous things they habitually do is the sense of *legitimacy* on the part of the stupefied public. The average citizen may not like—may even strongly object to—the policies and actions of his government. But he has been imbued with the idea—carefully indoctrinated by centuries of governmental propaganda—that the government is his legitimate sovereign, and that it would be wicked or mad to refuse to obey its dictates. It is this sense of legitimacy that the State’s intellectuals have fostered over the ages, aided and abetted by all the trappings of legitimacy: flags, rituals, ceremonies, awards, constitutions, etc. A bandit gang—even if all the police forces conspired together into one vast gang—could never command such legitimacy. The public would consider them purely bandits; their extortions and tributes would never be considered legitimate though onerous “taxes,” to be paid automatically. The public would quickly resist these illegitimate demands and the bandits would be resisted and overthrown. Once the public had tasted the joys, prosperity, freedom, and efficiency of a libertarian, State-less society, it would be almost impossible for a State to fasten itself upon them once again. Once freedom has been fully enjoyed, it is no easy task to force people to give it up.

But *suppose*—just suppose—that despite all these handicaps and obstacles, despite the love for their new-found freedom, despite the inherent checks and balances of the free market, suppose *anyway* that the State manages to reestablish itself. What then? Well, then, all that would have happened is that we would have a State once again. We would be no worse off than we are now, with our current State. *And*, as one libertarian philosopher has put it, “at least the world will have had a glorious holiday.” Karl Marx’s ringing promise applies far more to a libertarian society than to communism: In trying
freedom, in abolishing the State, we have nothing to lose and everything to gain.

NATIONAL DEFENSE

We come now to what is usually the final argument against the libertarian position. Every libertarian has heard a sympathetic but critical listener say: “All right, I see how this system could be applied successfully to local police and courts. But how could a libertarian society defend us against the Russians?”

There are, of course, several dubious assumptions implied in such a question. There is the assumption that the Russians are bent upon military invasion of the United States, a doubtful assumption at best. There is the assumption that any such desire would still remain after the United States had become a purely libertarian society. This notion overlooks the lesson of history that wars result from conflicts between nation-states, each armed to the teeth, each direly suspicious of attack by the other. But a libertarian America would clearly not be a threat to anyone, not because it had no arms but because it would be dedicated to no aggression against anyone, or against any country. Being no longer a nation-state, which is inherently threatening, there would be little chance of any country attacking us. One of the great evils of the nation-state is that each State is able to identify all of its subjects with itself; hence in any inter-State war, the innocent civilians, the subjects of each country, are subject to aggression from the enemy State. But in a libertarian society there would be no such identification, and hence very little chance of such a devastating war. Suppose, for example, that our outlaw Metropolitan Police Force has initiated aggression not only against Americans but also against Mexicans. If Mexico had a government, then clearly the Mexican government would know full well that Americans in general were not implicated in the Metropolitan’s crimes, and had no symbiotic relationship with it. If the Mexican police engaged in a punitive expedition to punish the Metropolitan force, they would not be at war with Americans.
in general—as they would be now. In fact, it is highly likely that other American forces would join the Mexicans in putting down the aggressor. Hence, the idea of inter-State war against a libertarian country or geographical area would most likely disappear.

There is, furthermore, a grave philosophical error in the very posing of this sort of question about the Russians. When we contemplate any sort of new system, whatever it may be, we must first decide whether we want to see it brought about. In order to decide whether we want libertarianism or communism, or left-wing anarchism, or theocracy, or any other system, we must first assume that it has been established, and then consider whether the system could work, whether it could remain in existence, and just how efficient such a system would be. We have shown, I believe, that a libertarian system, once instituted, could work, be viable, and be at once far more efficient, prosperous, moral, and free than any other social system. But we have said nothing about how to get from the present system to the ideal; for these are two totally separate questions: the question of what is our ideal goal, and of the strategy and tactics of how to get from the present system to that goal. The Russian question mixes these two levels of discourse. It assumes, not that libertarianism has been established everywhere throughout the globe, but that for some reason it has been established only in America and nowhere else. But why assume this? Why not first assume that it has been established everywhere and see whether we like it? After all, the libertarian philosophy is an eternal one, not bound to time or place. We advocate liberty for everyone, everywhere, not just in the United States. If someone agrees that a world libertarian society, once established, is the best that he can conceive, that it would be workable, efficient, and moral, then let him become a libertarian, let him join us in accepting liberty as our ideal goal, and then join us further in the separate—and obviously difficult—task of figuring out how to bring this ideal about.

If we do move on to strategy, it is obvious that the larger an area in which liberty is first established the better its chances for survival, and the better its chance to resist any violent
overthrow that may be attempted. If liberty is established instantaneously throughout the world, then there will of course be no problem of “national defense.” All problems will be local police problems. If, however, only Deep Falls, Wyoming, becomes libertarian while the rest of America and the world remain statist, its chances for survival will be very slim. If Deep Falls, Wyoming, declares its secession from the United States government and establishes a free society, the chances are great that the United States—given its historical ferocity toward secessionists—would quickly invade and crush the new free society, and there is little that any Deep Falls police force could do about it. Between these two polar cases, there is an infinite continuum of degrees, and obviously, the larger the area of freedom, the better it could withstand any outside threat. The “Russian question” is therefore a matter of strategy rather than a matter of deciding on basic principles and on the goal toward which we wish to direct our efforts.

But after all this is said and done, let us take up the Russian question anyway. Let us assume that the Soviet Union would really be hell-bent on attacking a libertarian population within the present boundaries of the United States (clearly, there would no longer be a United States government to form a single nation-state). In the first place, the form and quantity of defense expenditures would be decided upon by the American consumers themselves. Those Americans who favor Polaris submarines, and fear a Soviet threat, would subscribe toward the financing of such vessels. Those who prefer an ABM system would invest in such defensive missiles. Those who laugh at such a threat or those who are committed pacifists would not contribute to any “national” defense service at all. Different defense theories would be applied in proportion to those who agree with, and support, the various theories being offered. Given the enormous waste in all wars and defense preparations in all countries throughout history, it is certainly not beyond the bounds of reason to propose that private, voluntary defense efforts would be far more efficient than government boondoggles. Certainly these efforts would be infinitely more moral.
But let us assume the worst. Let us assume that the Soviet Union at last invades and conquers the territory of America. What then? We have to realize that the Soviet Union’s difficulties will have only just begun. The main reason a conquering country can rule a defeated country is that the latter has an existing State apparatus to transmit and enforce the victor’s orders onto a subject population. Britain, though far smaller in area and population, was able to rule India for centuries because it could transmit British orders to the ruling Indian princes, who in turn could enforce them on the subject population. But in those cases in history where the conquered had no government, the conquerors found rule over the conquered extremely difficult. When the British conquered West Africa, for example, they found it extremely difficult to govern the Ibo tribe (later to form Biafra) because that tribe was essentially libertarian, and had no ruling government of tribal chiefs to transmit orders to the natives. And perhaps the major reason it took the English centuries to conquer ancient Ireland is that the Irish had no State, and that there was therefore no ruling governmental structure to keep treaties, transmit orders, etc. It is for this reason that the English kept denouncing the “wild” and “uncivilized” Irish as “faithless,” because they would not keep treaties with the English conquerors. The English could never understand that, lacking any sort of State, the Irish warriors who concluded treaties with the English could only speak for themselves; they could never commit any other group of the Irish population.¹⁴

Furthermore, the occupying Russians’ lives would be made even more difficult by the inevitable eruption of guerrilla warfare by the American population. It is surely a lesson of the twentieth century—a lesson first driven home by the successful American revolutionaries against the mighty British Empire—that no occupying force can long keep down a native population determined to resist. If the giant United

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States, armed with far greater productivity and firepower, could not succeed against a tiny and relatively unarmed Vietnamese population, how in the world could the Soviet Union succeed in keeping down the American people? No Russian occupation soldier’s life would be safe from the wrath of a resisting American populace. Guerrilla warfare has proved to be an irresistible force precisely because it stems, not from a dictatorial central government, but from the people themselves, fighting for their liberty and independence against a foreign State. And surely the anticipation of this sea of troubles, of the enormous costs and losses that would inevitably follow, would stop well in advance even a hypothetical Soviet government bent on military conquest.
Session 2

The Typology and Direct Effects of Interventionism

- *Power and Market*
  Chapter 2: Fundamentals of Intervention

- *Economic Controversies*
  Toward a Reconstruction of Utility and Welfare Economics

- *Economic Controversies*
  In Defense of ‘Extreme Apriorism’
Individual valuation is the keystone of economic theory. For, fundamentally, economics does not deal with things or material objects. Economics analyzes the logical attributes and consequences of the existence of individual valuations. “Things” enter into the picture, of course, since there can be no valuation without things to be valued. But the essence and the driving force of human action, and therefore of the human market economy, are the valuations of individuals. Action is the result of choice among alternatives, and choice reflects values, that is, individual preferences among these alternatives.

Individual valuations are the direct subject matter of the theories of utility and of welfare. Utility theory analyzes the laws of the values and choices of an individual; welfare theory discusses the relationship between the values of many individuals, and the consequent possibilities of a scientific conclusion on the “social” desirability of various alternatives.

Both theories have lately been foundering in stormy seas. Utility theory is galloping off in many different directions at once; welfare theory, after reaching the heights of popularity among economic theorists, threatens to sink, sterile and abandoned, into oblivion.

The thesis of this paper is that both related branches of economic theory can be salvaged and reconstructed, using as a guiding principle of both fields the concept of “demonstrated preference.”

DEMONSTRATED PREFERENCE

A Statement of the Concept

Human action is the use of means to arrive at preferred ends. Such action contrasts to the observed behavior of stones and planets, for it implies purpose on the part of the actor. Action implies choice among alternatives. Man has means, or resources, which he uses to arrive at various ends; these resources may be time, money, labor energy, land, capital goods, and so on. He uses these resources to attain his most preferred ends. From his action, we can deduce that he has acted so as to satisfy his most highly valued desires or preferences.

The concept of demonstrated preference is simply this: that actual choice reveals, or demonstrates, a man’s preferences; that is, that his preferences are deducible from what he has chosen in action. Thus, if a man chooses to spend an hour at a concert rather than a movie, we deduce that the former was preferred, or ranked higher on his value scale. Similarly, if a man spends five dollars on a shirt we deduce that he preferred purchasing the shirt to any other uses he could have found for the money. This concept of preference, rooted in real choices, forms the keystone of the logical structure of economic analysis, and particularly of utility and welfare analysis.

While a similar concept played a role in the writings of the early utility economists, it had never received a name, and it therefore remained largely undeveloped and unrecognized as a distinct concept. It was generally discarded in the 1930s, before it had even achieved recognition. This view of preference as derived from choice was present in varying degree in the writings of the early Austrian economists, as well as in the works of Jevons, Fisher, and Fetter. Fetter was the only one who clearly employed the concept in his analysis. The clearest and most thorough formulation of the concept has been the works of Professor Mises.1

1See Alan R. Sweezy, “The Interpretation of Subjective Value Theory in the Writings of the Austrian Economists,” Review of Economic Studies (June 1934): 176–85, for an historical survey. Sweezy devotes a good part of the article to a criticism of Mises as the leading exponent of the demonstrated preference approach. For Mises’s views, see Human Action (New
Positivism and the Charge of Tautology

Before developing some of the applications of the demonstrated preference principle to utility and welfare theory, we must consider the methodological objections that have been levelled against it. Professor Alan Sweezy, for example, seizes on a sentence of Irving Fisher’s which very succinctly expressed the concept of demonstrated preference: “Each individual acts as he desires.” Sweezy is typical of the majority of present-day economists in not being able to understand how such a statement can be made with absolute validity. To Sweezy, insofar as it is not an empirically testable proposition in psychology, such a sentence must simply reduce to the meaningless tautology: “each individual acts as he acts.”

This criticism is rooted in a fundamental epistemological error that pervades modern thought: the inability of modern methodologists to understand how economic science can yield substantive truths by means of logical deduction (that is, the method of “praxeology”). For they have adopted the epistemology of positivism (now dubbed “logical empiricism” or “scientific empiricism” by its practitioners), which uncritically applies the procedures appropriate in physics to the sciences of human action.²

In physics, simple facts can be isolated in the laboratory. These isolated facts are known directly, but the laws to explain these facts are not. The laws may only be hypothecated. Their validity can only be determined by logically deducing consequents from them which can be verified by appeal to the laboratory facts. Even if the laws explain the facts, however, and their inferences are consistent with them, the laws of physics can never be absolutely established. For some other law may prove more elegant or capable of explaining a wider range of facts. In physics, therefore, postulated explanations have to be hypothecated in such a way that they or their consequents can be empirically tested. Even then, the laws are only tentatively rather than absolutely valid.

²See the methodological treatises of Kaufman, Hutchison, Souter, Stonier, Myrdal, Morgenstern, and so on.
In human action, however, the situation is reversed. There is here no laboratory where “facts” can be isolated and broken down into their simple elements. Instead, there are only historical “facts” which are complex phenomena, resultants of many causal factors. These phenomena must be explained, but they cannot be isolated or used to verify or falsify any law. On the other hand, economics, or praxeology, has full and complete knowledge of its original and basic axioms. These are the axioms implicit in the very existence of human action, and they are absolutely valid so long as human beings exist. But if the axioms of praxeology are absolutely valid for human existence, then so are the consequents which can logically be deduced from them. Hence, economics, in contrast to physics, can derive absolutely valid substantive truths about the real world by deductive logic. The axioms of physics are only hypothecated and hence subject to revision; the axioms of economics are already known and hence absolutely true. The irritation and bewilderment of positivists over the “dogmatic” pronouncements of praxeology stem, therefore, from their universal application of methods proper only to the physical sciences.

The suggestion has been made that praxeology is not really scientific, because its logical procedures are verbal (“literary”) rather than mathematical and symbolic. But mathematical logic is uniquely appropriate to physics, where the various logical steps along the way are not in themselves meaningful; for the axioms and therefore the

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Economic Controversies

Toward a Reconstruction of Utility and Welfare Economics (pp. 289–333)

Deductions of physics are in themselves meaningless, and only take on meaning “operationally,” insofar as they can explain and predict given facts. In praxeology, on the contrary, the axioms themselves are known as true and are therefore meaningful. As a result, each step-by-step deduction is meaningful and true. Meanings are far better expressed verbally than in meaningless formal symbols. Moreover, simply to translate economic analysis from words into symbols, and then to retranslate them so as to explain the conclusions, makes little sense, and violates the great scientific principle of Occam’s Razor that there should be no unnecessary multiplication of entities.

The crucial concept of the positivists, and the one that forms the basis for their attack on demonstrated preference, is that of “operational meaning.” Indeed, their favorite critical epithet is that such and such a formulation or law is “operationally meaningless.”6 The test of “operationally meaningful” is derived strictly from the procedures of physics as outlined above. An explanatory law must be framed so that it can be tested and found empirically false. Any law which claims to be absolutely true and not empirically capable of being falsified is therefore “dogmatic” and operationally meaningless—hence, the positivist’s view that if a statement or law is not capable of being falsified empirically, it must simply be a tautologous definition. And consequently, Sweezy’s attempted reduction of Fisher’s sentence to a meaningless identity.7

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6 Paul Samuelson has added the weight of his authority to Sweezy’s criticism of Mises and demonstrated preference, and has couched his endorsement in terms of “operational meaning.” Samuelson explicitly rejects the idea of a true utility theory in favor of one that is merely hypothetical. See Paul A. Samuelson, “The Empirical Implications of Utility Analysis,” Econometrica (1938): 344ff.; and Samuelson, Foundations of Economic Analysis (Cambridge, Mass.: Harvard University Press, 1947), pp. 91–92.

The concept of operational meaning was originated by the physicist Percy W. Bridgman explicitly to explain the methodology of physics. Cf. Bridgman, The Logic of Modern Physics (New York: Macmillan, 1927). Many founders of modern positivism, such as Mach and Boltzmann, were also physicists.

7 The hero of positivism, Rudolf Carnap and Ludwig Wittgenstein, disparaged deductive inference as merely drawing out “tautologies” from the axioms. Yet all reasoning is deductive, and this process is peculiarly vital to
Sweezy objects that Fisher’s “each man acts as he desires” is circular reasoning, because action implies desire, and yet desires are not arrived at independently, but are only discoverable through the action itself. Yet this is not circular. For desires exist by virtue of the concept of human action and of the existence of action. It is precisely the characteristic of human action that it is motivated by desires and ends, in contrast to the unmotivated bodies studied by physics. Hence, we can say validly that action is motivated by desires and yet confine ourselves to deducing the specific desires from the real actions.

Professor Samuelson and “Revealed Preference”

“Revealed preference”—preference revealed through choice—would have been an apt term for our concept. It has, however, been preempted by Samuelson for a seemingly similar but actually quite different concept of his own. The critical difference is this: Samuelson assumes the existence of an underlying preference scale that forms the basis of a man’s actions and that remains constant in the course of his actions over time. Samuelson then uses complex mathematical procedures in an attempt to “map” the individuals preference scale on the basis of his numerous actions.

The prime error here is the assumption that the preference scale remains constant over time. There is no reason whatever for making any such assumption. All we can say is that an action, at a specific point of time, reveals part of a man’s preference scale at that time. There is no warrant for assuming that it remains constant from one point of time to another.8

The “revealed preference” theorists do not recognize that they are assuming constancy; they believe that their assumption is simply that of consistent behavior, which they identify with “rationality.” They will admit that people are not always “rational,” but uphold arriving at truth. For a critique of Carnap and Wittgenstein, and a demonstration that inference is not merely identity to “tautology,” cf. Lalande, “Tautoglie,” in Vocabulaire, pp. 1103–04.

8Samuelson’s analysis suffers from other errors as well, such as the use of invalid “index number” procedures. On the theoretical fallacies of index numbers, cf. Mises, Theory of Money and Credit, pp. 187–94.
their theory as being a good first approximation or even as having normative value. However, as Mises has pointed out, constancy and consistency are two entirely different things. Consistency means that a person maintains a transitive order of rank on his preference scale (if A is preferred to B and B is preferred to C, then A is preferred to C). But the revealed preference procedure does not rest on this assumption so much as on an assumption of constancy—that an individual maintains the same value scale over time. While a violation of the former might be called irrational, there is certainly nothing irrational about someone’s value scales changing through time. Hence, no valid theory can be built on a constancy assumption.9

One of the most absurd procedures based on a constancy assumption has been the attempt to arrive at a consumer’s preference scale not through observed real action, but through quizzing him by questionnaires. In vacuo, a few consumers are questioned at length on which abstract bundle of commodities they would prefer to another abstract bundle, and so on. Not only does this suffer from the constancy error, no assurance can be attached to the mere questioning of people when they are not confronted with the choices in actual practice. Not only will a person’s valuation differ when talking about them from when he is actually choosing, but there is also no guarantee that he is telling the truth.10

9See Mises, Human Action, pp. 102–03. Mises demonstrates that Wicksteed and Robbins committed a similar error.

10It is to Samuelson’s credit that he rejects the questionnaire approach. Professors Kennedy and Keckskemeti, for different reasons, defend the questionnaire method. Kennedy simply says, rather illogically, that in vacuo procedures are being used anyway, when the theorist states that more of a good is preferred to less. But this is not in vacuo; it is a conclusion based on the praxeological knowledge that since a good is any object of action, more must be preferred to less while it remains a good. Kennedy is wrong, therefore, when he asserts that this is a circular argument, for the fact that action exists is not “circular.”

Keckskemeti actually asserts that the questionnaire method is preferable to observing behavior in discovering preferences. The basis of his arguments is a spurious dichotomy between utility and ethical valuations. Ethical valuations may be considered either as identical with, or a subset of, utility judgments, but they can not be separated.
The bankruptcy of the revealed-preference approach has never been better portrayed than by a prominent follower, Professor Kennedy. Says Kennedy: “In what respectable science would the assumption of consistency (that is, constancy) be accepted for one moment?” But he asserts it must be retained anyway, else utility theory could not serve any useful purpose. The abandonment of truth for the sake of a spurious usefulness is a hallmark of the positivist-pragmatist tradition. Except for certain auxiliary constructions, it should be clear that the false cannot be useful in constructing a true theory. This is particularly the case in economics, which is explicitly built on true axioms.

Psychologizing and Behaviorism: Twin Pitfalls

The revealed-preference doctrine is one example of what we may call the fallacy of “psychologizing,” the treatment of preference scales as if they existed as separate entities apart from real action. Psychologizing is a common error in utility analysis. It is based on the assumption that utility analysis is a kind of “psychology,” and that, therefore, economics must enter into psychological analysis in laying the foundations of its theoretical structure.

Praxeology, the basis of economic theory, differs from psychology, however. Psychology analyzes the how and the why of people forming values. It treats the concrete content of ends and values. Economics, on the other hand, rests simply on the assumption of the existence of ends, and then deduces its valid theory from such a

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12This error again stems from physics, where such assumptions as absence of friction are useful as first approximations—to known facts from unknown explanatory laws! For a refreshing skepticism on the value of false axioms, cf. Martin Bronfenbrenner, “Contemporary Economics Resurveyed,” *Journal of Political Economy* (April 1953).
The errors of psychologizing and of behaviorism have in common a desire by their practitioners to endow their concepts and procedures with “operational meaning,” either in the areas of observed behavior or in mental operations. Vilfredo Pareto, perhaps the founder of an explicitly positivist approach in economics, championed both errors. Discarding a demonstrated preference approach as “tautologous,” Pareto, on the one hand, sought to eliminate subjective preferences from economics and, on the other, to investigate and

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13The axiom of the existence of ends may be considered a proposition in philosophical psychology. In that sense, praxeology is grounded in psychology, but its development then completely diverges from psychology proper. On the question of purpose, praxeology takes its stand squarely with the Leibnizian tradition of philosophical psychology as opposed to the Lockean tradition upheld by positivists, behaviorists, and associationists. For an illuminating discussion of this issue, cf. Gordon W. Allport, Becoming (New Haven, Conn.: Yale University Press, 1955), pp. 6–17.

14Thus, the law of diminishing marginal utility does not at all rest on some postulated psychological law of satiety of wants, but on the praxeological truth that the first units of a good will be allocated to the most valuable uses, the next units to the next-most valuable uses, and so on.

measure preference scales apart from real action. Pareto was, in more ways than one, the spiritual ancestor of most current utility theorists.  

A Note on Professor Armstrong’s Criticism

Professor Armstrong has delivered a criticism of the revealed-preference approach which he would undoubtedly apply to demonstrated preference as well. He asserts that when more than one commodity is being ranked, individual preference scales cannot be unitary, and we cannot postulate the ranking of the commodities on one scale. On the contrary, it is precisely the characteristic of a deduced preference scale that it is unitary. Only if a man ranks two alternatives as more and less valuable on one scale can he choose between them. Any of his means will be allocated to his more preferred use. Real choice therefore always demonstrates relevant preferences ranked on a unitary scale.

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17 Vivian C. Walsh is an interesting current example of the combinations of both types of error. On the one hand, he is an extreme behaviorist, who refuses to recognize that any preferences are relevant to, or can be demonstrated by, action. On the other hand, he also takes the extreme psychologizing view that psychological states per se can be directly observed. For this, he falls back on “common sense.” But this position fails because Walsh’s psychological “observations” are ideal types and not analytic categories. Thus, Walsh says that: “saying that someone is a smoker is different from saying that he is smoking now,” upholding the former type of statement for economics. But such statements are historical ideal types, relevant to history and psychology, but not to economic analysis. Cf. Vivian C. Walsh, “On Descriptions of Consumers’ Behavior,” *Economica* (August 1954): 244–52. On ideal types and relation to praxeology, cf. Mises, *Human Action*, pp. 59–64.

UTILITY THEORY

Utility theory, over the last generation, has been split into two warring camps: (1) those who cling to the old concept of cardinal, measurable utility, and (2) those who have thrown over the cardinal concept, but have dispensed with the utility concept as well and have substituted an analysis based on indifference curves.

In its pristine form, the cardinalist approach has been abandoned by all but a rearguard. On demonstrated preference grounds, cardinality must be eliminated. Psychological magnitudes cannot be measured since there is no objectively extensive unit—a necessary requisite of measurement. Further, actual choice obviously cannot demonstrate any form of measurable utility; it can only demonstrate one alternative being preferred to another.19

Ordinal Marginal Utility and Total Utility

The ordinalist rebels, led by Hicks and Allen in the early 1930s, felt it necessary to overthrow the very concept of marginal utility along with measurability. In doing so, they threw out the Utility baby together with the Cardinal bathwater. They reasoned that marginal utility itself implies measurability. Why? Their notion rested on the implicit neoclassical assumption that the marginal in marginal utility is equivalent to the marginal of the differential calculus. Since, in mathematics, a total “something” is the integral of “marginal somethings,” economists early on assumed that “total utility” was the mathematical integral of a series of “marginal utilities.”20 Perhaps, too, they realized that this assumption was essential to a mathematical representation of utility. As a result, they assumed, for example, that the “marginal utility” of a good with a supply of six units is equal to the “total utility” of six units minus the “total utility” of five units. If utilities can be subjected to the arithmetical operation of subtraction, and can be differentiated and integrated, then obviously the

19 Mises’s priority in establishing this conclusion is acknowledged by Professor Robbins; cf. Lionel Robbins, “Robertson on Utility and Scope,” Economica (May 1953): 99–111; Mises, Theory of Money and Credit, pp. 38–47 and passim. Mises’s role in forging an ordinal marginal utility theory has suffered almost total neglect.

concept of marginal utility must imply cardinally measurable utilities.\textsuperscript{21}

The mathematical representation of the calculus rests on the assumption of \textit{continuity}, that is, infinitely small steps. In human action, however, there can be no infinitely small steps. Human action and the facts on which it is based must be in observable and discrete steps and not infinitely small ones. Representation of utility in the manner of the calculus is therefore illegitimate.\textsuperscript{22}

There is, however, no reason why marginal utility must be conceived in calculus terms. In human action, “marginal” refers not to an infinitely small unit, but to the \textit{relevant} unit. Any unit relevant to a particular action is marginal. For example, if we are dealing in a specific situation with single eggs, then each egg is the unit; if we are dealing in terms of six-egg cartons, then each six-egg carton is the unit. In either case, we can speak of a marginal utility. In the former case, we deal with the “marginal utility of an egg” with various supplies of eggs; in the latter, with the “marginal utility of cartons” whatever the supply of cartons of eggs. Both utilities are marginal. In no sense is one utility a “total” of the other.

To clarify the relationship between marginal utility and what has been misnamed “total utility” but actually refers to a marginal utility of a larger-sized unit, let us hypothetically construct a typical value scale for eggs:

\textsuperscript{21}That this reasoning lay at the base of the ordinalists’ rejection of marginal utility may be seen in John R. Hicks, \textit{Value and Capital}, 2nd ed. (Oxford: Oxford University Press, 1946), p. 19. That many ordinalists regret the loss of marginal utility may be seen in the statement by Arrow that: “The older discussion of diminishing marginal utility as aiming for the satisfaction of more intense wants first makes more sense” than the current “indifference-curve” analysis, but that, unfortunately it is “bound up with the untenable notion of measurable utility,” Quoted in D.H. Robertson, “Utility and All What?” \textit{Economic Journal} (December 1954): 667.

\textsuperscript{22}Hicks concedes the falsity of the continuity assumption but blindly pins his faith on the hope that all will be well when individual actions are aggregated. Hicks, \textit{Value and Capital}, p. 11.
Ranks in Value

5 eggs
4 eggs
3 eggs
2 eggs
1 egg
2nd egg
3rd egg
4th egg
5th egg

This is a man’s ordinal value, or preference, scale for eggs. The higher the ranking, the higher the value. At the center is one egg, the first egg in his possession. By the Law of Diminishing Marginal Utility (ordinal), the second, third, fourth eggs, and so on, rank below the first egg on his value scale, and in that order. Now, since eggs are goods and therefore objects of desire, it follows that a man will value two eggs more than he will one, three more than he will two, and so on. Instead of calling this “total utility,” we will say that the marginal utility of a unit of a good is always higher than the marginal utility of a unit of smaller size. A bundle of 5 eggs will be ranked higher than a bundle of 4 eggs, and so on. It should be clear that the only arithmetic or mathematical relationship between these marginal utilities is a simple ordinal one. On the one hand, given a certain sized unit, the marginal utility of that unit declines as the supply of units increases. This is the familiar Law of Diminishing Marginal Utility. On the other hand, the marginal utility of a larger-sized unit is greater than the marginal utility of a smaller-sized unit. This is the law just underlined. And there is no mathematical relationship between, say, the marginal utility of 4 eggs and the marginal utility of the 4th egg except that the former is greater than the latter.

We must conclude then that there is no such thing as total utility; all utilities are marginal. In those cases where the supply of a good totals only one unit, then the “total utility” of that whole supply is simply the marginal utility of a unit the size of which equals the
whole supply. The key concept is the variable size of the marginal unit, depending on the situation.\footnote{The analysis of total utility was first put forward by Mises, in Theory of Money and Credit, pp. 38–47. It was continued by Harro F. Bernardelli, especially in his “The End of the Marginal Utility Theory?” Economica (May 1938): 206. Bernardelli’s treatment, however, is marred by laborious attempts to find some form of legitimate mathematical representation. On the failure of the mathematical economists to understand this treatment of marginal and total, see the criticism of Bernardelli by Paul A. Samuelson, “The End of Marginal Utility: A Note on Dr. Bernardelli’s Article,” Economica (February 1939): 86–87; Kelvin Lancaster, “A Refutation of Mr. Bernardelli,” Economica (August 1953): 259–62. For rebuttals see Bernardelli, “A Reply to Mr. Samuelson’s Note,” Economica (February 1939): 88–89; and “Comment on Mr. Lancaster’s Refutation,” Economica (August 1954): 240–42.}

A typical error on the concept of marginal utility is a recent statement by Professor Kennedy that “the word ‘marginal’ presupposes increments of utility” and hence measurability. But the word “marginal” presupposes not increments of utility, but the utility of increments of goods, and this need have nothing to do with measurability.\footnote{See Charles Kennedy, “Concerning Utility,” Economica (February 1954): 13. Kennedy’s article, incidentally, is an attempt to rehabilitate a type of cardinalism by making distinctions between “quantity” and “magnitude,” and using the Bertrand Russell concept of “relational addition.” Surely, this sort of approach falls with one slash of Occam’s Razor—the great scientific principle that entities not be multiplied unnecessarily. For a criticism, cf. D.H. Robertson, “Utility and All What?” pp. 668–69.}

**Professor Robbins’s Problem**

Professor Lionel Robbins, in the course of a recent defense of ordinalism, raised a problem which he left unanswered. Accepted doctrine, he declared, states that if difference between utility rankings can be judged by the individual, as well as the rankings themselves, then the utility scale can in some way be measured. Yet, Robbins says, he can judge differences. For example, among three paintings, he can say that he prefers a Rembrandt to a Holbein far less than he prefers a Holbein to a Munnings. How, then, can ordinalism be saved?\footnote{Robbins, “Robertson on Utility and Scope,” p. 104.}
he not conceding measurability? Yet Robbins’s dilemma had already been answered twenty years earlier in a famous article by Oskar Lange.26 Lange pointed out that in terms of what we would call demonstrated preference, only pure rankings are revealed by acts of choice. “Differences” in rank are not so revealed, and are therefore mere psychologizing, which, however interesting, are irrelevant to economics. To this, we need only add that differences of rank can be revealed through real choice, whenever the goods can be obtained by money. We need only realize that money units (which are characteristically highly divisible) can be lumped in the same value-scale as commodities. For example, suppose someone is willing to pay $10,000 for a Rembrandt, $8,000 for a Holbein and only $20 for a Munnings. Then, his value-scale will have the following descending order: Rembrandt, $10,000; Holbein, $9,000, $8,000, $7,000, $6,000; . . . Munnings, $20. We may observe these ranks and no question of the measurability of utilities need arise.

That money and units of various goods can be ranked on one value scale is the consequence of Mises’s money-regression theorem, which makes possible the application of marginal utility analysis to money.27 It is characteristic of Professor Samuelson’s approach that he scoffs at the whole problem of circularity which money-regression had solved. He falls back on Léon Walras, who developed the idea of “general equilibrium in which all magnitudes are simultaneously


27See Mises, *Theory of Money and Credit*, pp. 97–123. Mises replied to critics in *Human Action*, pp. 405ff. The only further criticism has been that of Gilbert, who asserts that the theorem does not explain how a paper money can be introduced after the monetary system has broken down. Presumably he refers to such cases as the German Rentenmark. The answer, of course, is that such paper was not introduced de novo; gold and foreign exchange existed previously, and the Rentenmark could exchange in terms of these previously existing moneys. Cf. J.C. Gilbert, “The Demand for Money: The Development of an Economic Concept,” *Journal of Political Economy* (April 1953): 149.
determined by efficacious interdependent relations,” which he con-
trasts to the “fears of literary writers” about circular reasoning.28 This
is one example of the pernicious influence of the mathematical
method in economics. The idea of mutual determination is appro-
priate in physics, which tries to explain the unmotivated motions of
physical matter. But in praxeology, the cause is known: individual
purpose. In economics, therefore, the proper method is to proceed
from the causing action to its consequent effects.

The Fallacy of Indifference

The Hicksian Revolutionaries replaced the cardinal utility con-
cept with the concept of indifference classes, and for the last twenty
years, the economic journals have been rife with a maze of two- and
three-dimensional indifference curves, tangencies, “budget lines,”
and so on. The consequence of an adoption of the demonstrated
preference approach is that the entire indifference-class concept,
along with the complicated superstructure erected upon it, must fall
to the ground.

Indifference can never be demonstrated by action. Quite the
contrary. Every action necessarily signifies a choice, and every choice
signifies a definite preference. Action specifically implies the contrary
of indifference. The indifference concept is a particularly unfortu-
nate example of the psychologizing error. Indifference classes are
assumed to exist somewhere underlying and apart from action. This
assumption is particularly exhibited in those discussions that try to
“map” indifference curves empirically by the use of elaborate ques-
tionnaires.

28Samuelson, Foundations of Economic Analysis, pp. 117–18. For similar
attacks on earlier Austrian economists, cf. Frank H. Knight, “Introduction”
in Carl Menger, Principles of Economics (Glencoe, Ill.: The Free Press, 1950),
p. 23; George J. Stigler, Production and Distribution Theories (New Y ork:
“mutual determination” for “the older concept of cause and effect” and
explains this by saying that Böhm-Bawerk was untrained in mathematics.
For Menger’s attack on the mutual determination concept, cf. Terence W.
If a person is really indifferent between two alternatives, then he cannot and will not choose between them. Indifference is therefore never relevant for action and cannot be demonstrated in action. If a man, for example, is indifferent between the use of 5.1 ounces and 5.2 ounces of butter because of the minuteness of the unit, then there will be no occasion for him to act on these alternatives. He will use butter in larger-sized units, where varying amounts are not indifferent to him.

The concept of “indifference” may be important for psychology, but not for economics. In psychology, we are interested in finding out intensities of value, possible indifference, and so on. In economics, however, we are only interested in values revealed through choices. It is immaterial to economics whether a man chooses alternative A to alternative B because he strongly prefers A or because he tossed a coin. The fact of ranking is what matters for economics, not the reasons for the individuals arriving at that rank.

In recent years, the indifference concept has been subjected to severe criticism. Professor Armstrong pointed out that under Hicks's curious formulation of “indifference,” it is possible for an individual to be “indifferent” between two alternatives and yet choose one over the other. Little has some good criticisms of the indifference concept, but his analysis is vitiated by his eagerness to use faulty theorems in order to arrive at welfare conclusions, and by his radically behaviorist methodology. A very interesting attack on the indifference concept from the point of view of psychology has been levelled by Professor Macfie.

29 The “indifference theorists” also err in assuming infinitely small steps, essential for their geometric representation but erroneous for an analysis of human action.


31 Little, “Reformulation” and “Theory.” It is another defect of Samuelson's revealed preference approach that he attempts to “reveal” indifference-curves as well.

The indifference theorists have two basic defenses of the role of indifference in real action. One is to cite the famous fable of Buridan’s Ass. This is the “perfectly rational” ass who demonstrates indifference by standing, hungry, equidistant from two equally attractive bales of hay. Since the two bales are equally attractive in every way, the ass can choose neither one and starves therefore. This example is supposed to indicate how indifference can be revealed in action. It is, of course, difficult to conceive of an ass, or a person, who could be less rational. Actually, he is not confronted with two choices but with three, the third being to starve where he is. Even on the indifference theorists’ own grounds, this third choice will be ranked lower than the other two on the individuals value-scale. He will not choose starvation.

If both bundles of hay are equally attractive, then the ass or man, who must choose one or the other, will allow pure chance, such as the flip of a coin, to decide on either one. But then indifference is still not revealed by this choice, for the flip of a coin has enabled him to establish a preference.

The other attempt to demonstrate indifference classes rests on the consistency—constancy fallacy, which we have analyzed above. Thus, Kennedy and Walsh claim that a man can reveal indifference if, when asked to repeat his choices between A and B over time, he chooses each alternative 50 percent of the time.

If the concept of the individual indifference curve is completely fallacious, it is quite obvious that Baumol’s concept of the “community indifference curve,” which he purports to build up from individual curves, deserves the shortest possible shrift.

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34 Also see Croce’s warning about using animal illustrations in analyses of human action. Croce, “Economic Principle I,” p. 175.
35 Kennedy, “The Common Sense of Indifference Curves” and “On Descriptions of Consumer’s Behavior.”
The Neo-Cardinalists: The von Neumann-Morgenstern Approach

In recent years, the world of economics has been taken by storm by a neo-cardinalist, quasi-measurement theory of utility. This approach, which has the psychological advantage of being garbed in a mathematical form more advanced than economics had yet known, was founded by von Neumann and Morgenstern in their celebrated work. Their theory had the further advantage of being grounded on the most recent and fashionable (though incorrect) developments in the philosophy of measurement and the philosophy of probability. The von Neumann-Morgenstern thesis was adopted by the leading mathematical economists and has gone almost unchallenged to this day. The chief consolation of the ordinalists has been the assurance by the neo-cardinalists that their doctrine applies only to utility under conditions of uncertainty, and therefore does not shake the ordinalist doctrine too drastically. But this consolation is really quite limited, considering that some uncertainty enters into every action.

The von Neumann-Morgenstern theory is briefly as follows: an individual can compare not only certain events, but also combinations of events with definite numerical probabilities for each event. Then, according to the authors, if an individual prefers alternative A to B, and B to C, he is able to decide whether he prefers B or a 50:50 probability combination of C and A. If he prefers B, then his preference of B over C is deduced as being greater than his preference of A over B. In a similar fashion, various combinations of probabilities


Claims of the theory, even at its best, to measure utility in any way have been nicely exploded by Ellsberg, who also demolishes Marschak’s attempt to make the theory normative. Ellsberg’s critique suffers considerably, however, from being based on the “operational meaning” concept. D. Ellsberg, “Classic and Current Notions of Measurable Utility,” Economic Journal (September 1954): 528–56.
are selected. A quasi-measurable numerical utility is assigned to his utility scale in accordance with the indifference of utilities of B as compared with various probability combinations of A or C. The result is a numerical scale given when arbitrary numbers are assigned to the utilities of two of the events.

The errors of this theory are numerous and grave:

(1) None of the axioms can be validated on demonstrated preference grounds, since admittedly all of the axioms can be violated by the individual actors.

(2) The theory leans heavily on a constancy assumption so that utilities can be revealed by action over time.

(3) The theory relies heavily on the invalid concept of indifference of utilities in establishing the numerical scale.

(4) The theory rests fundamentally on the fallacious application of a theory of numerical probability to an area where it cannot apply. Richard von Mises has shown conclusively that numerical probability can be assigned only to situations where there is a class of entities, such that nothing is known about the members except they are members of this class, and where successive trials reveal an asymptotic tendency toward a stable proportion, or frequency of occurrence, of a certain event in that class. There can be no numerical probability applied to specific individual events.39

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39Richard von Mises, Probability, Statistics, and Truth (New York: Macmillan, 1957). Also Ludwig von Mises, Human Action, pp. 106–17. The currently fashionable probability theories of Rudolf Carnap and Hans Reichenbach have failed to shake the validity of Richard von Mises’s approach. Mises refutes them in the third German edition of his work, unfortunately unavailable in English. See Richard von Mises, Wahr scheinlichkeit, Statistik, und Wahrheit, 3rd ed. (Vienna: J. Springer, 1951). The only plausible critique of Richard von Mises has been that of W. Kneale, who pointed out that the numerical assignment of probability depends on an infinite sequence, whereas in no human action can there be an infinite sequence. This, however, weakens the application of numerical probability even to cases such as lotteries, rather than enabling it to expand into other areas. See also Little, “A Reformulation of the Theory of Consumers’ Behavior.”
Yet, in human action, precisely the opposite is true. Here, there are no classes of homogeneous members. Each event is a unique event and is different from other unique events. These unique events are not repeatable. Therefore, there is no sense in applying numerical probability theory to such events. It is no coincidence that, invariably, the application of the neo-cardinalists has always been to lotteries and gambling. It is precisely and only in lotteries that probability theory can be applied. The theorists beg the entire question of its applicability to general human action by confining their discussion to lottery cases. For the purchaser of a lottery ticket knows only that the individual lottery ticket is a member of a certain-sized class of tickets. The entrepreneur, in making his decisions, is on the contrary confronted with unique cases about which he has some knowledge and which have only limited parallelism to other cases.

(5) The neo-cardinalists admit that their theory is not even applicable to gambling if the individual has either a like or a dislike for gambling itself. Since the fact that a man gambles demonstrates that he likes to gamble, it is clear that the von Neumann-Morgenstern utility doctrine fails even in this tailor-made case.41

(6) A curious new conception of measurement. The new philosophy of measurement discards concepts of “cardinal” and “ordinal” in favor of such labored constructions as measurable up to a multiplicative constant (cardinal); “measurable up to a


41It is curious how economists have been tempted to discuss gambling by first assuming that the participant doesn’t like to gamble. It is on this assumption that Alfred Marshall based his famous “proof” that gambling (because of each individual’s diminishing utility of money) is “irrational.”
monotonic transform” (ordinal); “measurable up to a linear transform” (the new quasi-measurement, of which the von Neumann-Morgenstern proposed utility index is an example). This terminology, apart from its undue complexity (under the influence of mathematics), implies that everything, including ordinality, is somehow measurable. The man who proposes a new definition for an important word must prove his case; the new definition of measurement has hardly done so. Measurement, on any sensible definition, implies the possibility of a unique assignment of numbers which can be meaningfully subjected to all the operations of arithmetic. To accomplish this, it is necessary to define a fixed unit. In order to define such a unit, the property to be measured must be extensive in space, so that the unit can be objectively agreed upon by all. Therefore, subjective states, being intensive rather than objectively extensive, cannot be measured and subjected to arithmetical operations. And utility refers to intensive states. Measurement becomes even more implausible when we realize that utility is a praxeologic, rather than a directly psychologic, concept.

A favorite rebuttal is that subjective states have been measured; thus, the old, unscientific subjective feeling of heat has given way to the objective science of thermometry. But this rebuttal is erroneous; thermometry does not measure the intensive subjective feelings themselves. It assumes an approximate correlation between the intensive property and an objective extensive event—such as the physical expansion of gas or mercury. And thermometry can certainly lay no claim to precise measurement of subjective states: we all know that some people, for various reasons, feel warmer or colder at different times even if the external temperature remains the same. Certainly no correlation whatever can be found for demonstrated preference scales in relation to physical lengths. For preferences have no direct physical basis, as do feelings of heat.

No arithmetical operations whatever can be performed on ordinal numbers; therefore, to use the term measurable in any way for

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ordinal numbers is hopelessly to confuse the meaning of the term. Perhaps the best remedy for possible confusion is to avoid using any numbers for ordinal rank; the rank concept can just as well be expressed in letters (A, B, C . . .), using a convention that A, for example, expresses higher rank.

As to the new type of quasi-measurability, no one has yet proved it capable of existence. The burden of proof rests on the proponents. If an object is extensive, then it is at least theoretically capable of being measured, for an objective fixed unit can, in principle, be defined. If it is intensive, then no such fixed unit can apply, and any assignment of number would have to be ordinal. There is no room for an intermediate case. The favorite example of quasi-measurability that is always offered is, again, temperature. In thermometry, centigrade and Fahrenheit scales are supposed to be convertible into each other not at a multiplicative constant (cardinality) but by multiplying and then adding a constant (a “linear transform”). More careful analysis, however, reveals that both scales are simply derivations from one scale based on an absolute zero point. All we need to demonstrate the cardinality of temperature is to transform both centigrade and Fahrenheit scales into scales where “absolute zero” is zero, and then each will be convertible into the other by a multiplicative constant. Furthermore, the actual measurement in temperature is a measurement of length (say, of the mercury column) so that temperature is really a derived measure based on the cardinally measurable magnitude of length.44

Jacob Marschak, one of the leading members of the von Neumann-Morgenstern School, has conceded that the temperature case

44On measurement, see Norman Campbell, What is Science? (New York: Dover, 1952), pp. 109–34; and Campbell, An Account of the Principles of Measurement and Calculation (London: Longmans, Green, 1928). Although the above view of measurement is not currently fashionable, it is backed by the weighty authority of Mr. Campbell. A description of the controversy between Campbell and S. Stevens on the issue of measurement of intensive magnitudes was included in the unpublished draft of Carl G. Hempel’s Concept Formation, but was unfortunately omitted from Hempel’s published Fundamentals of Concept Formation in Empirical Science (Chicago: University of Chicago, 1952). Campbell’s critique can be found in A. Ferguson, et al. Interim Report (British Association for the Advancement of Science Final Report, 1940), pp. 331–49.
is inappropriate for the establishment of quasi-measurability, because it is derived from the fundamental, cardinal, measurement of dis-
tance. Yet, astonishingly, he offers altitude in its place. But if “tem-
perature readings are nothing but distance,” what else is altitude, which is solely and purely distance and length.45

**Welfare Economics: A Critique**

*Economics and Ethics*

It is now generally accepted among economists, at least *pro forma*, that economics *per se* cannot establish ethical judgments. It is not sufficiently recognized that to accept this need not imply accept-
ance of the Max Weber position that ethics can never be scientifically or rationally established. Whether we accept the Max Weber position, or we adhere to the older view of Plato and Aristotle that a rational ethics is possible, it should be clear that *economics* by itself cannot establish an ethical position. If an ethical science is possible, it must be built up out of data supplied by truths established by all of the other sciences.

Medicine can establish the fact that a certain drug can cure a certain disease, while leaving to other disciplines the problem whether the disease *should* be cured. Similarly, economics can establish that Policy A leads to the advancement of life, prosperity, and peace, while Policy B leads to death, poverty, and war. Both medicine and economics can establish these consequences scientifically, and without introducing ethical judgments into the analysis. It might be protested that doctors would not inquire into possible cures for a disease if they did not want a cure, or economists would not investigate causes of prosperity if they did not want the result. There are two answers to this point: (1) that this is undoubtedly true in almost all cases, but not *necessarily* so—some doctors or economists may care only about the discovery of truth, and (2) this only establishes the psychologic motivation of the scientists; it does not establish that the discipline itself arrives at values. On the contrary, it bolsters the thesis that ethics is arrived at apart from the specific sciences of medicine or economics.

45Jacob Marschak, “Rational Behavior, Uncertain Prospects, and Mea-
Thus, whether we hold the view that ethics is a matter of non-rational emotions or taste, or whether we believe in a rational ethic, we must agree that economic science per se cannot establish ethical statements. As political policy judgment is a branch of ethics, the same conclusion applies to politics. If prosperity vs. poverty, for example, are political alternatives, economic science cannot decide between them; it simply presents the truth about the consequences of each alternative political decision. As citizens, we take these truths into account when we make our politico-ethical decisions.

**The Problem of the New Welfare Economics: The Unanimity Rule**

The problem of “welfare economics” has always been to find some way to circumvent this restriction on economics, and to make ethical, and particularly political, statements directly. Since economics discusses individuals’ aiming to maximize their utility or happiness or welfare, the problem may be translated into the following terms: When can economics say that “society is better off” as a result of a certain change? Or alternatively, when can we say that “social utility” has been increased or “maximized”?

Neoclassical economists, led by Professor Pigou, found a simple answer. Economics can establish that a man’s marginal utility of money diminishes as his money-income increases. Therefore, they concluded, the marginal utility of a dollar is less to a rich man than to a poor man. Other things being equal, social utility is maximized by a progressive income tax which takes from the rich and gives to the poor. This was the favorite demonstration of the “old welfare economics,” grounded on Benthamite utilitarian ethics, and brought to fruition by Edgeworth and Pigou.

Economists continued blithely along this path until they were brought up short by Professor Robbins. Robbins showed that this demonstration rested on interpersonal comparisons of utility, and since utility is not a cardinal magnitude, such comparisons involve ethical judgments. What Robbins actually accomplished was to

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reintroduce Pareto’s Unanimity Rule into economics and establish it as the iron gate where welfare economics must test its credentials. This Rule runs as follows: We can only say that “social welfare” (or better, “social utility”) has increased due to a change, if no individual is worse off because of the change (and at least one is better off). If one individual is worse off, the fact that interpersonal utilities cannot be added or subtracted prevents economics from saying anything about social utility. Any statement about social utility would, in the absence of unanimity, imply an ethical interpersonal comparison between the gainers and the losers from a change. If X number of individuals gain, and Y number lose, from a change, any weighing to sum up in a “social” conclusion would necessarily imply an ethical judgment on the relative importance of the two groups.

The Pareto-Robbins Unanimity Rule conquered economics and liquidated the old Pigovian welfare economics almost completely. Since then, an enormous literature known as the “new welfare economics” has flourished, devoting itself to a series of attempts to square the circle: to assert certain political judgments as scientific economics, while still retaining the unanimity rule.

Professor Robbins’s Escape Route

Robbins’s own formulation of the Unanimity Rule far undervalues the scope of its restrictive power over the assertions of economists. Robbins stated that only one ethical assertion would be necessary for economists to make interpersonal comparisons: namely, that every man has an “equal capacity for satisfaction” in similar circumstances. To be sure, Robbins grants that this ethical assumption cannot be established by economics; but he implies that since all good democrats are bound to make this egalitarian assumption, we can all pretty well act as if interpersonal comparisons of utility can be made and go on to make ethical judgments.

48 Kemp tries to alter the Unanimity Rule to read that social utility is only increased if everyone is better off, none being worse off or indifferent. But, as we have seen, indifference cannot be demonstrated in action, and therefore this alteration is invalid. Murray C. Kemp, “Welfare Economics: A Stocktaking,” Economic Record (November 1954): 245.
In the first place, it is difficult, upon analysis, to make sense of the phrase “equal capacity for satisfaction.” Robbins, as we have seen, admits that we cannot scientifically compare utilities or satisfactions between individuals. But since there is no unit of satisfaction by which we can make comparisons, there is no meaning to any assumption that different men’s satisfactions will be “equal” to any circumstances. “Equal” in what way, and in what units? We are not at liberty to make any ethical assumption we please, because even an ethical assumption must be framed meaningfully, and its terms must be definable in a meaningful manner. Since there is no meaning to the term “equality” without some sort of definable unit, and since there is no unit of satisfaction or utility, it follows that there can be no ethical assumption of “equal capacity for satisfaction,” and that this cannot provide a shortcut to permit the economists to make conclusions about public policy.

The Robbins position, moreover, embodies a highly oversimplified view of ethics and its relation to politico-economic affairs. The problem of interpersonal comparisons of utility is only one of the very many ethical problems which must at least be discussed before any policy conclusions can rationally be framed. Suppose, for example, that two social changes take place, each of which causes 99 percent of the people to gain in utility and 1 percent to lose. Surely no assumption about the interpersonal comparison of utility can suffice to establish an ethical judgment, divorced from the content of the change itself. If, for example, one change was the enslavement of the 1 percent by the 99 percent, and the other was the removal of a governmental subsidy to the 1 percent, there is apt to be a great deal of difference in our ethical pronouncements on the two cases, even if the assumed “social utility” in the two cases is approximately the same.

The Compensation Principle

A particularly notable attempt to make policy conclusions within the framework of the Unanimity Rule was the Kaldor-Hicks “compensation principle,” which stated that “social utility” may scientifically be said to increase, if the winners may be able to compensate the losers and still remain winners. There are many fatal errors in

this approach. In the first place, since the compensation principle is supposed to help economists form policy judgments, it is evident that we must be able to compare, at least in principle, actual social states. We are therefore always concerned with actual, and not potential, winners and losers from any change. Whether or not the winners may compensate the losers is therefore irrelevant; the important question is whether the compensation does, in fact take place. Only if the compensation is actually carried out so that not a single person remains a loser, can we still assert a gain in social utility. But can this compensation ever be carried out? In order to do so, everybody’s utility scale would have to be investigated by the compensators. But from the very nature of utility scales this is an impossibility. Who knows what has happened to anyone’s utility scale? The compensation principle is necessarily divorced from demonstrated preference, and once this occurs, it is impossible to find out what has happened to anyone’s utility. The reason for the divorce is that the act of compensation is, necessarily, a unilateral gift to a person rather than an act of that person, and therefore it is impossible to estimate how much his utility has increased as compared to its decrease in some other situation. Only if a person is actually confronted with a choice between two alternatives can we say that he prefers one to the other.

Certainly, the compensators could not rely on questionnaires in a situation where everyone need only say that he has lost utility in order to receive compensation. And suppose someone proclaims that his sensibilities are so hurt by a certain change that no monetary reward could ever compensate him? The existence of one such person would annul any compensation attempt. But these problems necessarily occur when we leave the realm of demonstrated preference.

The Social Welfare Function

Under the impact of criticisms far less thoroughgoing than the above, the compensation principle has been abandoned by most economists. There have been recent attempts to substitute another device—the “Social Welfare Function.” But after a flurry of activity, this concept, originated by Professors Bergson and Samuelson, quickly struck rocky waters, and virtually sank under the impact of various criticisms. It came to be regarded as an empty and therefore meaningless concept. Even its founders have given up the struggle and concede that economists must import ethical judgments from outside economics in order to make policy conclusions.50 Professor Rothenberg has made a desperate attempt to salvage the social welfare function by radically changing its nature, that is, by identifying it with an existing “social decision-making process.” To uphold this shift, Rothenberg must make the false assumption that “society” exists apart from individuals and makes “its” own valuation. Furthermore, as Bergson has pointed out, this procedure abolishes welfare economics, since the function of the economist would be to observe empirically the social decision-making process at work and to pronounce its decisions as gains in “social utility.”

The Economist as Adviser

Failing the establishment of policy conclusions through the compensation principle or the social welfare function, there is another very popular route to enable the economist to participate in policy formation while still remaining an ethically neutral scientist. This view holds that someone else may set the ends, while the economist is justified in telling that person (and in being hired by that person) the correct means for attaining these desired ends. Since the economist takes someone else’s hierarchy of ends as given and only points out the means to attain them, he is alleged to remain ethically neutral.

and strictly scientific. This viewpoint, however, is a misleading and fallacious one. Let us take an example suggested by a passage in Professor Philbrook’s seminal article; a monetary economist advising the Federal Reserve System.\textsuperscript{51} Can this economist simply take the ends set by the heads of this System and advise on the most efficient means to attain them? \textit{Not unless the economist affirms these ends as being positively good}, that is, not unless he makes an ethical judgment. For suppose that the economist is convinced that the entire Federal Reserve System is pernicious. In that case, his best course may well be to advise that policy which would make the System highly inefficient in the pursuit of its ends. The economist employed by the System cannot, therefore, give any advice whatever without abandoning ethical neutrality. If he advises the System on the best way to achieve its ends, it must be logically inferred that he supports these ends. His advice involves no less an ethical judgment on his part if he chooses to “tacitly accept the decisions of the community as expressed through the political machinery.”\textsuperscript{52}

\textbf{The End of Welfare Economics?}

After twenty years of florid growth, welfare economics is once more confined to an even tighter Unanimity Rule. Its attempts to say anything about political affairs within the confines of this rule have been in vain.

The death of the New Welfare Economics has begun to be reluctantly recognized by all of its supporters, and each has taken turns in pronouncing its demise.\textsuperscript{53} If the strictures advanced in this paper are conceded, the burial rites will be accelerated, and the corpse

\textsuperscript{51}Clarence Philbrook, “‘Realism’ in Policy Espousal,” \textit{American Economic Review} (December 1953): 846–59. The entire article is of fundamental importance in the study of economics and its relation to public policy.


decently interred. Many New Welfare Economists understandably continue to grope for some way of salvaging something out of the wreckage. Thus, Reder suggests that economics make specific, piece-meal policy recommendations anyway. But surely this is only a despairing refusal to take the fundamental problems into account. Rothenberg tries to inaugurate a constancy assumption based on psychologizing about underlying basic personalities. Aside from the fact that “basic” changes can take place at any time, economics deals with marginal changes, and a change is no less a change for being marginal. In fact, whether changes are marginal or basic is a problem for psychology, not praxeology. Bergson tries the mystical route of denying demonstrated preference, and claiming it to be possible that peoples values “really differed” from what they chose in action. He does this by adopting the “consistency”-constancy fallacy.

Does the Unanimity Rule then spell the end of all possible welfare economics, as well as the “old” and the “new” versions? Superficially, it would seem so. For if all changes must injure nobody, that is, if no people must feel worse off as a result of a change, what changes could pass muster as socially useful within the Unanimity Rule? As Reder laments: “Consideration of the welfare implications of envy, for example, make it impossible even to say that welfare will be increased by everyone having more of every commodity.”

**WELFARE ECONOMICS: A RECONSTRUCTION**

*Demonstrated Preference and the Free Market*

It is the contention of this paper that the wake for all welfare economics is premature, and that welfare economics can be reconstructed with the aid of the concept of demonstrated preference. This reconstruction, however, will have no resemblance to either of the “old” or “new” edifices that preceded it. In fact, if Reder’s thesis is correct, our proposed resurrection of the patient may be considered by many as more unfortunate than his demise.

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55 Reder, “Comment,” p. 35.
56 “To a considerable extent, welfare (and related) theorizing of the 1930s and 1940s was an attempt to show the variety and importance of the circumstances under which lassiez-faire was inappropriate.” Ibid.
Demonstrated preference, as we remember, eliminates hypothetical imaginings about individual value scales. Welfare economics has until now always considered values as hypothetical valuations of hypothetical “social states.” But demonstrated preference only treats values as revealed through chosen action.

Let us now consider exchanges on the free market. Such an exchange is voluntarily undertaken by both parties. Therefore, the very fact that an exchange takes place demonstrates that both parties benefit (or more strictly, expect to benefit) from the exchange. The fact that both parties chose the exchange demonstrates that they both benefit. The free market is the name for the array of all the voluntary exchanges that take place in the world. Since every exchange demonstrates a unanimity of benefit for both parties concerned, we must conclude that the free market benefits all its participants. In other words, welfare economics can make the statement that the free market increases social utility, while still keeping to the framework of the Unanimity Rule.57

But what about Reder’s bogey: the envious man who hates the benefits of others? To the extent that he himself has participated in the market, to that extent he reveals that he likes and benefits from the market. And we are not interested in his opinions about the exchanges made by others, since his preferences are not demonstrated through action and are therefore irrelevant. How do we know that this hypothetical envious one loses in utility because of the exchanges of others? Consulting his verbal opinions does not suffice, for his proclaimed envy might be a joke or a literary game or a deliberate lie.

We are led inexorably, then, to the conclusion that the processes of the free market always lead to a gain in social utility. And we can say this with absolute validity as economists, without engaging in ethical judgments.

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57Haavelmo criticizes the thesis that the free market maximizes social utility on the grounds that this “assumes” that the individuals “somehow get together” to make an optimal decision. But the free market is precisely the method by which the “get together” takes place! See Trygve Haavelmo, “The Notion of Involuntary Economic Decision,” Econometrica (January 1950): 8.
The Free Market and the “Problem of Distribution”

Economics, in general, and welfare economics, in particular, have been plagued with the problem of distribution. It has been maintained, for example, that assertions of increased social utility on the free market are all very well, but only within the confines of assuming a given distribution of income. Since changes in the distribution of income seemingly injure one person and benefit another, no statements, it is alleged, can be made about social utility with respect to changes in distribution. And income distribution is always changing.

On the free market, however, there is no such thing as a separate “distribution.” A man’s monetary assets have been acquired precisely because his or his ancestors’ services have been purchased by others on the free market. There is no distributional process apart from the production and exchange processes of the market; hence the very concept of “distribution” becomes meaningless on the free market. Since “distribution” is simply the result of the free exchange process, and since this process benefits all participants in the market and increases social utility, it follows directly that the distributional results of the free market also increase social utility.

The strictures of the critics do apply, however, to cases of State action. When the State takes from Peter and gives to Paul it is effecting a separate distribution process. Here, there does exist a process separate from production and exchange, and hence the concept becomes meaningful. Moreover, such State action obviously and demonstrably benefits one group and injures another, thus violating the Unanimity Rule.

The Role of the State

Until quite recently, welfare economics has never analyzed the role of the State. Indeed, economics in general has never devoted much attention to this fundamental problem. Specific problems, such as public finance, or price controls, have been investigated, but the State itself has been a shadowy figure in the economic literature. Usually, it has vaguely been considered as representing “society” or “the public in some way.” “Society,” however, is not a real entity; it is

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58 It would be more correct to say given distribution of money assets.
only a convenient short-hand term for an array of all existing individuals. The largely unexplored area of the State and State actions, however, can be analyzed with the powerful tools of Demonstrated Preference and the Unanimity Rule.

The State is distinguished from all other institutions in society in two ways: (1) it and it alone can interfere by the use of violence with actual or potential market exchanges of other people; and (2) it and it alone obtains its revenues by a compulsory levy, backed by violence. No other individual or group can legally act in these ways. Now what happens when the State, or a criminal, uses violence to interfere with exchanges on the market? Suppose that the government prohibits A and B from making an exchange they are willing to make. It is clear that the utilities of both A and B have been lowered, for they are prevented by threat of violence from making an exchange that they otherwise would have made. On the other hand, there has been a gain in utility (or at least an anticipated gain) for the government officials imposing this restriction, otherwise they would not have done so. As economists, we can therefore say nothing about social utility in this case, since some individuals have demonstrably gained and some demonstrably lost in utility from the governmental action.

The same conclusion follows in those cases where the government forces C and D to make an exchange which they otherwise would not have made. Once again, the utilities of the government officials gain. And at least one of the two participants (C or D) lose in utility, because at least one would not have wanted to make the exchange in the absence of governmental coercion. Again, economics can say nothing about social utility in this case.

\[59\] On this fallacy of methodological collectivism, and the broader fallacy of conceptual realism, see the excellent discussion in Hayek, *Counter Revolution of Science*, pp. 53ff.

\[60\] Criminals also act in these ways, but they cannot do so legally. For the purpose of praxeologic rather than legal analysis, the same conclusions apply to both groups.

\[61\] We cannot discuss here the praxeological analysis of general economics which shows that, in the long run, for many acts of coercive interference, the coercer himself loses in utility.
We conclude therefore that no government interference with exchanges can ever increase social utility. But we can say more than that. It is the essence of government that it alone obtains its revenue by the compulsory levy of taxation. All of its subsequent acts and expenditures, whatever their nature, rest on this taxing power. We have just seen that whenever government forces anyone to make an exchange which he would not have made, this person loses in utility as a result of the coercion. But taxation is just such a coerced exchange. If everyone would have paid just as much to the government under a system of voluntary payment, then there would be no need for the compulsion of taxes. Given the fact that coercion is used for taxes, therefore, and since all government actions rest on its taxing power, we deduce that: no act of government whatever can increase social utility.

Economics, therefore, without engaging in any ethical judgment whatever, and following the scientific principles of the Unanimity Rule and Demonstrated Preference, concludes: (1) that the free market always increases social utility; and (2) that no act of government can ever increase social utility. These two propositions are the pillars of the reconstructed welfare economics.

Exchanges between persons can take place either voluntarily or under the coercion of violence. There is no third way. If, therefore, free market exchanges always increase social utility, while no coerced exchange or interference can increase social utility, we may conclude that the maintenance of a free and voluntary market “maximizes” social utility (provided we do not interpret “maximize” in a cardinal sense).

Generally, even the most rigorously Wertfrei economists have been willing to allow themselves one ethical judgment: they feel free to recommend any change or process that increases social utility under the Unanimity Rule. Any economist who pursues this method would have to (a) uphold the free market as always beneficial, and (b) refrain from advocating any governmental action. In other words, he would have to become an advocate of “ultra” laissez-faire.

Laissez-faire Reconsidered

It has been quite common to scoff at the French “optimist” laissez-faire school of the nineteenth century. Usually, their welfare economic analysis has been dismissed as naive prejudice. Actually, however, their writings reveal that their laissez-faire conclusions were
post-judices—were judgments based on their analysis, rather than preconceptions of their analysis.\textsuperscript{62} It was the discovery of the general social benefit from free exchange that led to the rhapsodies over the free exchange process in the works of such men as Frédéric Bastiat, Edmond About, Gustave de Molinari, and the American, Arthur Latham Perry. Their analyses of State action were far more rudimentary (except in the case of Molinari), but their analyses generally needed only the ethical presumption in favor of social utility to lead them to a pure \textit{laissez-faire} position.\textsuperscript{63} Their treatment of exchange may be seen in this passage from the completely neglected Edmond About:

Now what is admirable in exchange is that it benefits the two contracting parties. . . . Each of the two, by giving what he has for that which he has not, makes a good bargain. . . . This occurs at every free and straightforward exchange. . . . In fact, whether you sell, whether you buy, you perform an act of preference. No one constrains you to give over any of your things for the things of another.\textsuperscript{64}

The analysis of free exchange underlying the \textit{laissez-faire} position has suffered general neglect in economics. When it is considered, it is usually dismissed as “simple.” Thus, Hutchison calls the idea of exchange as mutual benefit “simple”; Samuelson calls it

\textsuperscript{62}Lionel Robbins’s \textit{The Theory of Economic Policy in English Classical Political Economy} (London: Macmillan, 1952) is devoted to the thesis that the English classical economists were really “scientific” because they did not uphold \textit{laissez-faire}, while the French optimists were dogmatic and “metaphysical” because they did. To uphold this, Robbins abandons his praxeological approach of twenty years before, and adopts positivism: “The final test whether a statement is metaphysical (sic) or scientific is . . . whether it argues dogmatically a priori or by way of appeal to experience.” Naturally, Robbins cites examples from the physical sciences to bolster this fallacious dichotomy. Ibid., pp. 23–24.

\textsuperscript{63}Bastiat’s writings are well known, but his “welfare” analysis was generally inferior to that of About or Molinari. For a brilliant analysis of State action, see Gustave de Molinari, \textit{The Society of Tomorrow} (New York: G.P. Putnam and Sons, 1904), pp. 65–96.

“unsophisticated.” Simple is perhaps it, but simplicity _per se_ is hardly a liability in science. The important consideration is whether the doctrine is correct; if it is correct, then Occam’s Razor tells us that the simpler it is, the better.⁶⁵

The rejection of the simple seems to have its root in the positivist methodology. In physics (the model of positivism), the task of science is to go beyond common-sense observation, building a complex structure of explanation of the common-sense facts. Praxeology, however, begins with the common-sense truths as its _axioms_. The laws of physics need complicated empirical testing; the axioms of praxeology are known as obvious to all upon reflection. As a result, positivists are uncomfortable in the presence of universal truth. Instead of rejoicing in the ability to ground knowledge on universally accepted truth, the positivist rejects it as simple, vague, or “naïve.”⁶⁶

Samuelson’s only attempt to refute the _laissez-faire_ position was to refer briefly to the allegedly classic refutation by Wicksell.⁶⁷ Wicksell, however, also dismissed the approach of the “French harmony economists” without argument, and went on to criticize at length the far weaker formulation of Léon Walras. Walras tried to prove “maximum utility” from free trade in the sense of an interpersonally cardinal utility and thus left himself wide open to refutation.

Furthermore, it should be stressed that the theorem of maximum social utility applies not to any type of “perfect” or “pure” competition, or even to “competition” as against “monopoly.” It applies simply to any voluntary exchange. It might be objected that a voluntary cartel’s action in raising prices makes many consumers worse off, and therefore that assertion of the benefits of voluntary exchange would have to exclude cartels. It is not possible, however, for an observer scientifically to compare the social utilities of results on the free market

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⁶⁶For an example of this attitude, see the critique of Hayek’s _Counter Revolution of Science_ by May Brodbeck, in “On the Philosophy of the Social Sciences,” _Philosophy of Science_ (April 1954). Brodbeck complains that the praxeologic axioms are not “surprising”; if she pursued the analysis, however, she might find the conclusions surprising enough.
from one period of time to the next. As we have seen above, we cannot determine a man’s value-scales over a period of time. How much more impossible for all individuals! Since we cannot discover people’s utilities over time, we must conclude that whatever the institutional conditions of exchange, however large or small the number of participants on the market, the free market at any time will maximize social utility. For all the exchanges are exchanges effected voluntarily by all parties. Then, suppose some producers voluntarily form a cartel in an industry. This cartel makes its exchanges in Period 2. Social utility is again maximized, for again no one’s exchanges are being altered by coercion. If, in Period 2, the government should intervene to prohibit the cartel, it could not increase social utility since the prohibition demonstrably injures the producers.68

The State as a Voluntary Institution: A Critique

In the development of economic thought, far more attention has been paid to analysis of free exchange than to State action. Generally, as we have indicated, the State has simply been assumed to be a voluntary institution. The most common assumption is that the State is voluntary because all government must rest on majority consent. If we adhere to the Unanimity Rule, however, it is obvious that a majority is not unanimity, and that therefore economics cannot consider the State as voluntary on this ground. The same comment applies to the majority voting procedures of democracy. The man who votes for the losing candidate, and even more the man who abstains from voting, can hardly be said voluntarily to approve of the action of the government.69

68It is also possible to argue, on general economic, rather than welfare-economic, grounds, that a voluntary cartel action, if profitable, will benefit consumers. In that case, consumers as well as producers would be injured by governmental outlawry of the cartel. As we have indicated above, welfare economics demonstrates that no governmental action can increase social utility. General economics demonstrates that, in many instances of government actions, even those who immediately benefit lose in the long run.

69Schumpeter is properly scornful when he says: “The theory which construes taxes on the analogy of club dues or of purchase of services of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind.” Joseph A. Schumpeter, Capitalism, Socialism, and
In the last few years, a few economists have begun to realize that the nature of the State needs careful analysis. In particular, they have realized that welfare economics must prove the State to be in some sense voluntary before it can advocate any State action whatever. The most ambitious attempt to designate the State as a “voluntary” institution is the work of Professor Baumol. Baumol’s “external economy” thesis may be put succinctly as follows: certain wants are by their nature “collective” rather than “individual.” In these cases, every individual will rank the following alternatives on his value scale: In (A) he would most prefer that everyone but himself be coerced to pay for the satisfaction of the group want (for example, military protection, public parks, dams, and so on). But since this is not practicable, he must choose between alternatives B and C. In (B) no one is forced to pay for the service, in which case the service will probably not be provided since each man will tend to shirk his share; in (C) everyone, including the particular individual himself, is forced to pay for the service. Baumol concludes that people will pick C; hence the State’s activities in providing these services are “really voluntary.” Everyone cheerfully chooses that he be coerced.

This subtle argument can be considered on many levels. In the first place, it is absurd to hold that “voluntary coercion” can be a demonstrated preference. If the decision were truly voluntary, no tax coercion would be necessary—people would voluntarily and publicly agree to pay their share of contributions to the common project. Since they are all supposed to prefer getting the project to not paying for it and not getting it, they are then really willing to pay the tax-price to obtain the project. Therefore, the tax coercion apparatus is not necessary, and all people would bravely, if a bit reluctantly, pay what they are “supposed” to without any coercive tax system.

Second, Baumol’s thesis undoubtedly is true for the majority, since the majority, passively or eagerly, must support a government if it is to survive any length of time. But even if the majority are willing to coerce themselves in order to coerce others (and perhaps tip

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the balance of coercion against the others), this proves nothing for welfare economics, which must rest its conclusions on unanimity, not majority, rule. Will Baumol contend that everyone has this value ordering? Isn’t there one person in the society who prefers freedom for all to coercion over all? If one such person exists, Baumol can no longer call the State a voluntary institution. On what grounds, a priori or empirical, can anyone contend that no such individual exists?71

But Baumol’s thesis deserves more detailed consideration. For even though he cannot establish the existence of voluntary coercion, if it is really true that certain services simply cannot be obtained on the free market, then this would reveal a serious weakness in the free-market “mechanism.” Do cases exist where only coercion can yield desired services? At first glance, Baumol’s “external economy” grounds for an affirmative answer seem plausible. Such services as military protection, dams, highways, and so on, are important. People desire that they be supplied. Yet wouldn’t each person tend to slacken his payment, hoping that the others would pay? But to employ this as a rationale for State provision of such services is a question-begging example of circular reasoning. For this peculiar condition holds only and precisely because the State, not the market, provides these services! The fact that the State provides a service means that, unlike the market, its provision of the service is completely separated from its collection of payment. Since the service is generally provided free and more or less indiscriminately to the citizens, it naturally follows that every individual—assured of the service—will try to shirk his taxes. For, unlike the market, his individual tax payment brings him nothing directly. And this condition cannot be a justification for State action; for it is only the consequence of the existence of the State action itself.

But perhaps the State must satisfy some wants because these wants are “collective” rather than “individual”? This is Baumol’s second line of attack. In the first place, Molinari has shown that the existence of collective wants does not necessarily imply State action. But, furthermore, the very concept of “collective” wants is a dubious

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one. For this concept must imply the existence of some existent collective entity who does the wanting! Baumol struggles against conceding this, but he struggles in vain. The necessity for assuming such an entity is made clear in Haavelmo’s discussion of “collective action,” cited favorably by Baumol. Thus, Haavelmo grants that deciding on collective action “requires a way of thinking and a power to act which are outside the functional sphere of any individual group as such.”

Baumol attempts to deny the necessity for assuming a collective entity by stating that some services can be financed only jointly, and will serve many people jointly. Therefore, he argues that individuals on the market cannot provide these services. This is a curious position indeed. For all large-scale businesses are “jointly” financed with huge aggregations of capital, and they also serve many consumers, often jointly. No one maintains that private enterprise cannot supply steel or automobiles or insurance because they are “jointly” financed. As for joint consumption, in one sense no consumption can be joint, for only individuals exist and can satisfy their wants, and therefore everyone must consume separately. In another sense, almost all consumption is “joint.” Baumol, for example, asserts that parks are an example of “collective wants” jointly consumed, since many individuals must consume them. Therefore, the government must supply this service. But going to a theater is even more joint, for all must go at the same time. Must all theaters therefore be nationalized and run by the government? Furthermore, in a broad view, all modern consumption depends on mass production methods for a wide market. There are no grounds by which Baumol can separate certain services and dub them “examples of interdependence” or “external economies.” What individuals could buy steel or automobiles or frozen foods, or almost anything else, if enough other individuals did not exist to demand them and make their mass-production methods worthwhile? Baumollian interdependencies are all around us, and there is no rational way to isolate a few services and call them “collective.”

72Haavelmo, “The Notion of Involuntary Economic Decision.” Yves Simon, cited favorably by Rothenberg, is even more explicit, postulating a “public reason” and a “public will” as contrasted to individual reasonings and wills. See Yves Simon, Philosophy of Democratic Government (Chicago: University of Chicago, 1951); Rothenberg, “Conditions,” pp. 402–03.
A common argument related to, though more plausible than, Baumol’s thesis is that certain services are so vital to the very existence of the market that they must be supplied collectively outside the market. These services (protection, transportation, and so on) are so basic, it is alleged, that they permeate market affairs and are a prior necessary condition for its existence. But this argument proves far too much. It was the fallacy of the classical economists that they considered goods in terms of large classes, rather than in terms of marginal units. All actions on the market are marginal, and this is precisely the reason that valuation and imputation of value-productivity to factors can be effected. If we start dealing with whole classes rather than marginal units, we can discover all sorts of activities which are necessary prerequisites of, and vital to, all market activity; land, room, food, clothing, shelter, power, and so on—and even paper! Must all of these be supplied by the State and the State only?

Stripped of its many fallacies, the whole “collective wants” thesis boils down to this: certain people on the market will receive benefits from the action of others without paying for them. This is the long and short of the criticism of the market, and this is the only relevant “external economy” problem. A and B decide to pay for the building of a dam for their uses; C benefits though he did not pay. A and B educate themselves at their expense and C benefits by being able to deal with educated people, and so on. This is the problem of the Free Rider. Yet it is difficult to understand what the hullabaloo is all about. Am I to be specially taxed because I enjoy the sight of my neighbor’s garden without paying for it? A’s and B’s purchase of a good reveals that they are willing to pay for it; if it indirectly benefits C as well, no one is the loser. If C feels that he would be deprived of the benefit if only A and B paid, then he is free to contribute too. In any case, all the individuals consult their own preferences in the matter.

73See the critique of a similar position of Spencer’s by “S.R.,” “Spencer As His Own Critic,” Liberty (June 1904).

74The famous “external diseconomy” problems (noise, smoke nuisance, fishing, and so on) are really in an entirely different category, as Mises has shown. These “problems” are due to insufficient defense of private property against invasion. Rather than a defect of the free market, therefore, they are the results of invasions, of property, invasions which are ruled out of the free market by definition. See Mises, Human Action, pp. 650–56.
In fact, we are all free riders on the investment, and the technological development, of our ancestors. Must we wear sackcloth and ashes, or submit ourselves to State dictation, because of this happy fact?

Baumol and others who agree with him are highly inconsistent. On the one hand, action cannot be left up to voluntary individual choice because the wicked free rider might shirk and obtain benefits without payment. On the other hand, individuals are often denounced because people will not do enough to benefit free riders. Thus, Baumol criticizes investors for not violating their own time-preferences and investing more generously. Surely, the sensible course is neither to penalize the free rider nor to grant him special privilege. This would also be the only solution consistent with the unanimity rule and demonstrated preference.75

Insofar as the “collective want” thesis is not the problem of the Free Rider, it is simply an ethical attack on individual valuations, and a desire by the economist (stepping into the role of an ethicist) to substitute his valuations for those of other individuals in deciding the latter’s actions. This becomes clear in the assertion by Suranyi-Unger: “he (an individual) may be led by a niggardly or thoughtless or frivolous evaluation of utility and disutility and by a corresponding low degree or complete absence of group responsibility.”76

Tibor Scitovsky, while engaging in an analysis similar to Baumol’s, also advances another objection to the free market based on what he calls “pecuniary external economies.”77 Briefly, this conception suffers

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75 In a good, though limited, criticism of Baumol, Reder points out that Baumol completely neglects voluntary social organizations formed by individuals, for he assumes the State to be the only social organization. This error may stem partly from Baumol’s peculiar definition of “individualistic” as meaning a situation where no one considers the effects of his actions on anyone else. See Melvin W. Reder, “Review of Baumol’s Welfare Economics and the Theory of the State,” Journal of Political Economy (December 1953): 539.


from the common error confusing the general (and unattainable!) equilibrium of the evenly rotating economy with an ethical ideal and therefore belaboring such ever-present phenomena as the existence of profits as departures from such an ideal.

Finally, we must mention the very recent attempts of Professor Buchanan to designate the State as a voluntary institution. Buchanan’s thesis is based on the curious dialectic that majority rule in a democracy is really unanimity because majorities can and do always shift! The resulting pulling and hauling of the political process, because obviously not irreversible, are therefore supposed to yield a social unanimity. The doctrine that endless political conflict and stalemate really amount to a mysterious social unanimity must be set down as a lapse into a type of Hegelian mysticism.

CONCLUSION

In his brilliant survey of contemporary economics, Professor Bronfenbrenner described the present state of economic science in the gloomiest possible terms. “Wilderness” and “hash” were typical epithets, and Bronfenbrenner ended his article in despair by quoting the famous poem Ozymandias. Applied to currently fashionable theory, his attitude is justified. The 1930s was a period of eager activity and seemingly pathbreaking advances in economic thought. Yet one by one, reaction and attenuation have set in, and in the mid-1950s the high hopes of twenty years ago are either dying or fighting desperate rearguard action. None of the formerly new approaches any longer inspires fresh theoretical contributions. Bronfenbrenner


79How flimsy this “unanimity” is, even for Buchanan, is illustrated by the following very sensible passage: “a dollar vote is never overruled; the individual is never placed in the position of being a member of dissenting minority”—as he is in the voting process (Buchanan, “Individual Choice in Voting and the Market,” p. 339). Buchanan’s approach leads him so far as to make a positive virtue out of inconsistency and indecision in political choices.

80Bronfenbrenner, “Contemporary Economics Resurveyed.”
specifically mentions in this connection the imperfect competition and the Keynesian theories, and justly so. He could also have mentioned utility and welfare theory. For the mid-1930s saw the development of the Hicks-Allen indifference curve analysis and the New Welfare Economics. Both of these theoretical revolutions have been enormously popular in the upper reaches of economic theory; and both are now crumbling.

The contention of this paper is that while the formerly revolutionary and later orthodox theories of utility and welfare deserve an even speedier burial than they have been receiving, they need not be followed by a theoretical vacuum. The tool of Demonstrated Preference, in which economics deals only with preference as demonstrated by real action, combined with a strict Unanimity Rule for assertions of social utility, can serve to effect a thoroughgoing reconstruction of utility and welfare economics. Utility theory can finally be established as a theory of ordinal marginal utility. And welfare economics can become a vital corpus again, even though its new personality might not attract its previous creators. It must not be thought that we have, in our discussion of welfare economics, been attempting to set any ethical or political program. On the contrary, the proposed welfare economics has been put forward without inserting ethical judgments. Economics by itself and standing alone cannot establish an ethical system, and we must grant this regardless of what philosophy of ethics we hold. The fact that the free market maximizes social utility, or that State action cannot be considered voluntary, or that the laissez-faire economists were better welfare analysts than they are given credit for, in itself implies no plea for laissez-faire or for any other social system. What welfare economics does is to present these conclusions to the framer of ethical judgments as part of the data for his ethical system. To the person who scorns social utility or admires coercion, our analysis might furnish powerful arguments for a policy of thoroughgoing Statism.
The stimulating methodological controversy between Professors Machlup and Hutchison proves that there are sometimes more than two sides to every question. In many ways, the two are debating at cross-purposes: Professor Hutchison is primarily tilting against the methodological (and political) views of Professor Ludwig von Mises; his most serious charge is that Professor Machlup’s entire position is, at bottom, an attempt to cloak the Misesian heresy in the garments of epistemological respectability. Professor Machlup’s reply, quite properly, barely mentions Mises; for, in fact, their methodological views are poles apart. (Machlup’s position is close to the central “positivist” tradition of economic methodology.) But, in the meanwhile, we find that Professor Mises and “extreme apriorism” go undefended in the debate. Perhaps an extreme apriorist’s contribution to this discussion may prove helpful.

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

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

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

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

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

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

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

4This holds also for Professor Machlup’s “heuristic principles” which area allegedly “empirically meaningful” without being verifiable as true.

I do not wish to deny that false assumptions are useful in economic theory, but only when they are used as auxiliary constructs, not as premises from which empirical theories can be deduced. The most important such construct is the evenly-rotating economy, or “equilibrium.” It is not intended that this state be considered as real, either actual or potential. On the contrary, the empirically impossible ERE is constructed precisely in order to analyze theoretically a state of no-change. Only by analyzing a fictive changeless state can we arrive at a proper analysis of the changing real economic world. However, this is not a “false” assumption in the sense used by the positivists, because it is an absolutely true theory of a changeless state, if such a state could exist.
Actually, despite the “extreme a priori” label, praxeology contains one Fundamental Axiom—the axiom of action—which may be called a priori, and a few subsidiary postulates which are actually empirical. Incredible as it may seem to those versed in the positivist tradition, from this tiny handful of premises the whole of economics is deduced—and deduced as absolutely true. Setting aside the Fundamental Axiom for a moment, the empirical postulates are: (a) small in number, and (b) so broadly based as to be hardly “empirical” in the empiricist sense of the term. To put it differently, they are so generally true as to be self-evident, as to be seen by all to be obviously true once they are stated, and hence they are not in practice empirically falsifiable and therefore not “operationally meaningful.” What are these propositions? We may consider them in decreasing order of their generality: (1) the most fundamental—variety of resources, both natural and human. From this follows directly the division of labor, the market, etc.; (2) less important, that leisure is a consumer good. These are actually the only postulates needed. Two other postulates simply introduce limiting subdivisions into the analysis. Thus, economics can deductively elaborate from the Fundamental Axiom and Postulates (1) and (2) (actually, only Postulate 1 is necessary) an analysis of Crusoe economics, of barter, and of a monetary economy. All these elaborated laws are absolutely true. They are only applicable in concrete cases, however, where the particular limiting conditions apply. There is nothing, of course, remarkable about this; we can enunciate as a law that an apple, unsupported, will drop to the ground. But the law is applicable only in those cases where an apple is actually dropped. Thus, the economics of Crusoe, of barter, and of a monetary economy are applicable when these conditions obtain. It is the task of the historian, or “applied economist,” to decide which conditions apply in the specific situations to be analyzed. It is obvious that making these particular identifications is simplicity itself.

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

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

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

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

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

The curious idea that failure to pursue monetary goals is “irrational,” or refutes economics, is similar to the old notion that consumers were being irrational, or “uneconomic,” when they preferred to pay higher prices in stores nearer to them, or with a more congenial atmosphere.
Professor Mises. Hutchison charges that Mises claims “all economic action was (or must be) rational.” This is flatly incorrect. Mises assumes nothing whatever about the rationality of human action (in fact, Mises does not use the concept at all). He assumes nothing about the wisdom of man’s ends or about the correctness of his means. He “assumes” only that men act, that is, that they have some ends, and use some means to try to attain them. This is Mises’s Fundamental Axiom, and it is this axiom that gives the whole praxeological structure of economic theory built upon it its absolute and apodictic certainty.

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

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

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

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6Hutchison, “Professor Machlup on Verification in Economics,” p. 483.
I may just as well continue to call it a priori for present purposes. For (1) it is a law of reality that is not conceivably falsifiable, and yet is empirically meaningful and true; (2) it rests on universal inner experience, and not simply on external experience, that is, its evidence is reflective rather than physical;7 and (3) it is clearly a priori to complex historical events.8

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

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


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

9Thus, Copleston calls self-evident principles “synthetic propositions a priori” (though not in the Kantian sense)—synthetic as conveying information about reality not contained logically in previous premises; and a priori as being necessary and universal. Toohey virtually obliterates the distinctions and terms self-evident propositions synthetic—a posteriori, because, while being necessary and universals, they are derived from experience. See F.C. Copleston, S.J., Aquinas (London: Penguin Books, 1955), pp. 28 and 19–41; John J.H. Toohey, S.J., Notes on Epistemology (Washington, D.C.: Georgetown University, 1952), pp. 46–55. All this raises the question of the usefulness of the whole “analytic-synthetic” dichotomy, despite the prominence implicitly given it in Hutchison’s “Significance and Basic Postulates of Economic Theory,” Journal of Political Economy 49 (1934). For a refreshing skepticism on its validity, and for a critique of its typical use to dispose of difficult-to-refute theories as either disguised definitions or debatable hypotheses, see Hao Wang, “Notes on the Analytic-Synthetic Distinction,” Theoria 21 (Parts 2–3, 1955): 158ff.
this law is not a disguised definition—that they maximize what they maximize. It is true that utility has no concrete content, because economics is concerned not with the content of a man’s ends, but with the fact that he has ends. And this fact, being deduced directly from the Action Axiom, is absolutely true.10

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

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

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

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

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

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

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

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

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Session 3

Monopoly

- *Man, Economy, and State*
  Chapter 10: Monopoly and Competition,
  3. The Illusion of Monopoly Price, 4. Labor Unions

- *Power and Market*
  Chapter 3: Triangular Intervention
marginal product. As long as competition is free, unhampered by governmental restrictions, no universal cartel could either exploit labor or remain universal for any length of time.21

3. The Illusion of Monopoly Price

So far we have established that there is nothing “wrong” with a monopoly price, either when instituted by one firm or by a cartel; that, in fact, whatever price the free market (unhampered by violence or the threat of violence) establishes will be the “best” price. We have also shown the impossibility of separating “monopolizing” from efficiency considerations in cartel actions or of separating technology from profitability in general; and we have seen the great instability of the cartel form.

In this section we investigate a further problem: Granted that there is nothing “wrong” with monopoly prices, how tenable is the very concept of “monopoly price” on the free market? Can it be distinguished at all from “competitive price,” its supposed polar opposite? To answer this question, we must explore what the theory of monopoly price is all about.

A. Definitions of Monopoly

Before investigating the theory of monopoly price, we must begin by defining monopoly. Despite the fact that monopoly problems occupy an enormous quantity of economic writings, little or no clarity of definition exists.22 There is, in fact, enormous vagueness and confusion on the subject. Very few economists have formulated a coherent, meaningful definition of monopoly.

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22 The same confusion exists in the laws concerning monopoly. Despite constitutional warnings against vagueness, the Sherman Anti-Trust Act outlaws “monopolizing” actions without once defining the concept. To this day there has been no clear legislative decision concerning what constitutes illegal monopolistic action.
A common example of a confused definition is: “Monopoly exists when a firm has control over its price.” This definition is a mixture of confusion and absurdity. In the first place, on the free market there is no such thing as “control” over the price in an exchange; in any exchange the price of the sale is voluntarily agreed upon by both parties. No “control” is exercised by either party; the only control is each person’s control over his own actions—stemming from his self-sovereignty—and consequently his control will be over his own decision to enter or not to enter into an exchange at any hypothetical price. There is no direct control over price because price is a mutual phenomenon. On the other hand, each person has absolute control over his own action and therefore over the price which he will attempt to charge for any particular good. Any man can set any price that he wants for any quantity of a good that he sells; the question is whether he can find any buyers at that price. Similarly, of course, any buyer can set any price at which he will purchase a certain good; the question is whether he can find a seller at that price. It is this process, indeed, of mutual bids and offers that yields the daily prices on the market.

There is an all-too-common assumption, however, that if we compare, say, Henry Ford and a small wheat farmer, the two differ enormously in their respective powers of control. It is believed that the wheat farmer finds his price “given” to him by the market, while Ford can “administer” or “set his own” price. The wheat farmer is allegedly subject to the impersonal forces of the market, and ultimately to the consumer, while Ford is, to a greater or lesser extent, the master of his own fate, if not indeed the ruler of the consumers. Further, it is believed that Ford’s “monopoly power” stems from his being “large” in relation to the automobile market, while the farmer is a “pure competitor” because he is “small” compared to the total supply of wheat. Usually, Ford is not considered an “absolute” monopolist, but someone with a vague “degree of monopoly power.”

In the first place, it is completely false to say that the farmer and Ford differ in their control over price. Both have exactly the
same degree of control and of noncontrol: i.e., both have absolute *control* over the quantity they produce and the price which they attempt to get;\(^2\) and absolute *noncontrol* over the price-and-quantity transaction that finally takes place. The farmer is free to ask any price he wants, just as Ford is, and is free to look for a buyer at such a price. He is not in the least compelled to sell his produce to the organized “markets” if he can do better elsewhere. Every producer of every product is free, in a free-market society, to produce as much as he wants of whatever he possesses or can purchase and to try to sell it, at whatever price he can get, to anyone he can find.\(^2\) Naturally, every seller, as we have repeatedly stated, will attempt to sell his produce for the highest possible price; similarly, every buyer will attempt to purchase goods at the lowest possible price. It is precisely the voluntary interaction of these buyers and sellers that establishes the entire supply and demand structure for consumers’ and producers’ goods. To accuse Ford or a waterworks or any other producer of “charging whatever the traffic will bear” and to take this as a sign of monopoly is pure nonsense, for this is precisely the action of everyone in the economy: the small wheat farmer, the laborer, the landowner, etc. “Charging whatever the traffic will bear” is simply a rather emotive synonym for charging as high a price as can be freely obtained.

Who officially “sets” the price in any exchange is a completely trivial and irrelevant technological question—a matter of institutional convenience rather than economic analysis. The fact that Macy’s posts its prices each day does not mean that Macy’s has some sort of mysterious “control” of its price over the consumer;\(^3\) similarly, that large-scale industrial buyers of

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\(^2\)We are, of course, not considering here particular uncertainties of agriculture resulting from climate, etc.

\(^3\)For further discussion, see Murray N. Rothbard, “The Bogey of Administered Prices,” *The Freeman*, September, 1959, pp. 39–41.

\(^3\)On the contrary, the consumers control Macy’s to the extent that the store desires monetary income. Cf. John W. Scoville and Noel Sargent,
raw materials often post their bid prices does not mean that they exercise some sort of extra control over the price obtained by the growers. Rather than acting as a means of control, in fact, posting simply furnishes needed information to all would-be buyers and/or sellers. The process of price determination through the interaction of value scales occurs in precisely the same way regardless of the concrete details and institutional conditions of market arrangements.26

Each individual producer, then, is sovereign over his own actions; he is free to buy, produce, and sell whatever he likes and to whoever will purchase. The farmer is not compelled to sell to any particular market or to any particular company, any more than Ford is compelled to sell to John Brown if he does not wish to do so (say, because he can get a higher price elsewhere). But, as we have seen, in so far as a producer wishes to maximize his monetary return, he does submit himself to the control of consumers, and he sets his output accordingly. This is true of the farmer, of Ford, or of anyone else in the entire economy—landowner, laborer, service-producer, product-owner, etc. Ford, then, has no more “control” over the consumer than the farmer has.

One common objection is that Ford is able to acquire “monopoly power” or “monopolistic power” because his product has a recognized brand name or trade-mark, which the wheat farmer has not. This, however, is surely a case of putting the cart before the horse. The brand name and the wide knowledge of the brand come from consumers’ desire for the product attached to that particular brand and are therefore a result of consumer demand rather than a pre-existing means for some sort of


26One reason often given for ascribing “control over price” to Ford and not the small wheat grower is that Ford is so large that his actions affect the market price of his product, while the farmer is so small that his actions do not affect the price. On this, see the critique below of “monopolistic competition” theories.
“monopolistic power” over the consumers. In fact, farmer Hiram Jones is perfectly free to stamp the brand name “Hiram Jones Wheat” on his product and attempt to sell it on the market. The fact that he has not done so signifies that it would not be a profitable step in the concrete market condition of his product. The chief point is that in some cases consumers and lower-order entrepreneurs consider each individual brand name as representing a unique product, while in other cases purchasers consider the output of one firm—one product-owner or set of product-owners operating jointly—as identical in use-value with products of other firms. Which situation will occur is entirely dependent on the buyers’ valuations in each concrete case.

Later in this chapter we shall analyze in greater detail the tangled web of fallacies involved in the various theories of “monopolistic competition”; at this point we are attempting to arrive at a definition of monopoly per se. To proceed: There are three possible coherent definitions of monopoly. One is derived from its linguistic roots: *monos* (only) and *polein* (to sell), i.e., *the only seller of any given good* (definition 1). This is certainly a legitimate definition, but it is an extraordinarily broad one. It means that, whenever there is any differentiation at all among individual products, the individual producer and seller is a “monopolist.” John Jones, lawyer, is a “monopolist” over the legal services of John Jones; Tom Williams, doctor, is a “monopolist” over his own unique medical services, etc. The owner of the Empire State Building is a “monopolist” over the rental services in his building. This definition, therefore, labels all consumer distinctions between individual products as establishing “monopolies.”

It must be remembered that only consumers can decide whether two commodities offered on the market are one good or two different goods. This issue cannot be settled by a physical inspection of the product. The elemental physical nature of the good may be only one of its properties; in most cases, a brand name, the “good will” of a particular company, or a more pleasant atmosphere in the store will differentiate the product from
its rivals in the view of many of its customers. The products then become *different goods* for the consumers. No one can ever be certain in advance—least of all the economist—whether a commodity sold by A will be treated on the market as homogeneous with the same basic physical good sold by B.27,28

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27 Economists have often charged, for example, that consumers who will pay a higher price for the same good at a store with a more pleasant atmosphere are acting “irrationally.” Actually, they are by no means doing so, since consumers are buying not just a physical can of beans, but a can of beans sold in a certain store by certain clerks, and these factors may (or may not) make a difference to them. Businessmen are far less motivated by such “nonphysical” considerations (although good will affects their purchases too), not because they are “more rational” than consumers, but because they are not concerned, as consumers are, with their own value scales in deciding their purchases. As we have seen above, businessmen are generally motivated purely by the expected revenue that goods will bring on the market. For an excellent treatment of the definition of “homogeneous product,” see G. Warren Nutter, “The Plateau Demand Curve and Utility Theory,” *Journal of Political Economy*, December, 1955, pp. 526–28. Also see Alex Hunter, “Product Differentiation and Welfare Economics,” *Quarterly Journal of Economics*, November, 1955, pp. 533–52.

28 Professor Lawrence Abbott, in one of the outstanding theoretical works of recent years, demonstrates also that as civilization and the economy advance, products will become more and more differentiated and less and less homogeneous. For one thing, greater differentiation occurs at the consumer than at the producer level, and the expanding economy takes over an increasing proportion of goods once made by the consumer himself and therefore supplies more finished goods than raw materials to the consumer than formerly (bread rather than flour, sweaters rather than wool yarn, etc.). Thus, there is greater opportunity for differentiation.

Furthermore, to the familiar charge that business advertising tends to create differentiation in the consumer’s mind that is not “really” there, Abbott replies incisively that the reverse is more likely to be true and that advancing civilization increases the consumer’s perception and discrimination of differences of which he was previously ignorant. Writes Abbott:

> as man becomes more civilized, he develops greater powers of perception with regard to quality differences. Subjective homogeneity may exist even when objective
Hence, there is hardly any way that definition 1 of “monopoly” can be successfully used. For this definition depends on how we choose a “homogeneous good,” and this can never be decided by an economist. What constitutes a homogeneous commodity” (i.e., an industry)—neckties, bow ties, bow ties with polka dots, etc., or bow ties made by Jones? Only consumers will decide, and they, as different consumers, will be likely to decide differently in each concrete case. Use of definition 1, therefore, will probably reduce to the barren definition of monopoly as each man’s exclusive ownership of his own property—and this, absurdly, would make every single person a monopolist!29

Homogeneity does not, due to the inability or unwillingness of buyers to perceive differences between almost identical products and discriminate between them. . . . As a society matures and education improves, people learn to develop more acute powers of discrimination. Their wants become more detailed. They begin . . . to develop a preference, say, not simply for white wine, but for 1948 Chablis. . . . People generally tend to underestimate the significance of apparently trivial differences in fields in which they are not expert. An unmusical person may be unwilling to concede that there is any difference in tone between a Steinway and a Chickering piano, being unable himself to detect it. A nongolfer is more likely than a habitual player to believe that all brands of golf balls are virtually alike. (Lawrence Abbott, Quality and Competition [New York: Columbia University Press, 1955], pp. 18–19, and chap. I)


Oddly, despite the reams of literature on monopolies, very few economists have bothered to define monopoly, and these problems have therefore been overlooked. Mrs. Robinson, in the beginning of her famous Economics of Imperfect Competition, saw the difficulty and then evaded the issue throughout the rest of the book. She concedes that under careful analysis either a monopoly would be defined as every producer’s control over his own product or monopoly could simply not exist
Definition 1, then, is coherent, but highly inexpedient. Its usefulness is very limited, and the term has acquired highly charged emotional connotations from past use of quite different definitions. For reasons detailed below, the term “monopoly” has sinister and evil connotations to most people. “Monopolist” is generally a word of abuse; to apply the term “monopolist” to at least the vast majority of the population and perhaps to every man would have a confusing and even ludicrous effect.

The second definition is related to the first, but differs very significantly. It, in fact, was the original definition of monopoly and the very definition responsible for its sinister connotations in the public mind. Let us turn to its classic expression by the great seventeenth-century jurist, Lord Coke:

A monopoly is an institution or allowance by the king, by his grant, commission, or otherwise . . . to any person or persons, bodies politic or corporate, for the sole buying, selling, making, working, or using of anything, whereby any person or persons, bodies

on the free market at all. For competition exists among all products for the consumer’s dollar, while very few articles are rigorously homogeneous. Mrs. Robinson then tries to evade the issue by falling back on “common sense” and defining monopoly as existing where there is a “marked gap” between the product and other substitutes the consumer may buy. But this will not do. Economics, in the first place, can establish no quantitative laws, so that there is nothing we can say about sizes of gaps. When does the gap become “marked”? Secondly, even if such “laws” were meaningful, there would be no way to measure the cross-elasticities of demands, the elasticity of substitution between the products, etc. These elasticities of substitution are changing all the time and could not be measured successfully even if they all remained constant, since supply conditions are always changing. No laboratory exists where all economic factors may be held fixed. After this point in her discussion, Mrs. Robinson practically forgets all about heterogeneity of product. Joan Robinson, *Economics of Imperfect Competition* (London: Macmillan & Co., 1933), pp. 4–6. Also cf. Hunter, “Product Differentiation and Welfare Economics,” pp. 547 ff.
In other words, by this definition, **monopoly** is a *grant of special privilege by the State, reserving a certain area of production to one particular individual or group*. Entry into the field is prohibited to others and this prohibition is enforced by the gendarmes of the State.

This definition of monopoly goes back to the common law and acquired great political importance in England during the sixteenth and seventeenth centuries, when an historic struggle took place between libertarians and the Crown over the issue of monopoly as opposed to freedom of production and enterprise. Under this definition of the term, it is not surprising that “monopoly” took on connotations of sinister interest and tyranny in the public mind. The enormous restrictions on production and trade, as well as the establishment by the State of a monopoly caste of favorites, were the objects of vehement attack for several centuries.

That this definition was formerly important in economic analysis is clear in the following quotation from one of the first American economists, Francis Wayland:


31The onrush of monopoly grants by Queen Elizabeth I and Charles I provoked resistance from even the Crown’s subservient judges, and, in 1624, Parliament declared that “all monopolies are altogether contrary to the laws of this realm and are and shall be void.” This antimonopoly spirit was deeply ingrained in America, and the original Maryland constitution declared that monopolies were “odious” and “contrary to . . . principles of commerce.” Ely, *Outlines of Economics*, pp. 191–92. Also see Francis A. Walker, *Political Economy* (New York: Henry Holt & Co., 1911), pp. 483–84.
A monopoly is an exclusive right granted to a man, or
to a monopoly of men, to employ their labor or cap-
ital in some particular manner.\footnote{Francis Wayland, The Elements of Political Economy (Boston: Gould & Lincoln, 1854), p. 116. Cf. this later definition by Arthur Latham Perry: “A monopoly, as the derivation of the word implies, is a restriction imposed by a government upon the sale of certain services.” Perry, Political Economy, p. 190. In recent years this definition has all but died out. A rare current example is: “Monopoly exists when government by its coercive power limits to a particular person or organization, or combination of them, the right to sell particular goods or services. . . . It is an infringement of the right to make a living.” Heath, Citadel, Market, and Altar, p. 237.}

It is obvious that this type of monopoly can \emph{never} arise on a
free market, unhampered by State interference. In the free econ-
omy, then, according to this definition, there can be \emph{no} “monop-
oly problem.”\footnote{As Weil stated: “Monopolies cannot be created by association or agreement. We now have no letters patent giving exclusive right. . . . It is therefore wholly unjustifiable to use the term monopoly as applied to the effects of industrial consolidation.” Weil, Chicago Conference, pp. 86 ff.} Many writers have objected that brand names and trade-marks, generally considered as part of the free market, really constitute grants of special privilege by the State. No other firm can “compete” with Hershey chocolates by producing its own product and calling it Hershey chocolates.\footnote{For example, Edward H. Chamberlin, Theory of Monopolistic Competition (7th ed.; Cambridge: Harvard University Press, 1956), pp. 57 ff., 270 ff.} Is this not a State-imposed restriction on freedom of entry? And how can there be “real” freedom of entry under such conditions?

This argument, however, completely misconceives the
nature of liberty and of property. Every individual in the free
society has a right to ownership of his \textit{own self} and to the exclu-
sive use of his own property. Included in his property is his \textit{name}, the linguistic label which is uniquely his and is identified with him. A name is an essential part of a man’s identity and
therefore of his property. To say that he is a “monopolist” over his name is saying no more than that he is a “monopolist” over his own will or property, and such an extension of the word “monopolist” to every individual in the world would be an absurd usage of the term. The “governmental” function of defense of person and property, vital to the existence of a free society so long as any people are disposed to invade them, involves the defense of each person’s particular name or trademark against the fraud of forgery or imposture. It means the outlawing of John Smith’s pretending to be Joseph Williams, a prominent lawyer, and selling his own legal advice after stating to clients that he is selling that of Williams. This fraud is not only implicit theft of the consumer, but it is also abusing the property right of Joseph Williams to his unique name and individuality. And the use by some other chocolate firm of the Hershey label would be an equivalent perpetration of an invasive act of fraud and forgery.35

Before adopting this definition of monopoly as the proper one, we must consider a final alternative: the defining of a monopolist as a person who has achieved a monopoly price (definition 3). This definition has never been explicitly set forth, but it has been implicit in the most worthwhile of the neoclassical writings on this subject. It has the merit of focusing attention on the important economic question of monopoly price, its nature and consequences. In this connection, we shall now investigate the neoclassical theory of monopoly price and inquire whether it really has the substance it seems at first glance to possess.

35 It might be objected that these concepts are vague and give rise to problems. Problems do arise, but they are not insuperable. Thus, if one man is named Joseph Williams, does this preclude anyone else from having the same name, and is any future Joseph Williams to be considered a criminal? The answer is clearly: No, so long as there is no attempt by one to impersonate the other. In short, it is not so much the name per se which an individual owns, but the name as an affiliate of his person.
B. THE NEOCLASSICAL THEORY OF MONOPOLY PRICE

In previous sections we have referred to a monopoly price as one established either by a monopolist or by a cartel of producers. At this point we must investigate the theory more closely. A succinct definition of monopoly price has been supplied by Mises:

If conditions are such that the monopolist can secure higher net proceeds by selling a smaller quantity of his product at a higher price than by selling a greater quantity of his supply at a lower price, there emerges a monopoly price higher than the potential market price would have been in the absence of monopoly.

The monopoly price doctrine may be summed up as follows: A certain quantity of a good, when produced and sold, yields a competitive price on the market. A monopolist or a cartel of firms can, if the demand curve is inelastic at the competitive-price point, restrict sales and raise the price, to arrive at the point of maximum returns. If, on the other hand, the demand curve as it presents itself to the monopolist or cartel is elastic at the competitive-price point, the monopolist will not restrict sales to attain a higher price. As a result, as Mises points out, there is no need to be concerned with the “monopolist” (in the sense of definition 1 above); whether or not he is the sole producer of a commodity is unimportant and irrelevant for catallactic problems. It becomes important only if the configuration of his demand curve enables him to restrict sales and achieve a higher income.


37Mises, *Human Action*, p. 278.
at a monopoly price. If he learns about the inelastic demand curve after he has erroneously produced too great a stock, he must destroy or withhold part of his stock; after that, he restricts production of the commodity to the most remunerative level.

The monopoly price analysis is portrayed in the diagram in Figure 67. The basic assumption, usually only implicit, is that

![Figure 67. Formation of a Monopoly Price According to Neoclassical Doctrine](image)

38Thus:
The mere existence of monopoly does not mean anything. The publisher of a copyright book is a monopolist. But he may not be able to sell a single copy, no matter how low the price he asks. Not every price at which a monopolist sells a monopolized commodity is a monopoly price. Monopoly prices are only prices at which it is more advantageous for the monopolist to restrict the total amount to be sold than to expand sales to the limit which a competitive market would allow. (Mises, Human Action, p. 356)
there is some identifiable stock, say $0A$, and some identifiable market price, say, $AC$, which will result from competitive conditions. $AB$ then represents the stock line under “competition.” Then, according to the theory, if the demand curve is elastic above this price, there will be no occasion to restrict sales and obtain a higher, or “monopoly,” price. Such a demand curve is $DD$. On the other hand, if the demand curve is inelastic above the competitive-price point, as in $D'D'$, it will pay the monopolist to restrict sales to, say, $0A'(stock line represented by $A'B'$) and achieve a monopoly price, $AM$. This would yield the maximum monetary income for the monopolist.\(^\text{39}\)

The inelastic demand curve, giving rise to an opportunity to monopolize, may present itself either to a single monopolist of a given product or to “an industry as a whole” when organized into a cartel of the different producers. In the latter case, the demand curve, as it presents itself to each firm, is elastic. At the competitive price, if one firm raises its price, the customers preponderantly shift to purchasing from its competitors. On the other hand, if the firms are cartelized, in many cases the lesser range of substitution by consumers would render the demand curve, as

\(^\text{39}\)Here we abstract from monetary expense or “money cost” considerations. When the producer is considering sale of already produced stock, such past monetary expenses are completely irrelevant. When he is considering present and future production for future sale, present money-cost considerations become important, and the producer strives for maximum net returns. At any rate, some $A’$ point will be set, whatever the actual configuration of money costs, unless, indeed, average money costs are falling rapidly enough in this region to make the “competitive point” the most remunerative after all. It is curious that it is precisely the condition of falling average cost that has given the most worry to anti-monopoly writers, who have been concerned that one given firm in any industry might grow to “monopoly” size because of this condition. And yet, if it is “monopoly price,” not monopoly, that is particularly important, such worry is clearly unfounded. On the general unimportance of cost considerations in monopoly theory, see Chamberlin, Theory of Monopolistic Competition, pp. 193–94.
presented to the cartel, inelastic. This condition serves as the im-petus to the formation of the cartels studied above.

C. CONSEQUENCES OF MONOPOLY-PRICE THEORY

(1) The Competitive Environment

Before engaging in a critical analysis of the monopoly-price theory itself, we might explore some of the consequences which do or do not follow from it. In this section we for the moment assume that the monopoly-price theory is valid.40 In the first place, it is not true that the “monopolist” (used here in the sense of definition 3—an obtainer of a monopoly price) is removed from the influence of competition or has the power to dictate to consumers at will. The best of the monopoly-price theorists admit that the monopolist is as subject to the forces of competition as are other firms. The monopolist cannot set prices as high as he would like, being limited by the configurations of consumer demand. By definition, in fact, the demand curve as presented to the monopolist becomes elastic above the monopoly-price point. There has been an unfortunate tendency of writers to refer to an “elastic demand curve” or an “inelastic demand curve” without pointing out that every curve has different ranges along which there will be varying degrees of elasticity or inelasticity. By definition, the monopoly-price point is that which maximizes the firm’s or the cartel’s income; above that price any further “restriction” of production and sales will lower the monopolist’s monetary income. This implies that the demand curve will become elastic above that point, just as it is also elastic above the competitive-price point when that is established on the market. Consumers make the curve elastic by their power of substituting purchases of other goods. Many other goods compete

40We are devoting space to analysis of monopoly-price theory and its consequences because the theory, though invalid on the free market, will prove very useful in analyzing the consequences of monopoly grants by government.
“directly” in their use-value to the consumer. If some firm or combination of firms should, for example, achieve a monopoly-price for cake soap, housewives can shift to detergents and thus limit the height of the monopoly price. But, in addition, all goods, without exception, compete for the consumer’s dollar or gold ounce. If the price of yachts becomes too high, the consumer can substitute expenditure on mansions, or he can substitute books for television sets, etc.41

Furthermore, as the market advances, as capital is invested and the market becomes more and more specialized, the demand curve for each product tends to become more and more elastic. As the market develops, the range of consumers’ goods available increases enormously. The more consumers’ goods are available, the more goods can be purchased by consumers, and the more elastic, ceteris paribus, the demand curve for each good will tend to be. As a result, the opportunities for the establishment of monopoly prices will tend to diminish as the market and “capitalist” methods develop.

41As Mises warns:
It would be a serious blunder to deduce from the antithesis between monopoly price and competitive price that the monopoly price is the outgrowth of the absence of competition. There is always catallactic competition on the market. Catallactic competition is no less a factor in the determination of monopoly prices than it is in the determination of competitive prices. The shape of the demand curve that makes the appearance of monopoly prices possible and directs the monopolists’ conduct is determined by the competition of all other commodities competing for the buyers’ dollars. The higher the monopolist fixes the price at which he is ready to sell, the more potential buyers turn their dollars toward other vendible goods. On the market every commodity competes with all other commodities. (Mises, Human Action, p. 278)
(2) Monopoly Profit versus Monopoly Gain to a Factor

Many monopoly-price theorists have declared that establishment of the monopoly price means that the monopolist is able to attain permanent “monopoly profits.” This is then contrasted with “competitive” profits and losses, which, as we have seen, disappear in the evenly rotating economy. Under “competition,” if one firm is seen to be making great profits in a particular productive process, other firms rush in to take advantage of the anticipated opportunities, and the profits disappear. But in the case of the monopolist, it is asserted, his unique position allows him to keep making these profits permanently.42

To use such terminology is to misconceive the nature of “profit” and “loss.” Profits and losses are purely the results of entrepreneurial activity, and that activity is the consequence of the uncertainty of the future. Entrepreneurship is the action on the market that takes advantage of estimated discrepancies between selling prices and buying prices of factors. The better forecasters make profits, and the incorrect ones suffer losses. In the evenly rotating economy, where everyone has settled down to an unchanging round of activity, there can be no profit or loss because there is no uncertainty on the market. The same is true for the monopolist. In the evenly rotating economy, he obtains his “specific monopoly gain,” not as an entrepreneur, but as the owner of the product which he sells. His monopoly gain is an added income to his monopolized product; whether for an individual or for a cartel, it is this product which earns more income through restriction of its supply.

The question arises: Why cannot other entrepreneurs seize the gainful opportunity and enter into the production of this good, thereby tending to eliminate the opportunity? In the case of the cartel, this is precisely the tendency that will always

42We are not discussing here the generally conceded point that monopoly profits are capitalized in capital gains to the shares of the firm’s stock.
prevail and lead to the breakup of a monopoly-price position. Even if new firms entering the industry are “bought off” by being offered quotal positions in the old cartel, and both the new and the old firms have been able to agree on allocations of production and income, such actions will not suffice to preserve the cartel. For new firms will be tempted to acquire a share in the monopoly gains, and ever more will be created until the entire cartel operation is rendered unprofitable, there being too many firms to share the benefits. In such situations, the pressure will become greater and greater for the more efficient firms to cut loose from the cartel and to refuse further to provide a comfortable shelter for the host of inefficient firms.

In the case of a single monopolist, either his brand name and unique goodwill with the consumers prevents others from taking away his monopoly gains, or else he is a recipient of special monopoly privilege from the government, in which case other producers are prevented by force from producing the same good.

Our analysis of monopoly gain must be pursued further. We have said that the gain is derived from income from the sale of a certain product. But this product must be produced by factors, and we have seen that the return to any product is resolved into returns to the factors which produce it. Such “imputation,” in the market, must also take place for monopoly gains. Let us say, for example, that the Staunton Washing Machine Company has been able to achieve a monopoly price for its product. It is clear that the monopoly gain cannot be attributed to the machines, the plant, etc., which produce the washers. If the Staunton Company bought these machines from other producers, then any monopoly gains would, in the long run, as the machines were replaced, accrue to the producers of the machines. In the evenly rotating economy, where entrepreneurial profits and losses disappear, and the price of a product equals the sum of the prices of its factors, all the monopoly gain would accrue to a factor and not a product. Furthermore, no income, except time
income, could accrue to the owner of a capital good, because every capital good must, in turn, be produced by higher-order factors. Ultimately, all capital goods are resolvable into labor, land, and time factors. But if the Staunton Washing Machine Company cannot itself achieve a monopoly gain from a monopoly price, then obviously it does not benefit by restricting production in order to obtain this gain. Therefore, just as no income in the evenly rotating economy can accrue specifically to owners of capital goods, neither can specific monopoly gains.

The monopoly gains must, then, be imputed to either labor or land factors. In the case of a brand name, for example, a certain kind of labor factor is being monopolized. A name, as we have seen, is a unique identifying label for a person (or a group of persons acting co-operatively), and is therefore an attribute of the person and his energy. Considered generally, labor is the term designating the productive efforts of personal energy, whatever its concrete content. A brand name, therefore, is an attribute of a labor factor, specifically the owner or owners of the firm. Or, considered catallactically, the brand name represents the decision-making rent accruing to the owner and his name. If a monopoly price is achieved by the baseball prowess of Mickey Mantle, this is a specific monopoly gain attributable to a labor factor. In both of these cases, then, the monopoly price stems, not simply from the unique possession of the final product, but, more basically, from the unique possession of one of the factors necessary to the final product.

A monopoly gain might also be imputable to ownership of a unique natural resource or “land” factor. Thus, a monopoly price for diamonds may be attributable to a monopoly of diamond mines, from which diamonds must be ultimately produced.

Under the analysis of monopoly price, then, there cannot be, in the evenly rotating system, any such thing as “monopoly profits”; there are only specific monopoly income gains to owners of labor or land factors. No monopoly gain can accrue to an
owner of a capital good. If a monopoly price has been imposed because of a grant of monopoly privilege by the State, then obviously the monopoly gain is attributable to this special privilege.\textsuperscript{43}

(3) \textit{A World of Monopoly Prices?}

Is it possible, within the framework of monopoly-price theory, to assert that all prices on the free market may be monopoly prices?\textsuperscript{44} Can all selling prices be monopoly prices?

There are two ways in which we may analyze this problem. One is by turning our attention to the monopolized industry. As we have seen, the industry with a monopoly price restricts production in that industry (either by a cartel or a single firm), thereby releasing nonspecific factors to enter other fields of production. But it is evidently impossible to conceive of a world of monopoly prices, because this would imply a piling up of unused nonspecific factors. Since wants do not remain unfulfilled, labor and other nonspecific factors will be used somewhere, and the industries that acquire more factors and produce more cannot be monopoly-price industries. Their prices will be below the competitive price level.

We may also consider consumer demand. We have seen that a necessary condition for the establishment of monopoly price is a consumers’ demand schedule inelastic above the competitive-price point. Obviously, it is impossible for every industry to have such an inelastic demand schedule. For the definition of inelastic is that consumers will spend a greater total sum of money on the good when the price is higher. But consumers

\textsuperscript{43}To attain a monopoly price, the factor-owner must meet two conditions: (a) He must be a monopolist (in the sense of definition 1) over the factor; if he were not, the monopoly gain could be bid away by competitors entering the field; and (b) the demand curve for the factor must be inelastic above the competitive-price point.

\textsuperscript{44}This is the underlying assumption in Mrs. Joan Robinson’s \textit{Economics of Imperfect Competition}.
have a certain given total stock of money assets and money income, as well as a given amount, at any one time, which they may allocate to consumption spending. If they spend more on a certain good, they have less to spend on other goods. Therefore, they cannot spend more on every good, and not all prices can be monopoly prices.

There can never, then, be a world of monopoly prices, even assuming monopoly-price theory. Because of the fixity of consumers’ monetary stock and the employment of displaced factors, monopoly prices could not be established in more than approximately half of the economy’s industries.

(4) “Cutthroat” Competition

A popular theme in the literature is the alleged evil of “cutthroat competition.” Curiously, cutthroat, or “excessive,” competition, is linked by critics to the achievement of a monopoly price. The usual charge is that a “big” firm, for example, deliberately sells below the most profitable price, even to the extent of suffering losses. The firm acts so peculiarly in order to force another firm producing the same product to cut its price also. The “stronger” firm, with the capital resources to endure the losses, then drives the “weaker” firm out of business and establishes a monopoly of the field.

But, first, what is wrong with such a monopoly (definition 1)? What is wrong with the fact that the firm more efficient in serving the consumer remains in business, while consumers refuse to patronize the inefficient firm? A firm’s suffering losses signifies that it is not as successful as other firms in serving consumer desires. Factors then shift from the inefficient to the efficient firms. A firm’s going out of business harms no owner of any factor it employs and injures only the entrepreneur who miscalculated in his advance-production decisions. A firm goes out of business precisely because it suffers entrepreneurial losses, i.e., its monetary revenues in sales to consumers are less than the money it paid out previously to owners of factors. But so much money had to be paid out for factors, i.e., costs were so
high, because these factors could earn as much money elsewhere. If this entrepreneur cannot profitably employ the factors at their given prices, the reason is that factor-owners can sell their services to other firms. In so far as factors may be specific to the firm, and to the extent that their owners will accept a reduced price and income as the price of the firm’s product is reduced, total money costs can be reduced and the firm can be maintained in operation. Therefore, failure by business firms is due solely to entrepreneurial error in forecasting and to entrepreneurial inability to secure the factors of production by outbidding those firms more successful in serving the consumer. Thus, the elimination of inefficient firms cannot harm factor-owners or lead to their “unemployment,” since their failure was due precisely to the more attractive competing bids made by other firms (or, in some cases, to the alternatives of leisure or production outside the market). Their failure also helps consumers by transferring resources from wasteful to efficient producers. It is largely the entrepreneurs who suffer from their own errors, errors incurred through their own voluntarily adopted risks.

It is curious that the critics of “cutthroat competition” are generally the same as those who complain about the market’s subversion of “consumers’ sovereignty.” For selling a product at very low prices, even at short-term losses, is a bonanza to the consumers, and there is no reason why this gift to the consumers should be deplored. Furthermore, if the consumers were really indignant about this form of competition, they would scornfully refuse to accept this gift and instead continue to patronize the allegedly “victimized” competitor. When they do not do so and instead rush to acquire the bargains, they are indicating their perfect contentment with this state of affairs. From the point of view of consumers’ sovereignty or individual sovereignty, there is nothing at all wrong with “cutthroat competition.”

45Bidding takes place among numerous firms in various industries, not only among firms in the same industry.
The only conceivable problem is the one usually cited: that after the single firm has driven everyone else out of business through sustained selling at very low prices, then the final monopolist will restrict sales and raise its price to a monopoly price. Even granting for a moment the tenability of the monopoly-price concept, this does not seem a very likely occurrence. In the first place, it is time enough to complain after the monopoly price is established, especially since we have seen that we cannot consider “monopoly” per se (definition 1) as an evil. Secondly, a firm will not always be able to achieve a monopoly price. In all such cases, including (a) where not all the other firms in the industry can be driven out, or (b) where the demand curve is such that the monopolist cannot achieve a monopoly price, the “cutthroat competition” is then a pure boon with no harmful effects.

Incidentally, it is by no means true that the large firms will always be the strongest in a “price-cutting war.” Often, depending on the concrete conditions, it is the smaller, more mobile firm, not burdened with heavy investments, that is able to “cut its costs” (particularly when its factors are more specific to it, such as the labor of its management) and outcompete the larger firm. In such cases, of course, there is no monopoly-price problem whatever. The fact that the lowly pushcart peddler for centuries has been set upon by governmental violence at the behest of his more lordly and heavily capitalized

46An amusing instance of this concern is this argument for compulsory legal cartelization by West German industrialists: “that the so-called unrestricted competition would produce a catastrophe in which the stronger industries would destroy the weaker and establish themselves as monopolies.” Create an inefficient monopoly now to avoid an efficient monopoly later! M.S. Handler, “German Unionism Supports Cartels,” New York Times, March 17, 1954, p. 12. For other such instances, see Charles F. Phillips, Competition? Yes, but . . . (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1955).
competitors bears witness to the practical possibilities of such a situation.47

Suppose, however, that after this lengthy and costly process, a firm has finally been able to achieve a monopoly price by the route of “cutthroat competition.” What is there to prevent this monopoly gain from attracting other entrepreneurs who will try to undercut the existing firm and achieve some of the gain for themselves? What is to prevent new firms from coming in and driving the price down to competitive levels again? Is the firm to resume “cutthroat competition” and the same deliberate losing process once more? In that case, we are likely to find that consumers of the good will be receiving gifts far more often than facing a monopoly price.48

47What of the allegedly vast “financial power” of a big firm, rendering it impervious to cost? In a brilliant article, Professor Wayne Leeman has pointed out that a larger firm will also have larger volume and will therefore suffer greater losses when selling below cost. Having a larger volume, it has more to lose. What is relevant, therefore, is not the absolute size of the financial resources of the competing firms, but the size of their resources in relation to their volume of sales and expenditures. And this changes the conventional picture drastically. Wayne A. Leeman, “The Limitations of Local Price-Cutting as a Barrier to Entry,” Journal of Political Economy, August, 1956, pp. 331–32.

48After investigating conditions in the retail gasoline industry (one particularly subject to allegedly “cutthroat” competition), an economist declared:

Some people think that leading marketers occasionally reduce prices to drive out competition so that they may later enjoy a monopoly. But, as one oil man has put it, “That is like trying to sweep back the ocean to get a dry place to sit down . . . .” [Competitors] . . . never scare, and never hesitate for long, and would move in immediately when prices were restored, offering little opportunity to a single marketer to recoup his losses. (Harold Fleming, Oil Prices and Competition [American Petroleum Institute, 1953], p. 54)
Professor Leeman has pointed out that the smaller firm, driven out by “cutthroat competition,” may simply close down, wait for the larger firm to reap its expected gain of a higher “monopoly price,” and then reopen! More important, even if the small firm is driven into bankruptcy, its physical plant remains intact, and it may be bought by a new entrepreneur at bargain prices. As a result, the new firm will be able to produce at very low cost and damage the “victor” firm considerably. To avoid this threat, the big firm would have to delay raising its price for the very long time required for the small plant to wear out or become obsolete.

Leeman also demonstrates that the big firm could not keep new, small firms out by a mere threat of cutthroat competition. For (a) new firms will probably interpret the high price charged by the “monopolist” as a sign of inefficiency, providing a ripe opportunity for profits; and (b) the “monopolist” can demonstrate his power satisfactorily only by actually selling at low prices for long periods of time. Hence, only by keeping its costs down and its prices low, i.e., by not extracting a monopoly price, can the “victor” firm keep out potential rivals. But this means that the cutthroat competition, far from being a route to a monopoly price, was a pure gift to consumers and a pure loss to the “victor.”

But what of a standard problem brought forward by critics of cutthroat competition? Cannot the big firm check the entry of efficient small firms by simply buying up the new rival’s plant and putting it out of production? Perhaps a short period of cutthroat price-cutting will convince the new small firm of the advantage of selling out and will permit the monopolist to avoid the long periods of losses just mentioned.

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50 A leading oil executive told Leeman: “We have invested too much in plant and equipment in this area to want to invite in a host of competitors under an umbrella of high prices.” Ibid., p. 331.
No one seems to realize, however, the high costs such buying will entail. Leeman points out that the really efficient small firm can demand such a high price for its assets as to make the whole procedure prohibitively expensive. And, further, any later attempt by the large firm to recoup its losses by charging the monopoly price will only invite new entry by other firms and redouble the expensive buying-out process again and again. Buying out competitors, then, will be even more costly than simple cutthroat competition, which we have seen to be unprofitable.\footnote{Leeman points out, in a striking refutation of one of the myths of our age, that this is \textit{precisely} what happened to John D. Rockefeller. According to a widely accepted view, he softened up small competitors in the oil business by a period of intensive price competition, bought them out \textit{for} a song, and then raised prices to consumers to make up his losses. Actually, the softening-up process did not work \ldots for Rockefeller usually ended up paying \ldots so handsomely that the sellers, often in violation of promises made, proceeded to build another plant for its nuisance value, hoping again to collect a reward from their benefactor. \ldots Rockefeller after a time got tired of paying \ldots “blackmail” and \ldots decided that the best way to hold the dominant position he wanted was to keep profit margins small all the time. (\textit{Ibid.}, p. 332)}\footnote{Leeman concludes, quite correctly, that large rather than small firms dominate many markets, \textit{not} as a result of victorious cutthroat competition and monopolistic pricing, but by taking advantage of the low costs of much large-scale production and keeping prices low in fear of \textit{potential} as well as actual rivals. Leeman, “The Limitations of Local Price-Cutting,” pp. 333–34.}

A final argument against the doctrines of “cutthroat competition” is that it is impossible to determine whether it is taking place or not. The fact that a monopoly might ensue afterward does not even establish the motive and is certainly no criterion of cutthroat procedures. One proposed criterion has been selling “below costs”—most cogently, below what is usually termed “variable costs,” the expenses of using factors in production, assuming previously sunk investment in a fixed plant. But this is no criterion at all. As we have already declared, there is no such thing as costs (apart from speculation on a higher future price) once the stock has been produced. Costs take place along the path of decisions to produce—at each step along the way that investments (of money and effort) are made in factors. The allocations, the opportunities forgone, take place at each step as future production decisions must be taken and commitments made. Once the stock has been produced, however (and there is no expectation of a price rise), the sale is costless, since there are no advantages forgone by selling the product (costs in making the sale being here considered negligible for purposes of simplification). Therefore, the stock will tend to be sold at whatever price is obtainable. There is no such thing, then, as “selling below costs” on stock already produced. The cutting of price may just as well be due to inability to dispose of stock at any higher price as to “cutthroat” competition, and it is impossible for an observer to separate the two elements.

D. THE ILLUSION OF MONOPOLY PRICE ON THE UNHAMPERED MARKET

Up to this point we have explained the neoclassical theory of monopoly price and have pointed out various misconceptions about its consequences. We have also shown that there is nothing bad about monopoly price and that it constitutes no infringement on any legitimate interpretation of individuals’ sovereignty or even of consumers’ sovereignty. Yet there has been a great deficiency in the economic literature on this whole issue: a failure to realize the illusion in the entire concept
of monopoly price. If we turn to the definition of monopoly price on page 672 above, or the diagrammatic interpretation in Figure 67, we find that there is assumed to be a “competitive price,” to which a higher “monopoly price”—an outcome of restrictive action—is contrasted. Yet, if we analyze the matter closely, it becomes evident that the entire contrast is an illusion. In the market, there is no discernible, identifiable competitive price, and therefore there is no way of distinguishing, even conceptually, any given price as a “monopoly price.” The alleged “competitive price” can be identified neither by the producer himself nor by the disinterested observer.

Let us take a firm which is considering the production of a certain good. The firm can be a “monopolist” in the sense of producing a unique good, or it can be an “oligopolist” among a few firms. Whatever its position, it is irrelevant, because we are interested only in whether or not it can achieve a monopoly price as compared to a competitive price. This, in turn, depends on the elasticity of the demand curve as it is presented to the firm over a certain range. Let us say that the firm finds itself with a certain demand curve (Figure 68).

The producer must decide how much of the good to produce and sell in a future period, i.e., at the time when this demand curve will become relevant. He will set his output at whatever point is expected to maximize his monetary earnings (other psychic factors being equal), taking into consideration the necessary monetary expenses of production for each quantity, i.e., the amounts that can be produced for each amount of money invested. As an entrepreneur he will attempt to maximize profits, as a labor-owner to maximize his monetary income, as a land-owner to maximize his monetary income from that factor.

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53 We have found in the literature only one hint of the discovery of this illusion: Scoville and Sargent, *Fact and Fancy in the T.N.E.C. Monographs*, p. 302. See also Bradford B. Smith, “Monopoly and Competition,” *Ideas on Liberty*, No. 3, November, 1955, pp. 66 ff.
On the basis of this logic of action, the producer sets his investment to produce a certain stock, or as a factor-owner to sell a certain amount of service, say $0S$. Assuming that he has correctly estimated his demand curve, the intersection of the two will establish the market-equilibrium price, $0P$ or $SA$.

The critical question is this: Is the market price, $0P$, a “competitive price” or a “monopoly price”? The answer is that there is no way of knowing. Contrary to the assumptions of the theory, there is no “competitive price” which is clearly established somewhere, and which we may compare $0P$ with. Neither does the elasticity of the demand curve establish any criterion. Even if all the difficulties of discovering and identifying the demand curve were waived (and this identifying can be done, of course, only by the producer himself—and only in a tentative fashion), we have seen that the price, if accurately estimated, will always be set by the seller so that the range above the market price will be elastic. How is anyone, including the producer himself, to know whether or not this market price is competitive or monopoly?
Suppose that, after having produced $0S$, the producer decides that he will make more money if he produces less of the good in the next period. Is the higher price to be gained from such a cutback necessarily a “monopoly price”? Why could it not just as well be a movement from a subcompetitive price to a competitive price? In the real world, a demand curve is not simply “given” to a producer, but must be estimated and discovered. If a producer has produced too much in one period and, in order to earn more income, produces less in the next period, this is all that can be said about the action. For there is no criterion that will determine whether or not he is moving from a price below the alleged “competitive price” or moving above this price. Thus, we cannot use “restriction of production” as the test of monopoly vs. competitive price. A movement from a subcompetitive to a competitive price also involves a “restriction” of production of this good, coupled, of course, with an expansion of production in other lines by the released factors. There is no way whatever to distinguish such a “restriction” and corollary expansion from the alleged “monopoly-price” situation.

If the “restriction” is accompanied by increased leisure for the owner of a labor factor rather than increased production of some other good on the market, it is still an expansion of the yield of a consumers’ good—leisure. There is still no way of determining whether the “restriction” resulted in a “monopoly” or a “competitive” price or to what extent the motive of increased leisure was involved.

To define a *monopoly price* as a price attained by selling a smaller quantity of a product at a higher price is therefore meaningless, since the same definition applies to the “competitive price” as compared with a subcompetitive price. There is no way to define “monopoly price” because there is also no way of defining the “competitive price” to which the former must refer.

Many writers have attempted to establish some criterion for distinguishing a monopoly price from a competitive price. Some call the monopoly price that price achieving permanent,
long-run “monopoly profits” for a firm. This is contrasted to the “competitive price,” at which, in the evenly rotating economy, profits disappear. Yet, as we have already seen, there are never permanent monopoly profits, but only monopoly gains to owners of land or labor factors. Money costs to the entrepreneur, who must buy factors of production, will tend to equal money revenues in the evenly rotating economy, whether the price is competitive or monopoly. The monopoly gains, however, are secured as income to labor or land factors. There is therefore never any identifiable element that could provide a criterion of the absence of monopoly gain. With a monopoly gain, the factor’s income is greater; without it, it is less. But where is the criterion for distinguishing this from a change in the income of a factor for “legitimate” demand and supply reasons? How to distinguish a “monopoly gain” from a simple increase in factor income?

Another theory attempts to define a monopoly gain as income to a factor greater than that received by another, similar factor. Thus, if Mickey Mantle receives a greater monetary income than another outfielder, that difference represents the “monopoly gain” resulting from his natural monopoly of unique ability. The crucial difficulty with this approach is that it implicitly adopts the old classical fallacy of treating all the various labor factors, as well as all the various land factors, as somehow homogeneous. If all the labor factors are somehow one good, then the variations in income accruing to each must be explained by reference to some sort of “monopolistic” or other mysterious element. Yet a good with a homogeneous supply is only a good if all its units are interchangeable, as we saw at the beginning of this work. But the very fact that Mantle and the other outfielder are treated differently in the market signifies that they are selling different, not the same, goods. Just as in tangible commodities, so in personal labor services (whether sold to other producers or to consumers directly): each seller may be selling a unique good, and yet he is “competing” with more or less close substitutability against all the other sellers for the purchases of consumers (or lower-order producers). But since each
good or service is unique, we cannot state that the difference between the prices of any two represents any sort of “monopoly price”; monopoly price vis-à-vis competitive price can refer only to alternative prices of the same good. Mickey Mantle may indeed be a person of unique ability and a “monopolist” (as is everyone else) over the disposition of his own talents, but whether or not he is achieving a “monopoly price” (and therefore a monopoly gain) from his service can never be determined.

This analysis is equally applicable to land. It is just as illegitimate to dub the difference between the income of the site of the Empire State Building and that of a rural general store a “monopoly gain” as to apply the same concept to the additional income of Mickey Mantle. The fact that both areas are land makes them no more homogeneous on the market than the fact that Mickey Mantle and Joe Doakes are both baseball players or, in a broader category, both laborers. The fact that each is remunerated at a different price and income signifies that they are considered different on the market. To treat differential gains for different goods as instances of “monopoly gain” is to render the term completely devoid of significance.

Neither is the attempt to establish the existence of idle resources as a criterion of monopolistic “withholding” of factors any more valid. Idle labor resources will always mean increased leisure, and therefore the leisure motive will always be intertwined with any alleged “monopolistic” motive. It therefore becomes impossible to separate them. The existence of idle land may always be due to the fact of the relative scarcity of labor as compared with available land. This relative scarcity makes it more serviceable to consumers, and hence more remunerative, to invest labor in certain areas of land, and not in others. The land areas least productive of potential earnings will be forced to lie idle, the amount depending on how much labor supply is available. We must stress that all “land” (i.e., every nature-given resource) is involved here, including urban sites and natural resources as well as agricultural areas. The allocation of labor to land is comparable to Crusoe’s having to decide on which plot...
of ground to build his shelter or in which stream to fish. Because of the natural, as well as voluntary, limitations on his labor effort, that area of land on which he produces the highest utility will be cultivated, and the rest will be left idle. This element also cannot be separated from any alleged monopolistic element. For if someone objects that the “withheld” land is of the same quality as the land in use and therefore that monopolistic restriction is afoot, it may always be answered that the two pieces of land necessarily differ—in location if in no other attribute—and that the very fact that the two are treated differently on the market tends to confirm this difference. By what mystical criterion, then, does some outsider assert that the two lands are economically identical? In the case of capital goods it is also true that the limitations of available labor supply will often make idle those goods which are expected to yield a lesser return as compared with other capital that can be employed by labor. The difference here is that idle capital goods are always the result of previous error by producers, since no such idleness would be necessary if the present events—demands, prices, supplies—had all been forecast correctly by all the producers. But though error is always unfortunate, the keeping idle of unrewardable capital is the best course to follow; it is making the best of the existing situation, not of the situation that would have obtained if foresight had been perfect. In the evenly rotating economy, of course, there would never be idle capital goods; there would be only idle land and idle labor (to the extent that leisure is voluntarily preferred to money income). In no case is it possible to establish an identification of purely “monopolistic” withholding action.

A similar proposed criterion for distinguishing a monopoly price from a competitive price runs as follows: In the competitive case, the marginal factor produces no rent; in the monopoly-price case, however, use of the monopolized factor is restricted, so that its marginal use does yield a rent. We may answer, in the first place, that there is no reason to say that every factor will, in the competitive case, always be worked until it
yields no rent. On the contrary, every factor is worked in a region of diminishing but positive marginal product, not zero product. Indeed, as we have shown above, if the value product of a unit of a factor is zero, it will not be used at all. Every unit of a factor is used because it yields a value product; otherwise, it would not be used in production. And if it yields a value product, it will earn its discounted value product in income.

It is clear, further, that this criterion could never be applied to a monopolized labor factor. What labor factor earns a zero wage in a competitive market? Yet many monopolized (definition 1) factors are labor factors—such as brand names, unique services, decision-making ability in business, etc. Land is more abundant than labor, and therefore some lands will be idle and receive zero rent. Even here, however, it is only the submarginal lands that receive no rent; the marginal lands in use receive some rent, however small.

Furthermore, even if it were true that marginal lands received zero rent, this would be irrelevant for our discussion. It would apply only to “poorer” or “inferior,” as compared with more productive, lands. But a criterion of monopoly or competitive price must apply, not to factors of different quality, but to homogeneous factors. The monopoly-price problem is one of a supply of units of one homogeneous factor, not of various different factors within the one broad category, land. In this case, as we have stated, every factor will earn some value product in a diminishing zone, and not zero.54

Since, in the “competitive” case, all factors in use will earn some rent, there is still no basis for distinguishing a “competitive” from a “monopoly” price.

54In the case of depletable natural resources, any allocation of use necessarily involves the use of some of the resource in the present (even considering the resource as homogeneous) and the “withholding” of the remainder for allocation to future use. But there is no way of conceptually distinguishing such withholding from “monopolistic” withholding and therefore of discussing a “monopoly price.”
Another very common attempt to distinguish between a competitive and a monopoly price rests on the alleged ideal of “marginal-cost pricing.” Failure to set prices equal to marginal cost is considered an example of “monopoly” behavior. There are several fatal errors in this analysis. In the first place, as we shall see further below, there can be no such thing as “pure competition,” that hypothetical state in which the demand curve for the output of a firm is infinitely elastic. Only in this never-never land does price equal marginal cost in equilibrium. Otherwise, marginal cost equals “marginal revenue” in the ERE, i.e., the revenue that a given increment of cost will yield to the firm. (Only if the demand curve were perfectly elastic would marginal revenue boil down to “average revenue,” or price.) There is now no way of distinguishing “competitive” from “monopolistic” situations, since marginal cost will in all cases tend to equal marginal revenue.

Secondly, this equality is only a tendency that results from competition; it is not a precondition of competition. It is a property of the equilibrium of the ERE that the market economy always tends toward, but never can reach. To uphold it as a “welfare ideal” for the real world, an ideal with which to gauge existing conditions, as so many economists have done, is to misconceive completely the nature of the market and of economics itself.

Thirdly, there is no reason why firms should ever deliberately balk at being guided by marginal-cost considerations. Their aiming at maximum net revenue will see to that. But there is no one simple, determinate “marginal cost,” because, as we have seen above, there is no one identifiable “short-run” period, such as is assumed by current theory. The firm faces a gamut of variable periods of time for the investment and use of factors, and its pricing and output decisions depend on the future period of time which it is considering. Is it buying a new machine, or is it selling old output piled up in inventory? The marginal cost considerations will differ in the two cases.
It is clear that it is impossible to distinguish competitive or monopolistic behavior on the part of a firm. It is no more possible to speak of monopoly price in the case of a cartel. In the first place, a cartel, when it sets the amount of its production in advance for the next period, is in exactly the same position as the single firm: it sets the amount of its production at that point which it believes will maximize its monetary earnings. There is still no way of distinguishing a monopoly from a competitive or a subcompetitive price.

Furthermore, we have seen that there is no essential difference between a cartel and a merger, or between a merger of producers with money assets and a merger of producers with previously existing capital assets to form a partnership or corporation. As a result of the tradition, still in evidence in the literature, of identifying a firm with a single individual entrepreneur or producer, we tend to overlook the fact that most existing firms are constituted through the voluntary merging of monetary assets. To pursue the similarity further, suppose that firm A wishes to expand its production. Is there an essential difference between its buying new land and building a new plant, and its purchasing an old plant owned by another firm? Yet the latter case, if the plant constitutes all the assets of firm B, will involve, in fact, a merger of the two firms. The degree of merger or the degree of independence in the various parts of the productive system will depend entirely upon the most remunerative method for the producers concerned. This will also be the method most serviceable to the consumers. And there is no way of distinguishing between a cartel, a merger, and one larger firm.

It might be objected at this point that there are many useful, indeed indispensable, theoretical concepts which cannot be practically isolated in their pure form in the real world. Thus, the interest rate, in practice, is not strictly separable from profits, and the various components of the interest rate are not separable in practice, but they can be separated in analysis. But these concepts are each definable in terms independent of one another and of the complex reality being investigated. Thus, the
“pure” interest rate may never exist in practice, but the market interest rate is theoretically analyzable into its components: pure interest rate, price-expectation component, risk component. They are so analyzable because each of these components is definable independently of the complex market-interest rate and, moreover, is independently deducible from the axioms of praxeology. The existence and determination of the pure interest rate is strictly deducible from the principles of human action, time preference, etc. Each of these components, then, is arrived at a priori in relation to the concrete market interest rate itself and is deduced from previously established truths about human action. In all such cases, the components are definable through independently established theoretical criteria. In this case, however, there is, as we have seen, no independent way by which we can define and distinguish a “monopoly price” from a “competitive price.” There is no prior rule available to guide us in framing the distinction. To say that the monopoly price is formed when the configuration of demand is inelastic above the competitive price tells us nothing because we have no way of independently defining the “competitive price.”

To reiterate, the seemingly unidentifiable elements in other areas of economic theory are independently deducible from the axioms of human action. Time preference, uncertainty, changes in purchasing power, etc., can all be independently established by prior reasoning, and their interrelations analyzed through the method of mental constructions. The evenly rotating economy can be seen as the ever-moving goal of the market, through our analysis of the direction of action. But here, all that we know from prior analysis of human action is that individuals co-operate on the market to sell and purchase factors, transform them into products, and expect to sell the products to others—eventually to final consumers; and that the factors are sold, and entrepreneurs undertake the production, in order to obtain monetary income from the sale of their product. How much any given person will produce of any given good or service is determined by his expectations of greatest monetary income, other psychic
considerations being equal. But nowhere in the analysis of such action is it possible to separate conceptually an alleged “restrictive” from a nonrestrictive act, and nowhere is it possible to define “competitive price” in any way that would differ from the free-market price. Similarly, there is no way of conceptually distinguishing “monopoly price” from free-market price. But if a concept has no possible grounding in reality, then it is an empty and illusory, and not a meaningful, concept. On the free market there is no way of distinguishing a “monopoly price” from a “competitive price” or a “subcompetitive price” or of establishing any changes as movements from one to the other. No criteria can be found for making such distinctions. The concept of monopoly price as distinguished from competitive price is therefore untenable. We can speak only of the free-market price.

Thus, we conclude not only that there is nothing “wrong” with “monopoly price,” but also that the entire concept is meaningless. There is a great deal of “monopoly” in the sense of a single owner of a unique commodity or service (definition 1). But we have seen that this is an inappropriate term and, further, that it has no catallactic significance. A “monopoly” would be of importance only if it led to a monopoly price, and we have seen that there is no such thing as a monopoly price or a competitive price on the market. There is only the “free-market price.”

E. SOME PROBLEMS IN THE THEORY OF THE ILLUSION OF MONOPOLY PRICE

(1) Location Monopoly

It might be objected that in the case of a location monopoly, a monopoly price can be distinguished from a competitive price on a free market. Let us consider the case of cement. There are cement consumers, say, who live in Rochester. A cement firm in Rochester could competitively charge a mill price of X gold grams per ton. The nearest competitor is stationed in Albany, and freight costs from Albany to Rochester are three gold grams per ton. The Rochester firm is then able to increase its price to
obtain \((X + 2)\) gold grams per ton from Rochester consumers. Does its locational advantage not confer upon it a monopoly, and is not this higher price a monopoly price?

First, as we have seen above, the good that we must consider is the good in the hands of the consumers. The Rochester firm is superior locationally for the Rochester market; the fact that the Albany firm cannot compete is not to be blamed on the Rochester firm. Location is also a factor of production. Furthermore, another firm could, if it wished, set itself up in Rochester to compete.

Let us, however, be generous to the location-monopoly theorists and grant that, in a sense (definition 1) this monopoly is enjoyed by all individual sellers of any good or service. This is due to the eternal law of human action, and indeed of all matter, that only one thing can be in one place at one time. The retail grocer on Fifth Street enjoys a monopoly of the sale of groceries for that street; the grocer on Fourth Street enjoys a monopoly of grocery service for his street, etc. In the case of stores which all cluster together in the same block, say radio stores, there are still a few feet of sidewalk over which each owner of a radio store exercises a location monopoly. Location is as specific to a firm or plant as ability is to a person.

Whether this element of location takes on any importance in the market depends on the configuration of consumer demand and on which policy is most profitable for each seller in the concrete case. In some cases a grocer, for example, can charge higher prices for his goods than another because of his monopoly of the block. In that case, his monopoly over the good “eggs available on Fifth Street” has taken on such a significance for the consumers in his block that he can charge them a higher price than the Fourth Street grocer and still retain their patronage. In other cases, he cannot do so because the bulk of his customers will desert him for the neighboring grocer if the latter’s prices are lower.

Now, a good is homogeneous if consumers evaluate its units in the same way. If that condition holds, its units will be sold for
a uniform price on the market (or rapidly tend to be sold at a uniform price). If, now, various grocers must adhere to a uniform price, then there is no location monopoly.

But what of the case where the Fifth Street grocer can charge a higher price than his competitor? Do we not have here a clear case of an identifiable monopoly price? Can we not say that the Fifth Street grocer who can charge more than his competitor for the same goods has found that the demand curve for his products is inelastic for a certain range above the “competitive price,” the competitive price being taken as that equal to the price charged by his neighbor? Can we not say this even though we recognize that there is no “infringement on consumers’ sovereignty” in this action, since it is due to the specific tastes of his consuming customers? The answer is an emphatic No. The reason is that the economist can never equate a good with some physical substance. A good, we remember, is a quantity of a thing divisible into a supply of homogeneous units. And this homogeneity, we repeat, must be in the minds of the consuming public, not in its physical composition. If a malted milk consumed at a luncheonette is the same good in the minds of consumers as the malted at a fashionable restaurant, then the price of the malted will be the same in both places. On the other hand, we have seen that the consumer buys not only the physical good, but all attributes of a thing, including its name, the wrappings, and the atmosphere in which it is consumed. If most of the consumers differentiate sufficiently between food consumed in the restaurant and food consumed at the luncheonette, so that a higher price can be charged in one case than in the other, then the food is a different good in each case. A malted consumed in the restaurant becomes, for a significant body of consumers, a different good from a malted consumed at the luncheonette. The same situation obtains for brand names, even in those situations where a minority of the consumers do regard several brands as “actually” the same good. As long as the bulk of the consumers regard them as different goods, then they are different goods, and their prices will differ. Similarly, goods may
differ physically, but as long as they are regarded by consumers as the same, they are the same good.\footnote{See the reference to Abbott, \textit{Quality and Competition}, in note 28 above.}

The same analysis applies to the case of location. Where the Fifth Street consumers regard groceries at Fifth Street as a significantly better good than groceries at Fourth Street, so that they are willing to pay more rather than walk the extra distance, \textit{then the two will become different goods}. In the case of location, there will always be a tendency for the two to be different goods, but very often this will not be significant on the market. For a consumer may and almost always will prefer groceries available on this block to groceries available on the next block, but often this preference will \textit{not be enough} to overcome any higher price for the former goods. If the bulk of the consumers shift to the latter good at a higher price, the two, on the market, \textit{will be the same good}. And it is action on the market, real action, that we are interested in, not the nonsignificant pure valuations by themselves. In praxeology we are interested only in preferences that result in, and are therefore demonstrated by, \textit{real choices}, not in the preferences themselves.

A good cannot be independently established as such apart from consumer preference on the market. Groceries on Fifth Street may be higher in price than groceries on Fourth Street to the Fifth Street consumers. If so, it will be because the former is a different good to the consumers. In the same way, Rochester cement may cost more than Albany cement in \textit{Albany} to Rochester consumers, but the two are different goods by virtue of their difference in location. And there is no way of determining whether or not the price in Rochester or on Fifth Street is a “monopoly price” or a “competitive price” or of determining what the “competitive price” might be. It certainly could not be the price charged by the other firm elsewhere, since these prices are really for two different goods. There is no theoretical criterion by which we can distinguish simple locational income to sites from alleged “monopoly” income to sites.
There is another reason for abandoning any theory of locational monopoly price. If all sites are purely specific in locational value, there is no sense to the statement that they earn a “monopoly rent.” For monopoly price, according to the theory, can be established only by selling less of a good and thus commanding a higher price. But all locational properties of a site differ in quality because they differ in location, and therefore there can be no restriction of sales to part of a site. Either a site is in production, or it is idle. But the idle sites necessarily differ in location from the sites in use and are therefore idle because their value productivity is inferior. They are idle because they are submarginal, not because they are “monopolistically” withheld parts of a certain homogeneous supply.

The locational-monopoly-price theorist, then, is refuted whichever way he turns. If he takes a limited view of locational monopoly (in the sense of definition 1) and confines it to such examples as Rochester vs. Albany, he can never establish a criterion for monopoly price, for another firm can enter Rochester, either actually or potentially, to bid away any locational profit that the first firm may earn. His prices cannot be compared with those of his competitors, because they are selling different goods. If the theorist takes an extensive view of locational monopoly—which would take into consideration the fact that every location necessarily differs from every other—and compares locations a few feet apart, then there is no sense at all in talking of “monopoly price,” for (a) the price of a product at one location cannot be precisely compared with another, because they are different goods, and (b) each site is different in locational quality, and therefore no site can be conceptually split up into different homogeneous units—some to be sold and some to be withheld from the market. Each site is a unit in itself. But such a splitting is essential for the establishment of a monopoly-price theory.

(2) Natural Monopoly

A favorite target of the critics of “monopoly” is the so-called “natural monopoly” or “public utility,” where “competition is
naturally not feasible.” A typically cited case is the water supply of a city. It is supposed to be technologically feasible for only one water company to exist for serving a city. No other firms are therefore able to compete, and special interference is alleged to be necessary to curb monopoly pricing by this utility.

In the first place, such a “limited-space monopoly” is just one case in which only one firm in a field is profitable. How many firms will be profitable in any line of production is an institutional question and depends on such concrete data as the degree of consumer demand, the type of product sold, the physical productivity of the processes, the supply and pricing of factors, the forecasting of entrepreneurs, etc. Spatial limitations may be unimportant; as in the case of the grocers, the spatial limits may allow only the narrowest of “monopolies”—the monopoly over the portion of sidewalk owned by the seller. On the other hand, conditions may be such that only one firm may be feasible in the industry. But we have seen that this is irrelevant; “monopoly” is a meaningless appellation, unless monopoly price is achieved, and, once again, there is no way of determining whether the price charged for the good is a “monopoly price” or not. And this applies to all circumstances, including a nation-wide telephone firm, a local water company, or an outstanding baseball player. All these persons or firms will be “monopolies” within their “industry.” And in all these cases, the dichotomy between “monopoly price” and “competitive price” is still an illusory one. Furthermore, there are no rational grounds by which we can preserve a separate sphere for “public utilities” and subject them to special harassment. A “public utility” industry does not differ conceptually from any other, and there is no nonarbitrary method by which we can designate certain industries to be “clothed in the public interest,” while others are not.56

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In no case, therefore, on the free market can a “monopoly price” be conceptually distinguished from a “competitive price.” All prices on the free market are competitive.57

4. Labor Unions
A. Restrictionist Pricing of Labor

It might be asserted that labor unions, in exacting higher wage rates on the free market, are achieving identifiable monopoly prices. For here two identifiable contrasting situations exist: (a) where individuals sell their labor themselves; and (b) where they are members of labor unions which bargain on their labor for

57See Mises:

Prices are a market phenomenon. . . . They are the resultant of a certain constellation of market data, of actions and reactions of the members of a market society. It is vain to meditate what prices would have been if some of their determinants had been different. . . . It is no less vain to ponder on what prices ought to be. Everybody is pleased if the prices of things he wants to buy drop and the prices of the things he wants to sell rise. . . . Any price determined on a market is the necessary outgrowth of the interplay of the forces operating, that is, demand and supply. Whatever the market situation which generated this price may be, with regard to it the price is always adequate, genuine, and real. It cannot be higher if no bidder ready to offer a higher price turns up, and it cannot be lower if no seller ready to deliver at a lower price turns up. Only the appearance of such people ready to buy or sell can alter prices. Economics . . . does not develop formulas which would enable anybody to compute a “correct” price different from that established on the market by the interaction of buyers and sellers. . . . This refers also to monopoly prices. . . . No alleged “fact finding” and no armchair speculation can discover another price at which demand and supply would become equal. The failure of all experiments to find a satisfactory solution for the limited-space monopoly of public utilities clearly proves this truth. (Mises, Human Action, pp. 392–94; italics added)
them. Furthermore, it is clear that while cartels, to be successful, must be economically more efficient in serving the consumer, no such justification can be found for unions. Since it is always the individual laborer who works, and since efficiency in organization comes from management hired for the task, forming unions never improves the productivity of an individual’s work.

It is true that a union provides an identifiable situation. However, it is not true that a union wage rate could ever be called a monopoly price.\textsuperscript{58} For the characteristic of the monopolist is precisely that he monopolizes a factor or commodity. To obtain a monopoly price, he sells only part of his supply and withholds selling the other part, because selling a lower quantity raises the price on an inelastic demand curve. It is the unique characteristic of labor in a free society, however, that it cannot be monopolized. Each individual is a self-owner and cannot be owned by another individual or group. Therefore, in the labor field, no one man or group can own the total supply and withhold part of it from the market. Each man owns himself.

Let us call the total supply of a monopolist’s product \( P \). When he withholds \( W \) units in order to obtain a monopoly for \( P - W \), the increased revenue he obtains from \( P - W \) must more than compensate him for the loss of revenue he suffers from not selling \( W \). A monopolist’s action is always limited by loss of revenue from the withheld supply. But in the case of labor unions,

\textsuperscript{58} The first to point out the error in the common talk of “monopoly wage rates” of unions was Professor Mises. See his brilliant discussion in Human Action, pp. 373–74. Also see P. Ford, The Economics of Collective Bargaining (Oxford: Basil Blackwell, 1958), pp. 35–40. Ford also refutes the thesis advanced by the recent “Chicago School” that unions perform a service as sellers of labor:

But a union does not itself produce or sell the commodity, labour, nor receive payment for it. . . . It could be more fitly described as . . . fixing the wages and other conditions on which its individual members are permitted to sell their services to the individual employers. (Ibid., p. 36)
this limitation does not apply. Since each man owns himself, the “withheld” suppliers are different people from the ones getting the increased income. If a union, in one way or another, achieves a higher price than its members could command by individual sales, its action is not checked by the loss of revenue suffered by the “withheld” laborers. If a union achieves a higher wage, some laborers are earning a higher price, while others are excluded from the market and lose the revenue they would have obtained. Such a higher price (wage) is called a restrictionist price.

A restrictionist price, by any sensible criterion, is “worse” than a “monopoly price.” Since the restrictionist union does not have to worry about the laborers who are excluded and suffers no revenue loss from such exclusion, restrictionist action is not curbed by the elasticity of the demand curve for labor. For unions need only maximize the net income of the working members, or, indeed, of the union bureaucracy itself.\(^{59}\)

How may a union achieve a restrictionist price? Figure 69 will illustrate. The demand curve is the demand curve for a labor factor in an industry. \(DD\) is the demand curve for the labor in the industry; \(SS\), the supply curve. Both curves relate the number of laborers on the horizontal axis and the wage rate on the vertical. At the market equilibrium, the supply of laborers offering their work in the industry will intersect the demand for the labor, at number of laborers \(0A\) and wage rate \(AB\). Now, suppose that a union enters this labor market, and the union decides that its members will insist on a higher wage than \(AB\), say \(0W\). What unions do, in fact, is to insist upon a certain wage

\(^{59}\)A restrictionist, rather than a monopoly, price can be achieved because the number of laborers is so important in relation to the possible variation in hours of work by an individual laborer that the latter can be ignored here. If, however, the total labor supply is limited originally to a few people, then an imposed higher wage rate will cut down the number of hours purchased from the workers who remain working, perhaps so much as to render a restrictionist price unprofitable to them. In such a case it would be more appropriate to speak of a monopoly price.
rate as a minimum below which they will not work in that industry.

The effect of the union decision is to shift the supply curve of labor available to the industry to a horizontal one at the wage rate $W_W'$, rising after it joins the $SS$ curve at $E$. The minimum reserve price of labor for this industry has risen, and has risen for all laborers, so that there are no longer laborers with lower reserve prices who would be willing to work for less. With a supply curve changing to $WE$, the new equilibrium point will be $C$ instead of $B$. The number of workers hired will be $WC$, and the wage rate $W$.

The union has thus achieved a restrictionist wage rate. It can be achieved regardless of the shape of the demand curve, granting only that it is falling. The demand curve falls because of the diminishing DMVP of a factor and the diminishing marginal utility of the product. But a sacrifice has been made—specifically, there are now fewer workers hired, by an amount $CF$. What happens to them? These discharged workers are the main
losers in this procedure. Since the union represents the remain-
ing workers, it does not have to concern itself, as the monopo-
list would, with the fate of these workers. At best, they must 
shift (being a nonspecific factor, they can do so) to some other—
nonunionized—industry. The trouble is, however, that the 
workers are less suited to the new industry. Their having been 
in the now unionized industry implies that their DMVP in that 
industry was higher than in the industry to which they must 
shift; consequently, their wage rate is now lower. Moreover, 
their entry into the other industry depresses the wage rates of 
the workers already there.

Consequently, at best, a union can achieve a higher, restric-
tionist wage rate for its members only at the expense of lowering 
the wage rates of all other workers in the economy. Production 
efforts in the economy are also distorted. But, in addition, the 
widener the scope of union activity and restrictionism in the econ-
omy, the more difficult it will be for workers to shift their locations 
and occupations to find nonunionized havens in which to work. 
And more and more the tendency will be for the displaced work-
ners to remain permanently or quasi-permanently unemployed, 
eager to work but unable to find nonrestricted opportunities for 
employment. The greater the scope of unionism, the more a 
permanent mass of unemployment will tend to develop.

Unions try as hard as they can to plug all the “loop-holes” of 
nonunionism, to close all the escape hatches where the dispos-
sessed workmen can find jobs. This is termed “ending the un-
fair competition of nonunion, low-wage labor.” A universal 
union control and restrictionism would mean permanent mass 
unemployment, growing ever greater in proportion to the 
degree that the union exacted its restrictions.

It is a common myth that only the old-style “craft” unions, 
which deliberately restrict their occupational group to highly 
skilled trades with relatively few numbers, can restrict the supply 
of labor. They often maintain stringent standards of mem-
bership and numerous devices to cut down the supply of labor 
entering the trade. This direct restriction of supply doubtless
makes it easier to obtain higher wage rates for the remaining workers. But it is highly misleading to believe that the newer-style “industrial” unions do not restrict supply. The fact that they welcome as many members in an industry as possible cloaks their restrictionist policy. The crucial point is that the unions insist on a minimum wage rate higher than what would be achieved for the given labor factor without the union. By doing so, as we saw in Figure 69, they necessarily cut the number of men whom the employer can hire. Ergo, the consequence of their policy is to restrict the supply of labor, while at the same time they can piously maintain that they are inclusive and democratic, in contrast to the snobbish “aristocrats” of craft unionism.

In fact, the consequences of industrial unionism are more devastating than those of craft unionism. For the craft unions, being small in scope, displace and lower the wages of only a few workers. The industrial unions, larger and more inclusive, depress wages and displace workers on a large scale and, what is even more important, can cause permanent mass unemployment.\(^60\)

There is another reason why an openly restrictionist union will cause less unemployment than a more liberal one. For the union which restricts its membership serves open warning on workers hoping to enter the industry that they are barred from joining the union. As a result, they will swiftly look elsewhere, where jobs can be found. Suppose the union is democratic, however, and open to all. Then, its activities can be described by the above figure; it has achieved a higher wage rate \(0\bar{W}\) for its working members. But such a wage rate, as can be seen on the \(SS\) curve, attracts more workers into the industry. In other words, while \(0\bar{A}\) workers were hired by the industry at the previous (nonunion) wage \(AB\), now the union has won a wage \(0\bar{W}\). At this wage, only \(WC\) workers can be employed in the industry. But this wage also attracts more workers than before, namely \(WE\). As a result, instead of only \(CF\) workers becoming unemployed from

\(^{60}\text{Cf. Mises, *Human Action*, p. 764.}\)
the union’s restrictionist wage rate, more—CE—will be un
employed in the industry.

Thus, an open union does not have the one virtue of the closed union—rapid repulsion of the displaced workers from the unionized industry. Instead, it attracts even more workers into the industry, thus aggravating and swelling the amount of unemployment. With market signals distorted, it will take a much longer time for workers to realize that no jobs are available in the industry. The larger the scope of open unions in the economy, and the greater the differential between their restrictionist wage rates and the market wage rates, the more dangerous will the unemployment problem become.

The unemployment and the misemployment of labor, caused by restrictionist wage rates need not always be directly visible. Thus, an industry might be particularly profitable and prosperous, either as a result of a rise in consumer demand for the product or from a cost-lowering innovation in the productive process. In the absence of unions, the industry would expand and hire more workers in response to the new market conditions. But if a union imposes a restrictionist wage rate, it may not cause the unemployment of any current workers in the industry; it may, instead, simply prevent the industry from expanding in response to the requirements of consumer demand and the conditions of the market. Here, in short, the union destroys potential jobs in the making and imposes a misallocation of production by preventing expansion. It is true that, without the union, the industry will bid up wage rates in the process of expansion; but if unions impose a higher wage rate at the beginning, the expansion will not occur.61

Some opponents of unionism go to the extreme of maintaining that unions can never be free-market phenomena and are always “monopolistic” or coercive institutions. Although this might be true in actual practice, it is not necessarily true. It is very possible that labor unions might arise on the free market and even gain restrictionist wage rates.

How can unions achieve restrictionist wage rates on the free market? The answer can be found by considering the displaced workers. The key problem is: Why do the workers let themselves be displaced by the union’s minimum? Since they were willing to work for less before, why do they now meekly agree to being fired and looking for a poorer-paying job? Why do some remain content to continue in a quasi-permanent pocket of unemployment in an industry, waiting to be hired at the excessively high rate? The only answer, in the absence of coercion, is that they have adopted on a commandingly high place on their value scales the goal of not undercutting union wage rates. Unions, naturally, are most anxious to persuade workers, both union and nonunion, as well as the general public, to believe strongly in the sinfulness of undercutting union wage rates. This is shown most clearly in those situations where union members refuse to continue working for a firm at a wage rate below a certain minimum (or on other terms of employment). This situation is known as a strike. The most curious thing about a strike is that the unions have been able to spread the belief throughout society that the striking members are still “really” working for the company even when they are deliberately and proudly refusing to do so. The natural answer of the employer, of course, is to turn somewhere else and to hire laborers who are willing to work on the terms offered. Yet

unions have been remarkably successful in spreading the idea through society that anyone who accepts such an offer—the “strikebreaker”—is the lowest form of human life.

To the extent, then, that nonunion workers feel ashamed or guilty about “strike-breaking” or other forms of undercutting union-proclaimed wage scales, the displaced or unemployed workers agree to their own fate. These workers, in effect, are being displaced to poorer and less satisfying jobs voluntarily and remain unemployed for long stretches of time voluntarily. It is voluntary because that is the consequence of their voluntary acceptance of the mystique of “not crossing the picket line” or of not being a strikebreaker.

The economist qua economist can have no quarrel with a man who voluntarily comes to the conclusion that it is more important to preserve union solidarity than to have a good job. But there is one thing an economist can do: he can point out to the worker the consequences of his voluntary decision. There are undoubtedly countless numbers of workers who do not realize that their refusal to cross a picket line, their “sticking to the union,” may result in their losing their jobs and remaining unemployed. They do not realize this because to do so requires knowledge of a chain of praxeological reasoning (such as we have been following here). The consumer who purchases directly enjoyable services does not have to be enlightened by economists; he needs no lengthy chain of reasoning to know that his clothing or car or food is enjoyable or serviceable. He can see each perform its service before his eyes. Similarly, the capitalist-entrepreneur does not need the economist to tell him what acts will be profitable or unprofitable. He can see and test them by means of his profits or losses. But for a grasp of the consequences of acts of governmental intervention in the market or of union activity, knowledge of praxeology is requisite.62

Economics cannot itself decide on ethical judgments. But in order for anyone to make ethical judgments rationally, he must know the consequences of his various alternative courses of action. In questions of government intervention or union action, economics supplies the knowledge of these consequences. Knowledge of economics is therefore necessary, though not sufficient, for making a rational ethical judgment in these fields. As for unions, the consequences of their activity, when discovered (e.g., displacement or unemployment for oneself or others), will be considered unfortunate by most people. Therefore, it is certain that when knowledge of these consequences becomes widespread, far fewer people will be “prounion” or hostile to “nonunion” competitors.63

Such conclusions will be reinforced when people learn of another consequence of trade union activity: that a restrictionist wage raises costs of production for the firms in the industry. This means that the marginal firms in the industry—the ones whose entrepreneurs earn only a bare rent—will be driven out of business, for their costs have risen above their most profitable price on the market—the price that had already been attained. Their ejection from the market and the general rise of average costs in the industry signify a general fall in productivity and output, and hence a loss to the consumers.64 Displacement and unemployment, of course, also impair the general standard of living of the consumers.

Unions have had other important economic consequences. Unions are not producing organizations; they do not work for capitalists to improve production.65 Rather they attempt to

63The same is true, to an even greater extent, of measures of governmental intervention in the market. See chapter 12 below.
64See James Birks, Trade Unionism in Relation to Wages (London, 1897), p. 30.
persuade workers that they can better their lot at the expense of the employer. Consequently, they invariably attempt as much as possible to establish work rules that hinder management’s directives. These work rules amount to preventing management from arranging workers and equipment as it sees fit. In other words, instead of agreeing to submit to the work orders of management in exchange for his pay, the worker now sets up not only minimum wages, but also work rules without which he refuses to work. The effect of these rules is to lower the marginal productivity of all union workers. The lowering of marginal value-product schedules has a twofold result: (1) it itself establishes a restrictionist wage scale with its various consequences, for the marginal value product has fallen while the union insists that the wage rate remain the same; (2) consumers lose by a general lowering of productivity and living standards. Restrictive work rules therefore also lower output. All this is perfectly consistent with a society of individual sovereignty, however, provided always that no force is employed by the union.

To advocate coercive abolition of these work rules would imply literal enslavement of the workers to the dictates of catallactic consumers. But, once again, it is certain that knowledge of these various consequences of union activity would greatly weaken the voluntary adherence of many workers and others to the mystique of unionism.66

66We can deal here only with the directly catallactic consequences of labor unionism. Unionism also has other consequences which many might consider even more deplorable. Prominent is the fusing of the able and the incompetent into one group. Seniority rules, for example, are invariable favorites of unions. They set restrictively high wages for less able workers and also lower the productivity of all. But they also reduce the wages of the more able workers—those who must be chained to the stultifying march of seniority for their jobs and promotions. Seniority also decreases the mobility of workers and creates a kind of industrial serfdom by establishing vested rights in jobs according to the length of time the employees have worked. Cf. David McCord Wright, “Regulating Unions” in Bradley, Public Stake in Union Power, pp. 113–21.
Unions, therefore, are theoretically compatible with the existence of a purely free market. In actual fact, however, it is evident to any competent observer that unions acquire almost all their power through the wielding of force, specifically force against strikebreakers and against the property of employers. An implicit license to unions to commit violence against strikebreakers is practically universal. Police commonly either remain “neutral” when strikebreakers are molested or else blame the strikebreakers for “provoking” the attacks upon them. Certainly, few pretend that the institution of mass picketing by unions is simply a method of advertising the fact of a strike to anyone passing by. These matters, however, are empirical rather than theoretical questions. Theoretically, we may say that it is possible to have unions on a free market, although empirically we may question how great their scope would be.

Analytically, we can also say that when unions are permitted to resort to violence, the state or other enforcing agency has implicitly delegated this power to the unions. The unions, then, have become “private states.”

We have, in this section, investigated the consequences of unions’ achieving restrictionist prices. This is not to imply, however, that unions always achieve such prices in collective bargaining. Indeed, because unions do not own workers and therefore do not sell their labor, the collective bargaining of unions is an artificial replacement for the smooth workings of “individual bargaining” on the labor market. Whereas wage rates on the nonunion labor market will always tend toward equilibrium in a smooth and harmonious manner, its replacement by collective bargaining leaves the negotiators with little or no rudder, with little guidance on what the proper wage rates

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would be. Even with both sides trying to find the market rate, neither of the parties to the bargain could be sure that a given wage agreement is too high, too low, or approximately correct. Almost invariably, furthermore, the union is not trying to discover the market rate, but to impose various arbitrary “principles” of wage determination, such as “keeping up with the cost of living,” a “living wage,” the “going rate” for comparable labor in other firms or industries, an annual average “productivity” increase, “fair differentials,” etc.68

B. SOME ARGUMENTS FOR UNIONS: A CRITIQUE

(1) Indeterminacy69

A favorite reply of union advocates to the above analysis is this: “Oh, that is all very well, but you are overlooking the indeterminacy of wage rates. Wage rates are determined by marginal productivity in a zone rather than at a point; and within that zone unions have an opportunity to bargain collectively for increased wages without the admittedly unpleasant effects of unemployment or displacement of workers to poorer jobs.” It is curious that many writers move smoothly through rigorous price analysis until they come to wage rates, when suddenly they lay heavy stress on indeterminacy, the huge zones within which the price makes no difference, etc.

In the first place, the scope of indeterminacy is very small in the modern world. We have seen above that, in a two-person barter situation, there is likely to be a large zone of indeterminacy between the buyer’s maximum demand price and the seller’s minimum supply price for a quantity of a good. Within this zone, we can only leave the determination of the price to

68On the nature and consequences of these various criteria of wage determination, see Ford, Economics of Collective Bargaining, pp. 85–110.
69See the excellent critique by Hutt, Theory of Collective Bargaining, passim.
bargaining. However, it is precisely the characteristic of an advanced monetary economy that these zones are ever and ever narrowed and lose their importance. The zone is only between the “marginal pairs” of buyers and sellers, and this zone is constantly dwindling as the number of people and alternatives in the market increase. Growing civilization, therefore, is always narrowing the importance of indeterminacies.

Secondly, there is no reason whatever why a zone of indeterminacy should be more important for the labor market than for the market for the price of any other good.

Thirdly, suppose that there is a zone of indeterminacy for a labor market, and let us assume that no union is present. This means that there is a certain zone, the length of which can be said to equal a zone of the discounted marginal value product of the factor. This, parenthetically, is far less likely than the existence of a zone for a consumers’ good, since in the former case there is a specific amount, a DMVP, to be estimated. But the maximum of the supposed zone is the highest point at which the wage equals the DMVP. Now, competition among employers will tend to raise factor prices to precisely that height at which profits will be wiped out. In other words, wages will tend to be raised to the maximum of any zone of the DMVP.

Rather than wages being habitually at the bottom of a zone, presenting unions with a golden opportunity to raise wages to the top, the truth is quite the reverse. Assuming the highly unlikely case that any zone exists at all, wages will tend to be at the top, so that the only remaining indeterminacy is downward. Unions would have no room for increasing wages within that zone.

(2) Monopsony and Oligopsony

It is often alleged that the buyers of labor—the employers—have some sort of monopoly and earn a monopoly gain, and that therefore there is room for unions to raise wage rates without injuring other laborers. However, such a “monopsony” for the purchase of labor would have to encompass all the entrepreneurs
in the society. If it did not, then labor, a nonspecific factor, could move into other firms and other industries. And we have seen that one big cartel cannot exist on the market. Therefore, a “monopsony” cannot exist.

The “problem” of “oligopsony”—a “few” buyers of labor—is a pseudo problem. As long as there is no monopsony, competing employers will tend to drive up wage rates until they equal their DMVPs. The number of competitors is irrelevant; this depends on the concrete data of the market. Below, we shall see the fallacy of the idea of “monopolistic” or “imperfect” competition, of which this is an example. Briefly, the case of “oligopsony” rests on a distinction between the case of “pure” or “perfect” competition, in which there is an allegedly horizontal—infinitely elastic—supply curve of labor, and the supposedly less elastic supply curve of the “imperfect” oligopsony. Actually, since people do not move en masse and all at once, the supply curve is never infinitely elastic, and the distinction has no relevance. There is only free competition, and no other dichotomies, such as between pure competition and oligopsony, can be established. The shape of the supply curve, furthermore, makes no difference to the truth that labor or any other factor tends to get its DMVP on the market.

(3) Greater Efficiency and the “Ricardo Effect”

One common prounion argument is that unions benefit the economy through forcing higher wages on the employers. At these higher wages the workers will become more efficient, and their marginal productivity will rise as a result. If this were true, however, no unions would be needed. Employers, ever eager for greater profits, would see this and pay higher wages now to reap the benefits of the allegedly higher productivity in the future. As a matter of fact, employers often train workers, paying higher wages than their present marginal product justifies, in order to reap the benefits of their increased productivity in later years.
A more sophisticated variant of this thesis was advanced by Ricardo and has been revived by Hayek. This doctrine holds that union-induced higher wage rates encourage employers to substitute machinery for labor. This added machinery increases the capital per worker and raises the marginal productivity of labor, thereby paying for the higher wage rates. The fallacy here is that only increased saving can make more capital available. Capital investment is limited by saving. Union wage increases do not increase the total supply of capital available. Therefore, there can be no general rise in labor productivity. Instead, the potential supply of capital is shifted (not increased) from other industries to those industries with higher wage rates. And it is shifted to industries where it would have been less profitable under nonunion conditions. The fact that an induced higher wage rate shifts capital to the industry does not indicate economic progress, but rather an attempt, never fully successful, to offset an economic retrogression—a higher cost in the manufacture of the product. Hence, the shift is “uneconomic.”

A related thesis is that higher wage rates will spur employers to invent new technological methods to make labor more efficient. Here again, however, the supply of capital goods is limited by the savings available, and there is almost always a sheaf of technological opportunities awaiting more capital anyway. Furthermore, the spur of competition and the desire of the producer to keep and increase his custom is enough of an incentive to increase productivity in his firm, without the added burden of unionism.70

70 On the Ricardo effect, see Mises, Human Action, pp. 767–70. Also see the detailed critique by Ford, Economics of Collective Bargaining, pp. 56–66, who also points to the union record of hindering mechanization by imposing restrictive work rules and by moving quickly to absorb any possible gain from the new equipment.
Session 4
The Nature of Taxation

- **Power and Market**
  Chapter 4: Binary Intervention: Taxation

- **Economic Controversies**
  The Myth of Neutral Taxation
The Myth of Neutral Taxation

A neutral mode of taxation is conceivable that would not divert the operation of the market from the lines in which it would develop in the absence of any taxation.

Ludwig von Mises, Human Action (1949)

Economists have long believed that government’s tax and expenditure policy either is, or can readily be made to be, neutral to the market. Free-market economists have advocated such neutrality of government, and even economists favoring redistributive actions by government have believed that the service activities and the redistributive activities of government can easily be distinguished, at least in concept. The purpose of this paper is to examine the nature and implications of fiscally neutral government; the paper argues that all government activities necessarily divert incomes, resources, and assets from the market, and therefore that the quest for a neutral tax or expenditure policy is an impossible one and the concept a myth.

Structure of the Free Market: Consumers and Incomes

To evaluate the idea of a neutral government, we must first define what neutrality to the market may be. Any firm or institution is neutral to the market when it functions as part of the market. That is, both General Motors and Mom and Pop’s Candy Store are part of the market, and insofar as their activities remain within the market, they are neutral to it.¹

¹Thus lobbying or other government-related activities by any business firm would not be neutral to the market.
We may analyze market institutions according to the following categories: (a) what and how much they produce, and (b) how much and from where the institution receives monetary funds. For every institution produces goods or services and receives money.

There are two types of market institutions. One is the business firm. The firm is guided by its expectations of monetary income from customers in payment for its products. The firm receives funds from two sources: (b1) customer expenditures, and (b2) entrepreneurial investments. Entrepreneurial investments are monies invested in the firm to purchase or hire factors of production to make goods and services to be sold to customers. The investments are savings spent in anticipation of greater returns from selling products to customers. Although the conspicuous resource and production decisions in the market are made by capitalist-entrepreneurs—by the owners of the firm and its capital assets—these decisions are made in accordance with their expectations of monetary income from customers. In short, businessmen are guided by the quest for monetary profits and the wish to avoid monetary losses, and their forecasting and anticipations must turn out to be good enough to reap profits from their production decisions. The intake of investment funds into the firm, then, is subordinate to the expected profit to be made from sales to customers.

Business firms and the structure of capital assets in the economy, as Austrian School economists have shown, are not a homogeneous lump: Production is a structure of stages, a latticework that moves from the most “roundabout” processes of production—the stages of production most remote from the consumers—down to nearer processes, and finally down to the production and sale of goods and services to the ultimate consumers. The ham sandwich at the local coffee shop begins with the mining of ore for tools and machines and the growing of grain to feed hogs, and continues in stage after stage down through the wholesale and retail stages, until it arrives in the maw of the final buyer, the consumer. Thus, for our purposes, we can short-circuit the structure and refer to the consumer as the basic source of the income of business firms; ultimately, it is consumer

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demand that provides profits or losses to business firms and either vindicates or not prior production decisions by investors.

Investments that bring money into the firm in anticipation of consumer demand, \((b_2)\), consist of two parts. The basic investment \((b_{2a})\) is investment by the owner or owners of the firm in the form of personal savings, partnerships, or investment in corporate stock. Auxiliary investment \((b_{2b})\), are loans to the owners of the firm by other capitalists, either in the form of short-term credit or long-term debentures. The willingness of the firm’s owners to pay a fixed-interest return to lenders is, of course, a function of their anticipated profit in selling the product to the consumers. Willingness to pay interest will always be less than or equal to the anticipated profit rate; and in the long-run general-equilibrium world of changeless certainty—a world that has never and can never come into existence—the rate of return would be equal throughout the market economy. In that world, the rate of profit in every firm would be equal to the rate of interest on loans.3

For market firms, therefore, there is no mystery about the determination of their production decisions and income. The former are determined by firms’ anticipation of consumer demand, and the latter by the reality of that demand. Hence, firms receive their income, in the final analysis, from serving consumers. The more efficiently and ably the firms anticipate and serve consumer demand, the greater their profits; the less ably, the less their profits and the more they suffer losses.

Finally, the owners of the factors of production—land, labor, and capital goods—receive their income in advance of production from the investor-owners of the firm. The more ably and productively a factor or factors are believed to serve consumer demand, the greater the

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3Both would be determined by the social rate of time preference as determined on the market, the premium of present as compared with future goods—an agio which would be the resultant of all the time-preference schedules by individuals on the market, in much the same way as consumer demand is the embodiment of the marginal-utility schedules of individuals. See Murray N. Rothbard, *Man, Economy, and State*, 2nd ed. (Los Angeles: Nash, 1970), vol. 1, chap. 6; Frank A. Fetter, *Capital, Interest, and Rent: Essays in the Theory of Distribution* (Kansas City: Sheed Andrews and McMeel, 1977), pt. 2.
demand for those factors by the owners, and the higher their income. Since capital goods themselves form part of the structure of production, ultimately factor incomes consist of the income from the exertion of labor energy (wages, salaries), the use of land (land rents), and the transfer of money (a present good) in exchange for anticipated future income (a future good)—that will yield interest (or long-run profit) for time preference, and entrepreneurial profits or losses. All these factor incomes then, are tied to the efficient service of anticipated consumer demand.4

Incomes to factors and entrepreneurs on the market, therefore, are tied inextricably to the effective satisfaction of consumer demand, a satisfaction that depends on the successful forecasting of the market conditions that will exist when and after the goods or services are produced. Income to the firm and to factors from consumers is linked inextricably to the satisfaction the consumers derive. In a deep sense, therefore, income to producers on the market reflects benefits to consumers.

The crucial point is that when consumers spend, they benefit, because the expenditures are voluntary. The consumers buy product X because they decide that, for whatever reason, it would benefit them to buy that product rather than use the money on some other product or save or add to their cash balances. They give up money for product X because they expect to prefer that product to whatever they could have done with the money elsewhere; their preference reflects a judgment of relative benefit from that, as compared to another, purchase. In my own terms, spending choices by consumers demonstrate their preference for one, as compared to another, way of using their money.5

4That is, each unit of each factor will tend to receive its discounted marginal revenue product, its marginal value productivity discounted by the rate of interest. So each unit of land and labor will tend to receive its DMRP, and the capitalist (or lender) will receive the discount (in the form of interest or long-run profit). Only in the never-never land of general equilibrium would each factor always receive its DMRP; in the real world, the positive or negative differences would reflect entrepreneurial profits and losses. See Rothbard, *Man, Economy, and State*, chap. 7.

5On the concept and implications of “demonstrated preference,” see Murray N. Rothbard, *Toward a Reconstruction of Utility and Welfare Economics*
And that is not all. The profit-and-loss tests of the market, the rewarding of effective producers and forecasters and the punishing of ineffective ones, ensures that the overall ability at any time of entrepreneurs to forecast and satisfy consumer demands will be high. Good forecasters will be rewarded with higher profits and incomes; poor forecasters will suffer losses and finally leave the business. So that the market tendency is toward a high level of fit between anticipation and reality, and for a minimum of erroneous investment. Producer income, therefore, reflects consumer benefit even more closely than we might at first realize.6

The second type of market institution—after the business firm—is the voluntary nonprofit membership organization: the bridge club, lodge, ideological organization, or charitable agency. Here, too, income and benefit are cognate. Income is no longer divided between investors and consumers. All income is obtained from members, either in the form of regular dues or systematic or occasional donations. The purpose of the organization is not to earn a monetary profit, but to pursue various purposes desired by the income-paying members. In a sense, then, the members are the “consumers,” except that they consume the services of the organization not by purchasing a product but by helping the organization pursue its goals. The member-donors are at the same time the consumers and the investors, the consumers and the makers of the production decisions.7 The organization will employ as much of its resources as the member-consumer-donors desire to contribute to the pursuit of their goals.

6This, however, is a long way from saying, with conventional neoclassical economists, that general equilibrium and perfect knowledge are facts of reality, or, with the rational-expectations economists, that the market always perfectly forecasts the future. If this were true, there would be no room for entrepreneurship at all, and the most dynamic and vital aspect of the market economy would go unremarked and unexplained. See Gerald P. O’Driscoll, Jr., “Rational Expectations, Politics, and Stagflation,” in *Time, Uncertainty, and Disequilibrium: Exploration of Austrian Themes*, Mario J. Rizzo, ed. (Lexington, Mass.: Lexington Books, 1979), pp. 153–76.

7For convenience, “members” and “donors” shall be used interchangeably throughout, although in many cases donors are technically not “members” of the organization.
Membership organizations, while clearly part of the market, are necessarily limited in their scope, for they do not follow the division of labor necessary for most market production. In virtually all other cases of production, the producers and the consumers are not one and the same: The producers of steel bars do not, Heaven forfend, use up those selfsame bars in their own consumption. They sell the bars for money and exchange the money for other goods that they would like to consume. In the case of membership organizations, however, the member-investors are the consumers of the service.

Even where the explicit goals of the organization are to help non-donors, this rule—that the consumers guiding production decisions are the donors—still applies. Suppose, for example, the organization is a charity giving alms to the poor. In a sense, the purpose is to benefit the poor, but the actual consumers here, the guides to production decisions, are the donors, not the recipients of charity. The charity serves the purposes of the donors, and these purposes are in turn to help the poor. But it is the donors who are consuming, the donors who are demonstrating their preference for sacrificing a lesser benefit (the use of their money elsewhere) for a greater (giving money to the charity to help the poor). It is the donors whose production decisions guide the actions of the charity.

In this case, presumably, the donors themselves will be guided, in their turn, by how effective the organization is in ministering to the poor. But the ways of judging this effectiveness lack the precision of monetary purchase, or profit and loss. They depend on subjective interpretation by the donors, an interpretation that is necessarily subject to a great deal of error. Donors, in the same way, are the consumers regardless of the purpose of the nonprofit organization, whether it is chess playing, medical research, or ideological agitation. In all these cases, precise profit-and-loss tests of effectiveness are lacking; in all these cases, too, donors voluntarily pursue their activity, preferring it to other uses of their resources.\(^8\)

Nonprofit organizations also purchase and hire factors of production. To a large extent, these organizations compete with business

\(^8\)The lack of precise guidance in nonprofit organizations is not a criticism of their existence; this lack is simply a part of the nature of the case, and it is taken into account by the donors when they make their “investment” decisions in the organization.
firms for factors; to that extent, they must pay the factors at least the discounted marginal product they can earn elsewhere. To some extent, however, the factors may be specific to these organizations; to that extent their marginal product incorporates their service to the donor-consumers, that is, the extent to which they pursue the same goal as the sources of income. Thus, in both the profit-making and the nonprofit sectors, in their different forms, production decisions are guided by service to the consumers. The main difference is that in the case of business firms, the consumers are separate from the producers, and (we hope) recoup producers’ investments by buying the products of the firm; while in nonprofit organizations, the consumers are the donor-investors.

We have been describing two polar cases: the business firm, and the nonprofit organization. Probably most real-world institutions on the market fall into one of these categories. In some cases, however, an organization can partake of both modes. Let us consider two cases. First, a charitable organization, instead of, or in addition to, giving away alms, may sell some products to the poor at a low, subsidized price. In this case, while the donors provide the overall thrust and guidance, part of the feedback gained by the firm is willingness to buy goods by the recipients. In some sense, the recipients of alms provide a guide to their interest in the organization. There are now two sets of consumers: the donors, and the charity recipients, each of whom demonstrates its preference for this organization in contrast to other uses for its money.9 But the overall purpose of the organization is not to make a profit, but rather to serve the values and goals of the donors, and so the donors must be considered the regnant consumers in this situation.

Another case is a profit-making business firm where the owner or owners decide to accept a lesser monetary profit on behalf of some other goals of the owners: for example, because a certain line of product is considered immoral by the owners or because the owner wishes to hire incompetent relatives in order to keep peace in the family.

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9 In a trivial sense, of course, being willing to accept a free gift by a charity is also a demonstration of preference by the recipient, but only in the trivial sense that he prefers more of a good to less. The recipient is not sacrificing any good or service in exchange.
Here once again, these are two sets of consumers—the buyers of the product, and the producers or owners themselves. Because of his own values as a “consumer,” the owner decides to forego monetary profit because of his own moral principles or because he holds keeping peace in the family high on his value scale. In either case, the owner is forgoing some monetary profit in order to achieve psychic profit. Which motive will dominate depends on the facts of each particular case. Since the market is generally characterized by a division of labor between producers and consumers, however, the general tendency will be for monetary profit, or service to nonowning consumers, to dominate the decisions of business firms.\(^\text{10}\)

It is a basic fact that all voluntary actions are undertaken because actors expect to benefit from them. When two persons make a voluntary exchange of goods or services, they do so because each expects to benefit from the exchange. When A trades commodity X for B’s commodity Y, A is demonstrating a preference—an expected net benefit—for Y over X, while B is demonstrating the opposite, a preference for X over Y. The free market is a vast latticework of two-person (or two-group) exchanges, an array of mutually beneficial exchanges up and down and across the structure of production.\(^\text{11}\)

\(^\text{10}\)It is curious that statist critics of the market invariably denounce “production for [monetary] profit” as greedy and selfish, and instead uphold “production for use” as unselfish and altruistic. On the contrary, producers can only make monetary profits to the extent that they serve other consumers. Logically, altruists should deeply admire the successful pursuit of monetary gain on the market.

It is also curious that many writers believe that the maximum-(monetary)-profit assumption for business motivation may have been true for personally owned nineteenth-century firms, but that it no longer holds for the modern corporation. On the contrary, it is precisely the modern corporation where “impersonality” of investment and producer decision will tend to dominate, since the personal wishes of single owners are no longer nearly as important. Unprofitable nepotism, for example, is far more likely to reign in the mom and pop store than in the large corporation.

\(^\text{11}\)In a voluntary gift transaction, both parties also benefit; the donee benefits from the receipt of the gift and demonstrates this benefit by accepting it; the donor benefits psychically from the fact of having made the gift, and demonstrates that benefit by making it.
ROBBERY AND THE MARKET

Having dealt with this idyll of harmonious and mutually beneficial exchanges, let us now introduce a discordant note. A thief now appears, making his living by robbing and coercively preying on others: The robber obtains his income by presenting the victim with a choice: your money or your life (or, at least, your health)—and the victim then yields his assets. Or, to be more precise, the robber presents the victim with a choice between paying immediately or waiting until the robber injures him. In this situation both parties do not benefit; instead, the robber benefits precisely at the expense of the victim. Instead of the consumer’s paying, guiding, and being benefited by the producer’s activity, the robber is benefiting from the victim’s payment. The robber benefits to the extent that the victim pays and loses. Instead of helping expand the amount and degree of production in society, the robber is parasitically draining off that production. Whereas an expanded market encourages increases in production and supply, theft discourages production and contracts the market.

It should be clear that the robber is not producing any goods and services at all. In contrast to consumers who purchase goods and services, or who contribute voluntarily to a nonprofit organization, no one is voluntarily purchasing from or contributing to our criminals at all. If they were, the criminals would not be criminal. In fact, what distinguishes a criminal group is that its income, in contrast to that of all other organizations, is extracted by the use of violence, against the wishes or consent of the victims. The criminals, then, are “producing” nothing, except their own income at the expense of others.

It has been maintained that the payments by the victims are “really” voluntary because the victim decides to transfer his funds under penalty of violence by the robber. This kind of sophistry, however, destroys the original, as well as the common-sense, meaning of the term “coercion” and renders all actions whatever “voluntary.” But if there is no such thing as coercion and all conceivable actions are voluntary, then the distinctive meaning of both terms is destroyed. In this paper, we are defining “voluntary” and “coercion”

12Burglars, as distinct from robbers, do not confront their victims directly and so present him with no choice; but they employ physical coercion by seizing his property without his consent.
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in a common-sense way: that is, “voluntary” are all actions not taken under the threat of coercion; and “coercion” is the use of violence or threat of violence to compel actions of others. Robbery at gunpoint, then, is “coercion”; the universal need to work and produce is not. In a trivial sense, the victim agrees to be victimized rather than lose his life; but surely, to call such a choice or decision “voluntary” is a corruption of ordinary language. In contrast to truly voluntary decisions, where each person is better off than he was before the prospect of exchange came into view, the robbery victim is simply struggling to cut his losses, for, in any case, he is worse off because of the entry of the robber onto the scene than he was before.

Just as the claim that the victim’s payment to the thief is “voluntary” is patently sophistical, so is it absurd to claim that the robber is “producing” some service to the victim or anyone else. The fact that the victim paid him revenue proves no demonstrated preference or value; it proves only that the victim prefers the imposition to being shot.

The robber may well spin elaborate arguments for his productivity and for his alleged benefit to the victim. He may claim that by extracting money he is providing the victim a defense from other robbers. In attempting to achieve and maintain his monopoly of loot, he may very well act against other robbers trying to muscle in on his territory. But this “service” scarcely demonstrates his productivity to the victims. Only if the victims pay the robber voluntarily can any case be made for a nexus of payment and benefit. Since payments are now coercive instead of voluntary, since the consumer has now become the victim, all arguments offered by the criminal and his apologists about why the victim should have been eager to pay the criminal voluntarily are in vain, for the stark and overriding fact is that these payments are compulsory.

The robber takes the funds extracted from the victims and spends them for his own consumption purposes. The total revenue collected by theft we may call tribute; the expenditures of the robbers, apart from the small sums spent on burglars’ tools, weapons, planning, and so on, are consumption expenses by the robbers. In this way, just as income and assets are diverted from the productive sector to the robbers, so the robbers are able to use that money (in their purchasing) to extract productive resources from the market.
We conclude, then, that the activities of thieves are most emphatically not neutral to the market. In fact, the robbers divert income and resources from the market by the use of coercive violence, and thereby skew and distort production, income, and resources from what they would have been in the absence of coercion. If, on the contrary, we adhere to the view that theft is voluntary and criminals productive, then criminal activities, too, would be neutral to the market, in which case the entire problem of neutrality would disappear by semantic legerdemain, and everything by definition would be neutral to the market because the rubric of the market would encompass all conceivable activities of man. In that case, nothing could be called “intervention” into the market. By labeling aggressive violence as “coercion” and as an interference into the market, we avoid this kind of absurd trap, and we cleave closely to the commonsense view of such concepts as “coercion,” “voluntary,” “market,” and “intervention.”

**Government as Robber**

We are now in a position to analyze government and its relationship to the market. Economists have generally depicted the government as a voluntary social institution providing important services to the public. The modern “public choice” theorists have perhaps gone furthest with this approach. Government is considered akin to a business firm, supplying its services to the consumer-voters, while the voters in turn pay voluntarily for these services. All in all, government is treated by conventional economists as a part of the market, and therefore, as in the case of a business firm or a membership organization, either totally or in part neutral to the market.

It is true that if taxation were voluntary and the government akin to a business firm, the government would be neutral to the market. We contend here, however, that the model of government is akin, not to the business firm, but to the criminal organization, and indeed that the State is the organization of robbery systematized and writ large. The State is the only legal institution in society that acquires its revenue by the use of coercion, by using enough violence and threat of violence on its victims to ensure their paying the desired tribute. The State benefits itself at the expense of its robbed victims. The State is, therefore, a centralized, regularized organization of theft. Its payments extracted by coercion are called “taxation”
instead of tribute, but their nature is the same. The German sociologist Franz Oppenheimer saw this clearly when he wrote that

there are two fundamentally opposed means whereby man, requiring sustenance, is impelled to obtain the necessary means for satisfying his desires. These are work and robbery, one's own labor and the forcible appropriation of the labor of others. . . . I propose . . . to call one's own labor and the equivalent exchange of one's own labor for the labor of others, the "economic means" for the satisfaction of needs, while the unrequited appropriation of the labor of others will be called the "political means."13

Oppenheimer then proceeded to identify the State as the "organization of the political means."14 Or, as the libertarian writer Albert Jay Nock vividly put it:

The State claims and exercises the monopoly of crime. . . . It forbids private murder, but itself organizes murder on a colossal scale. It punishes private theft, but itself lays unscrupulous hands on anything it wants, whether the property of citizen or alien.15

Or, as Ludwig von Mises points out, this regularization establishes a systematic coercive hegemonic bond between the rulers of the State and the subject that contrasts vividly with the contractual bond of mutual benefit.

There are two different kinds of social cooperation: cooperation by virtue of contract and coordination, and cooperation by virtue of command and subordination or hegemony. Where and as far as cooperation is based on contract, the logical relation between the cooperating parties is symmetrical. They are all parties to interpersonal exchange contracts. John has the same relation to Tom as Tom has to John. Where and as far as cooperation is based on command and subordination, there is the man who commands and there are those who obey his order. The logical relation between these two classes of men is asymmetrical. There is a director and

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14 Ibid.
there are people under his care. The director alone chooses and directs; the others—the wards—are mere pawns in his actions.\footnote{Mises, \textit{Human Action}, p. 196.}

In this coercive, hegemonic condition, the individual must either accept the orders of the ruler or rebel. To the extent that the person submits, this choice then subjects him to the continuing hegemony of the rulers of the State. Contrasting the contractual and the hegemonic, Mises states:

In the frame of a contractual society the individual members exchange definite quantities of goods and services of a definite quality. In choosing subjection in a hegemonic body a man neither gives nor receives anything that is definite. He integrates himself into a system in which he has to render indefinite services and will receive what the director is willing to assign to him. He is at the mercy of the director. The director alone is free to choose. Whether the director is an individual or an organized group of individuals, a directorate, and whether the director is a selfish maniacal tyrant or a benevolent paternal despot is of no relevance for the structure of the whole system.\footnote{Ibid., p. 197.}

Mises goes on to contrast the system of contractual coordination that is responsible for much of the achievements of Western civilization with the hegemonic system embodied in the State, “an apparatus of compulsion and coercion . . . by necessity a hegemonic organization.”\footnote{Ibid., p. 198. this is not to imply that Mises believed that the State could or should be abolished; instead, he believed that the world should be preponderantly a product of contractual relations. (Italics mine.)}

The idea that taxation is voluntary seems to be endemic among economists and social scientists, though hardly so among the general public.\footnote{We speak here of “voluntary” in the nontrivial sense that distinguishes it from the “involuntary” or “coerced” payment to thieves.}

Failure to pay taxes subjects one to civil and criminal penalties. There should be little need to pursue the matter beyond this, were not economists determined to deny this
patently obvious fact. As Joseph Schumpeter trenchantly declared: “The theory which construes taxes on the analogy of club dues or of the purchases of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind.”

But if taxation is coercive and a system of organized theft, then any “services” that the government may supply to its subjects are beside the point, for they do not establish the government as voluntary or as part of the market any more than a criminal band’s providing the “service” of defending its victims from competing bands establishes that its services are voluntarily paid for. These services are not voluntarily paid for by the taxpayers, and we therefore cannot say that the taxes measure or reflect any sort of benefit. In the case of voluntary purchase on the market, as we have seen, the consumer demonstrates by his purchase that he values the good or service he buys more than the price he pays; but in paying taxes he demonstrates no such thing—only the desire not to be the recipient of further violence by the State. We have no idea how much the taxpayers would value these services, if indeed they valued them at all. For example, suppose that the government levies a tax of X dollars on A, B, C, and so on, for police protection—for protection, that is, against irregular, competing looters and not against itself. The fact that A is forced to pay $1,000 is no indication that $1,000 in any sense gauges the value to A of police protection. It is possible that he values it very little, and would value it less if he could turn to competing defense agencies. Moreover, A may be a pacifist; so he may consider the State’s police protection a net harm rather than a benefit. But one thing we do know: If these payments to government were voluntary, we can be sure that they would be substantially less than present total tax revenue. Why? Because if people were willing to pay voluntarily, then there would be no need for the apparatus of coercion so intimately wrapped up in taxation.

A second important point is that, in contrast to the market, where consumers pay for received benefits (or, in nonprofit organizations,
where members pay for psychic benefits), the State, like the robber, creates a total disjunction between benefit and payment. The taxpayer pays; the benefits are received, first and foremost, by the government itself, and secondarily, by those who receive the largess of government expenditures.

But if, under coercive taxation, tax payments far exceed benefits to the victim, and if benefits accrue to the government itself and to the recipients of its expenditures at the expense of taxpayers, then it should be quite clear that it is impossible for taxes ever to be neutral to the market. Taxation, whatever its size or incidence, must distort market processes, must alter the allocation and distribution of assets, incomes, and resources.

**The Alleged Voluntariness of Taxation**

Despite the fact that government and taxation are patently coercive, economists have devoted considerable energy, in numerous ways, to maintaining the contrary. If government and taxation were truly voluntary, then taxation would be akin to a market payment, and government could be deemed a part of, and therefore neutral to, the market.

By lumping government along with private expenditures as a gauge of the output of the economy, the conventional national income statisticians are implicitly assuming that government is neutral to the market because government provides those “services” that “society” desires it to supply. Government “output” is equated to the salaries paid to the bureaucracy. By employing the seemingly precise method of segregating some government expenses as mere “transfer payments”—the taxing of Peter to pay Paul—rather than productive purchases of goods and services, the national income statisticians are in reality making an unsupportable ideological judgment. For in what sense does the hiring of bureaucrats, or the purchasing of paper clips, add to the production of the economy and therefore become somehow voluntary, while transfer payments are frankly taxing one group to subsidize another? As we shall see further below, all taxation necessarily involves taking from one group to subsidize another; therefore all government expenditures, taken together, constitute one giant transfer payment.

Even if one does not go that far, it is a rare person who would not concede that at least 50 percent of government expenditures are
sheer waste, which would mean that they should not form part of the estimated national product at all. Despite his recognition of this fact, as well as the shakiness of ranking government expenses along with market expenditures, Sir John Hicks finally sees no alternative. He puts it this way:

I can see no alternative but to assume that the public services are worth to society in general at least what they cost . . . One may feel considerable qualms about such an assumption—it is obvious that the government spends far too much on this, far too little on that: but if we accept the actual choices of the individual consumer as reflecting his preferences . . . then I do not see that we have any choice but to accept the actual choices of the government, even if they are expressed through a Nero or a Robespierre, as representing the actual wants of society.21

Elsewhere, Hicks explains that in constructing national product figures, “the social accountant . . . must work upon some convention which is independent of his individual judgment.”22 It is remarkable that Hicks can find security from the shoals of individual judgment in assuming that Nero or Robespierre embody “the actual wants of society.” Can he really believe that this fictive “society” and its head of State adequately represent the preferences of individual citizens?

Collective Goods

More intellectually respectable is the contention that insofar as government supplies society with “collective goods” or “public goods,” it is supplying a necessary service and is in a sense voluntary and neutral to the market. Collective goods are goods that allegedly cannot be supplied on the private market because they are indivisible and therefore cannot be allocated by having individual consumers pay for their own portions of the product. No consumer can be excluded from receiving the good. Like the sun, collective goods shine on all alike, and none can be made to pay for the service. Professor Buchanan, sympathetic to the idea of an “ideally neutral fiscal system,” defines it as one that “uniquely aims at providing the social group with some

22Hicks to Rubner, Sept 28, 1966. In Rubner, Sacred Cows, p. 54 n.
‘optimal’ or ‘efficient’ quantity of collective goods and services.” Then, if “the fiscal system is conceived as the means through which collective goods and services are provided to members of the society without any subsidiary or supplementary social purposes,” we have, says Buchanan, an “analogy with the market economy.” The fiscal system is then “ideally neutral” to the market economy.23

In the first place, even if there were such things as collective goods, government supply would establish neither its voluntarism nor its neutrality. Even if there were no other way to supply these services, taxation to provide them is still compulsory. And since it is coercive, there is no standard, as there is on the market, to decide how much of these services to supply by taxation. And the more the government provides, the less people are allowed to spend on their own private consumption.

Furthermore, if there exists but one anarchist in any society, the very existence of the State coercively supplying a collective good constitutes a great psychic harm to that anarchist. The anarchist, therefore, receives not a collective service but an individual harm from the operations of the State. It follows therefore that the good or service cannot be truly collective; its “service” is separable, and distinctly negative, to the anarchists. Hence, the good can neither be truly collective (indivisible, and positive) nor can it be voluntary.24 No matter how “divisible” the service, furthermore, a collective good


24After identifying the essence of government as coercion, and after carefully analyzing each type of government and “political entrepreneurship,” Montemartini concludes that “there are no public, or collective needs in the strict sense of the word, as opposed to private needs. It is always real individuals who calculate the advantages of imposing on the community the production of certain specific goods.” And these individuals’ valuations will differ: “The calculations of economic advantage differ from one associate to another when it comes to determining the needs to be satisfied collectively.” Hence, the production of “collective goods” is always coercive: “The collectivization of the satisfaction of some needs always aims at a participation in the costs of economic units which would not voluntarily have so participated.” Giovanni Montemartini, “The Fundamental Principles of a Pure Theory of Public Finance,” in Classics in the Theory of Public Finance, Richard Musgrave and Alan Peacock, eds. (New York: Macmillan, 1958), pp. 150–51.
is not quite like the sum: The more resources the government expends, the greater will be its output. These resources will have to be extracted from other potential products. Take, for example, “defense” or police protection, which is often considered to be provided as a homogeneous lump to everyone. But every good or service in the world, “collective” ones included, are provided, not in lump sum, but in marginal units. Yet strangely, economists, trained to think of marginal units everywhere else, suddenly start referring to defense as a “lump” when discussing government. In reality, however, there is a vast range of “defense” services that the government (or any other defense agency) could supply to its customers. To take two polar extremes, the government could supply one unarmed policeman for an entire country, or it could sink most of the national product into providing an armed bodyguard, replete with tank and flame throwers, for every citizen. The question that must be answered by any defense agency is not whether or not to supply defense, but how much defense to supply to whom? In the same way, the question confronting a steel company is not whether or not to produce steel, but how much steel of various grades and types to supply.

But this failure to provide rational criteria for amounts and types of collective services is an inherent flaw in any provision by government. The market’s price system and profit-and-loss test tell private firms how much of what kind of steel to produce; rational criteria for satisfying consumers most efficiently are inherent in the free market. But government can have no such criteria. Since the consumers of defense do not pay for the service, since taxes do not measure the service, and since the government does not have to worry about losses that can be recouped by further taxation, there are no criteria of how much defense to provide to whom. Decisions are purely arbitrary, as well as coercive. If, on the other hand, defense were provided by private firms on the market, then these firms would, as in the rest of the market, supply efficiently the amounts and types of protection desired by particular customers. Those customers, for example, who desired and were willing to pay for round-the-clock bodyguards would do so; those who felt no need for protection—or pacifists aghast at the very idea—would pay nothing; and there might be a large spectrum of services in between.

More specifically: Only a minority of specific individuals find themselves in actual need of police or judicial protection during any
given period. If A and B are attacked, the police can spring to the aid of these specific persons. It will be objected that even if only a few persons are actually attacked at any one time, no one can determine who will be attacked in the future, and so everyone will want to be sure of protection in advance, thus salvaging the notion of a “collective want.” But, again, there will be a spectrum of opinion among individuals. Some persons may feel pretty sure that they will not be attacked, and will therefore be willing to opt out of protection, to take their chance rather than pay a protection tax. Others will be confident of their own ability to repulse an attack, or would only patronize another, competing private defense agency. Others may fear an attack so little that the cost of paying protection will not be worth the benefit. On the free market, individuals would be free to choose any or none of these protection-insurance packages.

Even if it be conceded that not all people demand protection, it might still be argued that defense is a “collective good” because no one can be excluded from receiving its benefits. But surely if the inhabitants of a particular block refuse to pay for the police protection, the police may simply exclude that block from its patrols or other services. In the case of judicial protection, the conventional case for a collective good is even weaker. For surely a court, financed by voluntary payment (either by insurance premium or by fee-for-service), can refuse to hear the case of a nonpaying plaintiff. Even in the case of national defense, which seems to be a particularly strong example of a collective good, the pacifist or anarchist receives a harm rather than a good, and exclusion can be practiced in such ways as not rushing troops or planes to defend nonpaying areas, or at the very least not to defend them as rapidly and as diligently as areas that do pay.

Thus defense cannot be a collective good so long as only one pacifist or one anarchist exists in the society, for these persons will receive a harm rather than a benefit when they receive the “service” of coercive defense. And defense is not a collective good because its recipients can be excluded and separated.

Professor Kenneth Goldin is one of the very few economists to recognize that defense service is separable and not indivisible. He also points out that increased police service requires increased expense:
As communities grow, and more residents must be supplied with crime defense, most communities hire more policemen; clearly an increased cost. If more policemen are not hired, then new residents can be served only by decreasing service to others: more streets can be patrolled only if there are fewer patrols at night; more properties can be checked only if each one is checked less thoroughly, and only the more urgent calls can be responded to. Each of these service changes imposes costs on residents. Either they will suffer from more crime, or they will incur the costs of purchasing other types of crime defense. Many types of crime defense are selectively available such as locks, fences, guard dogs, guards, and also alarm companies which respond if the burglar alarm is tripped. And don’t overlook private police patrols, which check selected houses on selected streets, as thoroughly and as often as each customer requests, for a fee.\(^\text{25}\)

Court services are clearly separable, and private arbitrators are indeed generally more efficient than government courts. Goldin adds:

To service more persons generally requires more judges and courtrooms. If more facilities are not acquired, additional users will impose costs on others, in the form of longer days for trial and/or less judicial time spent on each case. It is costless to serve additional persons only if they have no disputes.

To some extent, he goes on, even government courts charge fees to users and therefore charge for benefits received, although the fees usually do not vary with the difficulty of the case. And “private arbitrators are also available, selectively, to those parties willing to pay a fee. So, although adjudication is a fundamental service in any society, it does not follow that adjudication is a public good.”\(^\text{26}\)

And even in the case of national defense, Goldin points out, there is certainly some variation in protection, especially among cities (regarding protection by missiles), and among Americans who either travel or have property abroad. While the troops may be sent out to protect some Americans or their property from some foreign seizures (such as the Mayaguez), in other cases no action is


\(^{26}\)Ibid., pp. 65–66.
taken (tuna boats). One of the firmly embedded myths of modern public finance is that it doesn’t matter if population increases: The costs of defending the U.S. from external attack will not change. But consider two points. First, the new population must live somewhere. If they cause an increase in the U.S. land area, then either more defenses must be provided, or there will be a decrease in the level of protection to earlier residents and either way the marginal cost of protecting additional persons is positive. . . . Second, even if the new population resides within the existing boundaries, they will generally increase the amount of physical and human wealth which might be coveted by an enemy. That is, foreign attack is (at least partially) an economically motivated action, and is more likely to occur if there is more capital worth coveting. 27

Not only does total cost of national defense vary with population, but the service of protection against foreign attack can be variable. First, there once existed private armies, and such armies, serving private individuals or groups, still exist today. Goldin mentions the armies of religious groups in contemporary Lebanon, as well as a Central American army owned by Robert Vesco. These armies, as Goldin states, “yield benefits primarily to their owner.” 28

Second, even a collective State army can vary its services to individual citizens:

A military force also protects people from theft of property and kidnapping by foreigners. Exclusion from this service is relatively easy: The military force simply makes no attempt to stop theft or kidnapping of named persons. These persons would either hire their own guards, or suffer the damages of theft or kidnapping by foreigners. . . . Americans with substantial property abroad or at sea might well prefer to provide their own anti-theft defenses, rather than pay for a communal army which cannot be counted on to protect their property. . . . Contrary to public goods theory, even

27Ibid., pp. 60–61.
28Ibid., p. 61. Goldin amusingly adds: “A medieval lord could scarcely be a ‘free rider’ on a neighboring lord’s defense efforts. If he did not have his own defenses, he would probably suffer attacks from his neighbor.” Cf. Wicksell: “Side by side with the national army, many countries have voluntary rifle clubs and similar institutions which sometimes constitute no mean military force.” Knut Wicksell, “A New Principle of Just Taxation,” in Classics in the Theory of Public Finance, Musgrave and Peacock, eds., p. 90.
in this key case of defense from external attack, exclusion is not impossible and the marginal cost of serving additional persons generally is not zero.\textsuperscript{29}

Moreover, as Buchanan concedes, a collective defense may be a service to one citizen and be considered a distinctly negative “service” by another:

The common availability of collective goods or services does not, of course, imply that similar evaluations are placed on these by different persons. The Vietnam War effort demonstrated this point. The services of the plane that bombed North Vietnam in October, 1968, were equally available to all U.S. citizens. But the value placed on these services may have ranged from significantly positive levels . . . to significantly negative levels for those who felt that continued bombing was both immoral and a barrier to peace negotiations.\textsuperscript{30}

To Professor Buchanan, the “classic” example of a collective good is the lighthouse. The beams of the lighthouse are indivisible: “If one boat gets all the light beams, all boats may do likewise.”\textsuperscript{31} Or, as Samuelson has put it, “A businessman could not build it for a profit, since he cannot claim a price from each user.”\textsuperscript{32} The theory is that it would be virtually impossible for a lighthouse keeper to row out to each boat to demand payment for use of the light. And that hence lighthouses have always been supplied by government.


\textsuperscript{30}Buchanan, \textit{Public Finances}, pp. 25–26. Buchanan errs, however, in claiming that “few persons” would place a negative value on internal law and order. Pacifists would, and how “few” they may be will vary, and their number is unknown in any case. Even the existence of one pacifist negates the very concept of defense as a collective good, just as the existence of one anarchist negates the very concept of a collective good supplied by the State.\textsuperscript{31}

\textsuperscript{31}Ibid., p. 23.

\textsuperscript{32}Paul A. Samuelson, \textit{Economics}, 6th ed. (New York: McGraw-Hill, 1964), p. 159. In his tenth edition, Samuelson, perhaps in an unacknowledged response to Professor Coase’s noteworthy article (see below), gives the case away by adding, after “from each user” the words “without great difficulty” (p. 160). For he thereby concedes that lighthouses are not “collective goods.”
But, first, the problem has now been eliminated by modern technology. It is now technologically highly feasible for a lighthouse’s rays to be available only to that boat that has the proper electronic equipment, and to pay a fee for the use of that equipment. But, apart from this, it turns out, as Ronald Coase has discovered, that from the seventeenth until the early nineteenth centuries, the British lighthouse system was developed and operated by private enterprise. The lighthouse owners hardly bothered about collecting a fee from each boat on the spot. Instead, the owners employed agents at ports who found out what routes each ship entering the port had sailed and therefore what lighthouses the ship had passed and charged them accordingly. Furthermore, additional users of lighthouses will impose higher costs for providing them. More ships will increase the likelihood of congestion in the protected waters and will require more navigational aids.

In his trenchant critique of the offhanded way in which economists, from Mill to Samuelson and Arrow, have wrongly used the lighthouse as an example of a collective good, Coase concludes:

These references by economists to lighthouses are not the result of their having made a study of lighthouses or having read a detailed study by some other economist. Despite the extensive use of the lighthouse example in the literature, no economist, to my knowledge, has ever made a comprehensive study of lighthouse finance and administration. The lighthouse is simply plucked out of the air to serve as an illustration. . . .

This seems to me to be the wrong approach. . . . Generalizations are not likely to be helpful unless they are derived from studies of how such activities are actually carried out within different institutional frameworks. . . .

33The tolls were collected at the ports by agents (who might act for several lighthouses). . . . The toll varied with the lighthouse and ships paid a toll, varying with the size of the vessel, for each lighthouse passed. It was normally a rate per ton (say 1/4d or 1/2d) for each voyage. Later, books were published setting out the lighthouses passed on different voyages and the charges what would be made. (Ronald H. Coase, “The Lighthouse in Economics,” Journal of Law and Economics 17 [October 1974]: 364–65)

The account in this paper of the British lighthouse system shows that, contrary to the belief of many economists, a lighthouse service can be provided by private enterprise. The lighthouses were built, operated, financed and owned by private individuals, who could sell the lighthouse or dispose of it by bequest. The role of the government was limited to the establishment and enforcement of property rights in the lighthouse. The charges were collected at ports by agents from the lighthouses. The problem of enforcement was no different for them than for other suppliers of goods and services to the shipowner.

The analogous navigational aid for air traffic, the services of the air-control tower, can be and is sold separately to individual consumers. Control towers will distribute radar information, for example, to whoever has radar equipment, but the equipment must be purchased by individual users. And heavier use of airspace or airport runways requires more navigational aids and therefore more expenses to service the users.

Radio and television have been cited as collective goods since servicing another viewer allegedly involves no additional cost. But additional service is far from costless, and viewers are separable and excludable; therefore radio and TV fail both tests of a collective good. An increased viewing audience means supplying more, and more varied, programs. And new users must either be supplied with a stronger signal or may require cable or stronger antennas because of the increased congestion. Moreover, consumers are excluded now from television. To watch television programs they must buy sets and then must either pay as they go (various forms of pay TV) or else advertisers must pay, imposing on many viewers the psychic costs of

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36Since commercial airports are all owned by (largely municipal) government, the pricing of their runway and other services is scarcely akin to market pricing; generally, landing and takeoff fees are set far too low to clear the market, and the resulting shortage is rationed by increased and dangerous air congestion. See Ross D. Eckert, Airports and Congestion (Washington, D.C.: American Enterprise Institute, 1972).
commercials. And public television imposes on its viewers the psychic costs of being subjected to lengthy requests for donations.\textsuperscript{37}

Moreover, in a sense the collective goods case for radio and television proves too much. For movies may also be said to be “costless” if additional viewers fill empty seats in a theater. Must movies, too, be nationalized, be supplied only by government, and perhaps be free to all?

Research has also been termed a “collective good”; don’t we all enjoy the benefits of the research and inventions of Edison, Faraday, et al., without paying for them? But of course we do pay for the fruits of research, and we pay separably. For we must purchase the papers or books of researchers, or pay fees for lectures, demonstrations, or consulting. Those who do not pay such fees are excluded from learning of or absorbing these new ideas. And, of course, the holders of patents and copyrights are able to obtain the income from these inventions or discoveries while excluding other producers.\textsuperscript{38}

Again, this argument proves too much. For not only patents and inventions are produced by creators: There is also art, sculpture, music, literature, philosophy. Are we to say that all these products of the human spirit are “collective goods” because we cannot be fully excluded from enjoying the products of Beethoven, Shakespeare, or Vermeer? Must all artists therefore be nationalized?

Another commonly cited example of a collective good is insect control by airplane spraying. It is alleged to be impossible to exclude land underneath from being sprayed, and the marginal cost of adding more land sprayed is zero. But if new residents live in previously uninhabited areas, then extra cost is incurred in servicing them, and the same is true if they are engaged in activities that attract insects. More airplane time and fuel must be used as well as more spray. Furthermore, the airplane could often, if it wished, exclude specific parcels of land from its spray. And more important, many of those receiving this “service” have not wanted it and have objected to the spraying as vigorously as the pacifist has protested the use of violence in defense. Indeed, a shift in public attitudes toward chemical sprays has greatly reduced their use in recent years.

\textsuperscript{38}Ibid., pp. 63–64.
But if some people consider a service such as a spray as “bad,” how can it be an indivisible, positive collective good?

Moreover, as Goldin points out, individual consumers have another option: to buy their own spray guns and spray their own property. In that case, each individual could choose and pay for the type and amount of spray that he precisely desires.\(^{39}\)

For many reasons, then, there are no collective goods, and even if there were, as we have already seen, their supply would be coercive if furnished by government and taxation. But there is yet another vital point: For even if a good or service could only be supplied “collectively,” why must that collection be compulsory? Why couldn’t individuals pool their resources voluntarily, as in club dues, and make voluntary contributions for the supply of the service?\(^{40}\) Or, as Gustave de Molinari argued, couldn’t a government even contract for the supply of collective services with private, competitive, and therefore more efficient firms?\(^{41}\)

Or, as Spencer Heath urged, on the model of real estate developments, shopping centers, and hotels, couldn’t such “collective” or “public” goods as police, fire, roads, sanitation, and so on, be supplied by a large private firm with tenants paying for these services in their rents?\(^{42}\)

\(^{39}\)Ibid., p. 54.


\(^{41}\)Gustave de Molinari, \textit{The Society of Tomorrow} (New York: G.P. Putnam’s Sons, 1904), pp. 71–72, 84–86. In earlier years, this Belgian-born nineteenth-century French economist believed that all services now supplied by government could be supplied better and more efficiently by privately competitive firms on the free market. See Gustave de Molinari, \textit{The Production of Security} (New York: Center for Libertarian Studies, May 1977); and David M. Hart, “Gustave de Molinari and the Anti-Etatiste Liberal Tradition” (history, honors thesis, Macquarie University, Australia, 1979).

\(^{42}\)Spencer Heath, \textit{Citadel, Market and Altar} (Baltimore, Maryland: Science of Society Foundation, 1957). For the most developed work on the Heathian proposal, see Spencer Heath, \textit{The Art of Community} (Menlo Park, Calif.: Institute for Humane Studies, 1970). Disney World is a spectacular example of a successful business firm supplying all of these services out of tourists’ fees.
Finally, if we look at human history, we find that every good, without exception, that economists glibly term a “collective good” has actually been successfully supplied by the free market. Not only do private guards and patrols exist, and private lighthouses in the past, but there have been societies, such as medieval Ireland, that supplied a complex network of defense service and insurance—including police, crime insurance, and competitive courts—without a State or taxation. Competing market courts serviced for centuries the vitally important fairs of Champagne in the Middle Ages. Common-law courts were marked by competitive, nongovernmentally appointed judges. Private guards and private arbitrators exist successfully even in our society where the State monopolizes most forms of defense.43

It seems clear, then, that voluntary rather than governmental supply of the collective good would be possible in every case; the only objection might be, not that the good—defense, firefighting, or whatever—could not be supplied, but that “too little” would be supplied. But that brings us to the second line of argument by the proponents of government.

External Benefits

If forced to retreat from the “strong” concept of collective goods, the advocates of government supply or subsidization of such goods, fall back on a “weak,” and therefore more plausible argument. Even though every collective good might be furnishable by private means, “not enough” will be supplied because of the difficulty or impossibility of capturing enough payment from “free riders” who benefit from these services without paying for their benefits. Government supply, or taxation of free riders to subsidize supplies, then becomes required in order to “internalize the external benefits” acquired, but not paid for, by the free riders.44


44Gordon Tullock advances the curious argument that revolutions are impossible (or virtually so) because individual revolutionaries work and sacrifice whereas the entire public reaps the benefits; hence the public are free
But this argument generates far more difficulties than it solves. It proves too much in many directions. In the first place, how much of the deficient good should be supplied? What criterion can the State have for deciding the optimal amount and for gauging by how much the market provision of the service falls short? Even if free riders benefit from collective service X, in short, taxing them to pay for producing more will deprive them of unspecified amounts of private goods Y, Z, and so on. We know from their actions that these private consumers wish to continue to purchase private goods Y, Z, and so on, in various amounts. But where is their analogous demonstrated preference for the various collective goods? We know that a tax will deprive the free riders of various amounts of their cherished private goods, but we have no idea how much benefit they will acquire from the increased provision of the collective good; and so we have no warrant whatever for believing that the benefits will be greater than the imposed costs. The presumption should be quite the reverse. And what of those individuals who dislike the collective goods, pacifists who are morally outraged at defensive violence, environmentalists who worry over a dam destroying snail darters, and so on? In short, what of those persons who find other people’s good their “bad”? Far from being free riders receiving external benefits, they are yoked to absorbing psychic harm from the supply of these goods. Taxing them to subsidize more defense, for example, will impose a further twofold injury on these hapless persons: once by taxing them, and second by supplying more of a hated service.

Since the tax-and-subsidy, or government-operation, route abandons the process of the market, there is no way of knowing who riders on the efforts of revolutionaries. (Gordon Tullock, “The Paradox of Revolution,” Public Choice 9 [Fall, 1971]: 89–99). If he were consistent, Professor Tullock should therefore advocate that government tax people and subsidize revolutionaries in order to solve the problem of “underproduction of revolution!” In point of fact, of course, revolutions do take place from time to time, and they occur because much of the public has placed high on their values scales the success of the revolution. In short, a strongly held ideology among the public can overcome the free-rider problem for revolution. People’s “interest” is not only job or immediate monetary payment, but also the attainment of such concepts as justice, liberty, and so on, none of which has any place in the economic calculus of the public-choice theorists.
the “negative free riders” are, and how much they will be suffering from an increased tax. We do have a pretty good idea, however, that one or more of these people exists: that there is at least one pacifist, anti-dam environmentalist, anarchist opposed to all government actions, and so on, in every society. But in that case, the free-rider as well as the “stronger” collective-good argument for the neutrality of government falls to the ground.

The young Herbert Spencer, in his great treatise *Social Statics*, declared that an individual should be able to opt out of taxation, to “ignore the State,” and to renounce its services. Criticizing his own work a half-century later, Spencer, in his *Autobiography*, employs the free-rider argument. “Mr. Spencer,” he charges,

actually contends that the citizen may properly refuse to pay taxes, if at the same time he surrenders the advantages which State aid and State protection yield him! But how can he surrender them? In whatever way he maintains himself, he must make use of sundry appliances which are indirectly due to governmental organization; and he cannot avoid benefiting by the social order which government maintains. Even if he lives on a moor and makes shoes, he cannot sell his goods or buy the things he wants without using the road to the neighboring town, and profiting by the paving and perhaps the lighting when he gets there. And, though he may say he does not want police guardianship, yet, in keeping down footpads and burglars, the police necessarily protect him, whether he asks them or not. Surely it is manifest . . . that the citizen is so entangled in the organization of his own society that he can neither escape the evils nor relinquish the benefits which come to him from it.

The later Spencer was properly refuted, on his own earlier grounds, by “S.R.” “S.R.” points out first that on the later Spencer’s own grounds, a man at least has the right to refuse to pay for advantages that he can relinquish. “S.R.” then quotes from the earlier Spencer’s application of his “law of equal freedom”:

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If every man has freedom to do all that he wills, provided he infringes not the equal freedom of any other man, then he is free to stop connection with the State—to relinquish its protection and to refuse paying toward its support. It is self-evident that in so behaving he in no way trenches upon the liberty of others; for his position is a passive one, and while passive he cannot become an aggressor . . . He cannot be coerced into a political combination without a breach of the law of equal freedom; he can withdraw from it without committing any such breach; and he therefore has the right to withdraw.

“S.R.” then proceeds: “Is a man who refuses to pay for incidental advantages he has not solicited an aggressor? Is it a breach of the law of equal freedom to withdraw from a combination that, in working for itself and pursuing its own benefit, indirectly benefits one who is perfectly willing to forego the blessings of the uninvited beneficence?” “S.R.” then points out that Spencer is implicitly modifying his equal freedom formula to say that anyone can do whatever he wishes, provided not only that he does not infringe on anyone else’s freedom, but also provided “that no one confers upon him benefits which he cannot wholly surrender while remaining a producer and trader.”

“S.R.” then tellingly supplies the logical reductio of the free-rider argument:

Has an individual the right to withhold proper contributions from neighbors who, individually or collectively, benefit him by caring for their own interests? If my neighbors hire private watchmen, they benefit me indirectly and incidentally. If my neighbors build fine houses or cultivate gardens, they indirectly minister to my pleasure. Are they entitled to tax me for these benefits because I cannot “surrender” them?47

Thus the free-rider argument proves far too much. After all, civilization itself is a process of all of us “free-riding” on the achievements of others. We all free-ride, every day, on the achievements of Edison, Beethoven, or Vermeer. When capital investment increases, and technology improves, the real wages of workers and the standard of living of consumers increase, even though they have contributed

47“S.R.,” “Spencer as His Own Critic,” Liberty 14 (June 1904): 2.
nothing to these advances. By simply continuing to work and consume, laborers and consumers receive the benefits of the inventions and investments of others without paying for them. So what must we infer from this? Are we all to wear sackcloth and ashes? If our neighbors are wiser, prettier, or happier, we all benefit in countless ways. So what must we do about it? Must we all be taxed to subsidize their beauty and wisdom?

And if people feel that not enough beauty, wisdom, inventions, police protection, and so on, will be provided by consumer payment and because of free riders, they are perfectly at liberty to subsidize provision of such goods on their own, individually or through societies or foundations. By doing so, the donor will demonstrate that, to him, the expected psychic benefit from his subsidy is worth more than the money he pays.

It will be objected that potential donors will not donate if they are rankled by the spectacle of free riders who stubbornly refuse to donate for the benefits they receive. And, further, that consumers on the market will not be willing to purchase these goods if they know that free riders abound. If we wished to moralize here, we might respond that these persons might be well advised to attend to their own affairs without wallowing in envy at benefits received by others. But, in any case, if the rankling at the existence of free riders is strong enough, these persons are always free to boycott the miscreants, either by not trading with them or by general ostracism.48

The consumers or donors can also, if they wish, get around the free-rider problem by making contracts, either singly or in organized fashion, that will pay for the “collective good,” but only on condition that everyone else, including the potential free riders, pay as well.

48Attacking the late Spencer’s argument, in Man vs. the State, for taxation for defense based on the free rider, “S.R” points out that Spencer “overlooked the fact that there are several methods of securing cooperation for necessary ends, some manifestly nonaggressive and consonant with the principle of equal freedom. It is, of course, unfair for any man to enjoy the benefits of pace and stability while declining to share the risks, sacrifices, and burdens entailed by actual and probable attacks from within or without; but such an unsocial and mean-spirited individual can be brought to terms by the boycott, material and moral.” “S.R,” “Spencer and Political Science,” Liberty 14 (February 1904): 2.
This form of contract would enable those willing to pay, in effect, to put the choice to the free riders: Either you join in paying or the service will not be provided.49

**Transaction Costs**

It has been objected that the “transaction costs” of identifying the free riders or channeling donations, or organizing boycotts or of making conditional contracts, are “too high,” and that therefore those who want these services are justified in turning to the government to force the free riders to pay.

There are several grave fallacies in the transaction costs argument for taxation. In the first place, it ignores the transaction costs of the government process itself. The implication is that government is a costless Mr. Fixit, levitating angelically above the fray and busily correcting “market failures.” If private persons have difficulty in identifying free riders, will government be able to limit its taxation to free riders only? What of the external costs of the inevitable taxation beyond the free rider? And, as we have seen, since market and demonstrated preference through individual action is not available to government, there is no way that government can either identify the free riders or the “negative free riders,” or to discover how much benefit each person would derive from the subsidized supply and therefore how much each person should be taxed. There are also the inevitable grave inefficiencies in the political supply of goods and services and in the political process itself that need not be expounded here. At any rate, there is no reason to assume that the transaction costs of turning to government will be lower than those of private operation, and every reason to assume the opposite.

Second, another definitive rebuttal of the transaction-cost argument for government is the impossibility of comparing transaction costs, not simply of private and government action, but at any time and in any situation. For costs, like utilities, are subjective, and therefore nonmeasurable and noncomparable between persons. There is no such thing as social transaction costs or any social costs

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49I am indebted to Dr. David Gordon of the Center for Libertarian Studies for pointing this out to me.
whatever. Any government action will impose enormous psychic cost on the anarchist; any private action will do likewise for the dedicated totalitarian. How are we to compare them? If an entity does not and cannot exist, then it is senseless to take as one’s goal that it be minimized.

And third, even if transaction costs were measurable and comparable, we must ask: What is so terrible about transaction costs? On what basis are they considered the ultimate evil, so that their minimization must override all other considerations of choice, freedom, or justice? After all, if minimizing these dread costs were truly the be-all and end-all, we could all pledge to obey one dictator, one Brezhnev or Idi Amin, in all things, and then everyone would have the assurance of knowing everyone else’s relevant value-scales. Other problems would abound, but at least transaction costs would be forced down to a minimum.

**Coercion as “Really” Voluntary**

A final fallback argument for the voluntariness of taxation and government asserts that every member of society wishes to pay for the collective goods but will do so only if everyone else pays. Therefore the seeming coercion of taxation is a fallacy, for everyone voluntarily pays in the serene knowledge that all beneficiaries are paying. In a kind of Hegelian leap, we are all voluntarily and cheerfully forcing ourselves to be free.

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50 Even Professor Buchanan, one of the founders of public-choice theory, admits the subjectivity and hence the noncomparability of costs. James M. Buchanan, *Cost and Choice: An Inquiry in Economic Theory* (Chicago: Markham, 1969).

51 If transaction costs are to be absolute and override all other considerations, then the transaction cost theorists are taking the very same position they deride in ethicists: that is, rendering their values absolute, with no trade-off for other values. If transaction-cost economists are to scorn ethicists for ignoring cost-benefit considerations, why are they to be allowed to ignore ethics?

52 Professors Buchanan and Tullock and the public-choice theorists are the outstanding modern proponents of this theory, which was also enunciated by Professor Baumol. See William J. Baumol, *Welfare Economics and the Theory of the State* (Cambridge, Mass.: Harvard University Press, 1952), and idem, “Economic Theory and the Political Scientist,” *World Politics* (January 1954): 275–77.
This argument adds a heavy dose of mysticism to the other collective goods and external benefits arguments. For how do we know that everyone is voluntarily paying knowing that everyone else is doing so? There is no evidence, there is no social compact whatever to that effect. Is all that they pay supposed to be voluntary, or just some? Are they perhaps in mourning that their payments are not higher? And what of the anarchist and the pacifist and the tax rebel? Is their bitter opposition to taxation only a cloak for their cheerful acceptance? On what basis are we supposed to accept this curious doctrine?

There is, in short, no warrant whatever for Baumol’s contention that every individual prefers to be coerced into paying for a service rather than have none of it supplied at all. Moreover, this argument ignores the options as discussed above, of conditional contracts to finance the service voluntarily, or of voluntary boycotts of free riders.\(^5\)

A popular argument holds that the fact of democracy establishes the voluntary nature of government. This idea need not detain us here long. As Herbert Spencer pointed out, democracy at best can only reduce the number of people being coerced; it does not eliminate coercion:

\(^{5}\)See Rothbard, Toward a Reconstruction of Utility and Welfare Economics, pp. 33ff. On collective goods and external benefits, also see Rothbard, Man, Economy, and State, vol., 2, pp. 883–90.

Buchanan and public-choice theorists argue that the all-voluntarily-forcing-themselves process actually takes place at the basic “constitutional” level. But again there is no evidence for this whatever. If they have the American Constitution in mind, then they should realize that the Constitution was put across against the wishes of the majority of the public and that the Constitution makers were interested not in “general rules” for the benefit of all, but in pushing through measures—protective tariffs, opening up of export markets, repayment of public debt at far above market price, expanded bank credit for privileged groups, public works—for one set of people at the expense of another. Contrast James M. Buchanan and Gordon Tullock, The Calculus of Consent: Logical Foundations of Constitutional Democracy (Ann Arbor: University of Michigan Press, 1962), with among others, E. James Ferguson, The Power of the Purse (Chapel Hill: University of North Carolina, 1961), and Jackson Turner Main, The Antifederalists (Chapel Hill: University of North Carolina Press, 1961).
By no process can coercion be made equitable. . . . The rule of the many by the few we call tyranny: the rule of the few by the many is tyranny also. . . . “You shall do as we will, and not as you will,” is in either case the declaration; and if the hundred make it to the ninety-nine, instead of the ninety-nine to the hundred, it is only a fraction less immoral. Or two such parties, whichever fulfills this declaration necessarily breaks the law of equal freedom: the only difference being that by the one it is broken in the persons of the ninety-nine, whilst by the other it is broken in the persons of a hundred. And the merit of the democratic form of government consists solely in this, that it trespasses against the smallest number.54

Spencer concludes that “the very existence of majorities and minorities is indicative of an immoral state.” For the “enactment of public arrangements by vote,” he points out, “implies that the desires of some cannot be satisfied without sacrificing the desires of others . . . implies therefore, organic immorality.”55

Spencer goes on to point out that the doctrine that men may only be taxed by their own consent implies their right not to pay taxes, to “ignore the State.” He then notes the reply of the statists that “this consent is not a specific, but a general one, and that the citizen is understood to have assented to everything his representative may do, when he voted for him.” Spencer’s rebuttal to this democratic mythos is definitive:

But suppose he did not vote for him; and on the contrary did all in his power to get elected some one holding opposite views—what then? The reply will probably be that, by taking part in such an election, he tacitly agreed to abide by the decision of the majority. And how if he did not vote at all? Why then he cannot justly complain of any tax, seeing that he made no protest against its imposition. So, curiously enough, it seems that he gave his consent in whatever way he acted—whether he said yes, whether he said no, or whether he remained neuter! A rather awkward doctrine this. Here stands an unfortunate citizen who is asked if he will pay money for a certain preferred advantage; and whether he employs the only means of expressing his refusal or does not employ it, we are told that he practically agrees; if only the number of others who

55Ibid., p. 211.
agree is greater than the number of those who dissent. And thus we are introduced to the novel principle that A’s consent to a thing is not determined by what A says, but by what B may happen to say!  

The Unanimity Principle  
Sensing the problems of coercion by majority rule, social theorists from Calhoun (the “concurrent majority” theory) to Wicksell and Buchanan (the Unanimity Principle) have been trying to arrive at a polity free of this coercion. Although the search for a way out of coercion may be commendable, the seeming voluntariness of the Unanimity Principle suffers from two grave flaws. First, Wicksell and Buchanan apply the Unanimity Principle only to changes in the status quo, that is, to new acts of taxation and expenditure. But this simply ratifies existing property titles, and assumes that these existing property titles are just and must be maintained. In short, the ratification of changes from the zero point only by unanimous consent, virtually freezes that zero point permanently. But should it be? Suppose that, previous to the installation of the Unanimity Principle, a group of persons, either by their own violent conquest or through State action, had stolen and confiscated the property of another large group and called that property their own. The Unanimity Principle would then prohibit the victims from taking back their property, since such action would have to gain the consent of the robbers. In his classic article on the Unanimity Principle, Knut Wicksell first acknowledged this problem and then brusquely dismissed it. Thus Wicksell first concluded:

If there are within the existing property and income structure certain titles and privileges of doubtful legality or in open contradiction with modern concepts of law and equity, then society has both the right and the duty to revise the existing property structure. It would obviously be asking too much to expect such revision ever to be carried out if it were to be made dependent upon the agreement of the persons primarily involved.  

56Ibid., pp. 211–12.  
But having admitted that, Wicksell then proceeded as if it had not been said, asserting that “no [such] measure should be carried out unless it have the prior unanimous or at any rate overwhelming support of the whole people.”

Second, the Unanimity Principle turns out to be something less than unanimous. Pacifists, tax rebels, and anarchists are apparently inconvenient to the goal of achieving unanimity in taxation, so the proponents speak of “relative unanimity” (Buchanan and Tullock), “approximate unanimity” (Wicksell), or “virtual unanimity” (the later Spencer). But these are all oxymorons, comparable to the phrase “only a little pregnant.” Unanimity must mean consent by all and nothing less. Anything less is necessarily coercive and not voluntary.

**J.B. Say on Taxation**

In contrast to almost all other economists, J.B. Say was astonishingly clear-sighted about the true nature of the State and of taxation. In Say there was no vain, mystical quest for a truly voluntary State or for a benign quasi-business firm supplying services to the grateful public. Say saw clearly that government supplies services to itself and its favorites, that all government spending is therefore consumption spending by the politicians and the bureaucracy, and that that spending is extracted by coercion at the expense of the taxpaying public.

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58Ibid.

59Thus, “S.R.”’s critique of the later Spencer’s argument for compulsory military service, compulsory justice, and compulsory taxation, to the effect that there is “virtual unanimity” behind these forms of State action, pointed out: “The word virtual is fatal. The question is evaded, not answered. Has the one man, or the insignificant group of men, that refuses to support the State, even in the simplest of its functions, the right to stand alone, to ignore it? Spencer never refuted his own early demonstration of this right.” “S.R.” “Spencer and Political Science,” p. 2.

60Here we might note the curious position of Laffer-Wanniski that the tax rate that maximized government revenue along the “Laffer curve” is, for some obscure reason, the point at which the electorate desires to be taxed. (Italics Wanniski’s.) Jude Wanniski, “Taxes, Revenues, and the ‘Laffer Curve’” in _The Economics of the Tax Revolt_, Arthur Laffer and Jan Seymour (New York: Harcourt Brace Jovanovich, 1979), p. 8.
As Say points out: “The government exacts from a taxpayer the payment of a given tax in the shape of money. To meet this demand, the taxpayer exchanges part of the products at his disposal for coin, which he pays to the tax-gatherers.” Eventually, the government spends the money on its own needs, and so “in the end . . . this value is consumed; and then the portion of wealth, which passes from the hands of the taxpayer into those of the tax-gatherer, is destroyed and annihilated.” Were it not for taxes, the taxpayer would have spent his money on his own consumption. As it is, “The state . . . enjoys the satisfaction resulting from the consumption.”

Say goes on to attack the “prevalent notion, that the values, paid by the community for the public service, return to it again . . . , that what government and its agents receive, is refunded again by their expenditures.” Say is indignant:

This is a gross fallacy; but one that has been productive of infinite mischief, inasmuch as it has been the pretext for a great deal of shameless waste and dilapidation. The value paid to government by the tax-payer is given without equivalent or return: it is expended by the government in the purchase of personal service, of objects of consumption.

At this point Say revealingly quotes with approval Robert Hamilton's likening of government to a robber in refuting the argument that taxation is harmless because the money is recirculated into the economy by the State. Hamilton compares this impudence to the “forcible entry of a robber into a merchant’s house, who should take away his money, and tell him he did him no injury, for the money, or part of it, would be employed in purchasing the commodities he dealt in, upon which he would receive a profit.” Say then adds “that the encouragement afforded by the public expenditure is precisely analogous.”

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62Ibid., p. 413.
63Ibid., p. 413n. Say likens government to a robber at another point. He states that government’s claim to a right over individual property, which it makes through taxation, is pure usurpation. The government is no more the proper owner of its claimed property than a thief over the property he has robbed. Ibid., p. 414n.
Say bitterly goes on to denounce the “false and dangerous conclusion” of writers who claim that public consumption increases general wealth. “If such principles were to be found only in books,” Say went on, “and had never crept into practice, one might suffer them without care or regret to swell the monstrous heap of printed absurdity.” But unfortunately they have been put into “practice by the agents of public authority, who can enforce error and absurdity at point of the bayonet or mouth of the cannon.” Once again, Say sees the uniqueness of government as the naked exercise of force and coercion.

Taxation, then, is the coercive imposition of a burden on members of the public for the benefit of consumption by the ruling class, by those in command of the government. Say writes:

Taxation is the transfer of a portion of the national products from the hands of individuals to those of the government, for the purpose of meeting the public consumption of expenditure. ... It is virtually a burden imposed upon individuals, either in a separate or corporate character, by the ruling power ... for the purpose of supplying the consumption it may think proper to make at their expense; in short, an impost, in the literal sense.

Thus Say is not impressed with the notion, properly ridiculed by Schumpeter, that all of society somehow voluntarily pay their taxes for the general benefit; instead, taxes are a burden coercively imposed upon society by the “ruling power.” Neither is Say impressed if the taxes are voted by the legislature: For “what avails it ... that taxation is imposed by consent of the people or their representatives, if there exists in the state a power, that by its acts can leave the people no alternative but consent?”

Taxation, Say clearly pointed out, cripples rather than stimulates production, for taxation robs people of resources that they would rather use in a different way:

Taxation deprives the producer of a product, which he would otherwise have the option of deriving a personal gratification from, if consumed ... or of turning to profit, if he preferred to devote it to

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64Ibid., pp. 414–15.
65Ibid., p. 446.
any useful employment. . . . [T]herefore, the subtraction of a product must needs diminish, instead of augmenting, productive power.\textsuperscript{66}

Say continues with a devastating critique of the argument that taxation is useful in stimulating people’s exertions and the development of industry. But first, industry is looted to satisfy the demands of the State, and hence productive capital is crippled:

Mere exertion cannot alone produce, there must be capital for it to work upon and capital is but an accumulation of the very products, that taxation takes from the subject: . . . in the second place, it is evident, that the values, which industry creates expressly to satisfy the demands of taxation, are no increase of wealth; for they are seized on and devoured by taxation.

As for the argument that taxes stimulate exertions:

To use the expedient of taxation as a stimulative to increased production, is to redouble the exertions of the community, for the sole purpose of multiplying its privations, rather than its enjoyments. For, if increased taxation be applied to the support of a complex, overgrown, and ostentatious internal administration, or of a superfluous and disproportionate military establishment, that may act as a drain of individual wealth, and of the flower of the national youth, and an aggressor upon the peace and happiness of domestic life, will not this be paying as dearly for a grievous public nuisance, as if it were a benefit of the first magnitude?\textsuperscript{67}

Say is also properly critical of Ricardo for maintaining that the suppression of one branch of private industry by taxation will always be compensated by a diversion of capital to some other industry. Say rebuts that:

I answer, that whenever taxation diverts capital from one mode of employment to another, it annihilates the profits of all who are thrown out of employ by the change, and diminishes those of the rest of the community: for industry may be presumed to have chosen the most profitable channel. I will go further, and say, that a forcible diversion of the current of production annihilates many additional sources of profit to industry. Besides, it makes a vast

\textsuperscript{66}Ibid., p. 447.
\textsuperscript{67}Ibid., pp. 447, 447n–448n.
difference to the public prosperity, whether the individual or the state be the customer... [In the latter case] wealth and production decline in consequence, and prosperity vanishes, leaving behind the pressure of unremitting taxation.  

Say concludes with a scornful attack on the very idea that taxation and government spending add to national wealth:

It is a glaring absurdity to pretend that taxation contributes to national wealth, by engrossing part of the national produce, and enriches the nation by consuming part of its wealth. Indeed, it would be trifling with my reader’s time, to notice such a fallacy, did not most governments act upon this principle, and had not well-intentioned and scientific writers endeavored to support and establish it.  

Say’s basic recommendation on the tax question was, in consequence, simple, trenchant, and clear-cut: “The best scheme of finance is, to spend as little as possible; and the best tax is always the lightest.” In short, that government is best that spends and taxes least. But then, paraphrasing Thoreau’s and Benjamin R. Tucker’s logical extension of the similar conclusion of Jefferson: May we not say that that government is best that spends and taxes not at all?  

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68Ibid., p. 452n. In a charming aside, Say chides Ricardo for erring because of his penchant for introducing “the unbending maxims of geometrical demonstration.” For, “in the science of political economy, there is no method less worthy of reliance.”  

69Ibid., p. 447.  

70Ibid., p. 449. Here we may note with amusement Frédéric Bastiat’s reaction to these passages of Say. In the light of Bastiat’s reputation as a “laissez-faire extremist” in contrast to Say’s “moderation,” we might note that Bastiat was shocked at the extremism of Say’s views: Doesn’t the State supply some services to the public? Frédéric Bastiat, Economic Harmonies (Princeton, N.J.: D. Van Nostrand, 1964), p. 567.  

71In a famous passage, Thoreau wrote: “I heartily accept the motto—‘That government is best which governs least,’ and I should like to see it acted up to more rapidly and systematically. Carried out, it amounts to this, which also I believe—‘that government is best which governs not at all.” Or, as Tucker concluded succinctly: “That which governs least is no government at all.” Henry D. Thoreau, “Civil Disobedience” [1849], in Walden and Other Writings (New York: Modern Library, 1937), p. 635; Benjamin R. Tucker, Instead of a Book (New York: B.R. Tucker, 1893), p. 14.
THE NEUTRAL TAX

Any quest for a nonredistributive neutral tax, such as free-market economists indulge in, must succeed in providing criteria for two basic questions about taxes: (a) how much taxes should be paid? and (b) who should pay them? The free market answers questions of “who” and “how much” very easily for its goods and services. But free-market economists have been singularly unsuccessful in providing either of these criteria for taxation. Thus the answer of laissez-faire economists to the former question—that taxation should be limited strictly to protection or defense—founders, not only on the coercive nature of the payment, but also on the nonhomogeneity of the defense service. Defense, as we have seen above, is not a homogeneous lump but a good available in different quantities and qualities, in marginal units. Since the free market has been abandoned in this area, there is no way to arrive at any rational criteria for the optimal total amount or distribution of government defense, or of any other good or service.

72Thus Ludwig von Mises, by far the most thoughtful and systematic of free-market economists, devotes only a few unsatisfactory paragraphs to the subject of a neutral tax, or indeed to taxation in general. While conceding the impossibility of a neutral tax in the real world, he maintains without demonstration that it would be possible in a world of general equilibrium. And, despite its conceded impossibility, he seems to advocate pursuing the neutral tax as an ideal. (He also does not explain why everyone’s income would be equal in general equilibrium.) Apart from this, Mises maintains that taxes, despite “directly curtail[ing] the taxpayer’s satisfaction,” are “the price he pays for the services which government renders to . . . each of its members.” He warns that taxes should remain “low,” but the only criterion offered for this lowness is that they “do not exceed the amount required for securing the smooth operation of the government apparatus”; in that case, “they are necessary costs and repay themselves.” We may here reiterate all the questions we’ve discussed above, emphasizing such problems as: How much service? To which members? How about pacifists? Who pays the necessary costs and who gets repaid and then some? And what exactly is the “smooth operation of the government apparatus,” and should that be the overriding desideratum? Mises, Human Action, pp. 730–31, 733–34, 738.
Taxpayers and Tax-Consumers

It might be claimed that neutral taxation could be achieved in one way, if in no other: if the precise amounts that each individual paid in taxes were returned to him in government expenditure. Thus if A paid $1,000 in taxes in a certain year, B paid $500, and C $300, and so on, then A would receive $1,000, B $500, and so on. It might be thought that such a taxation system would be at best absurd; for why construct an elaborate machinery that would simply take and then give back the same amounts to each person? Why then have taxation at all? But there is a grave flaw even in this attempt at a neutral tax: neglect of the bureaucratic handling charge.

For even if such a precisely equal tax-and-payment mechanism were constructed, there would have to be salaries paid to the bureaucracy administering the system (and to the politicians ruling the administrators). But these bureaucrats, then, would, in contrast to the rest of society, be net tax-receivers, and hence by at least the amount and dispensation of their salaries, the fiscal system could not be neutral to the market economy. For even if A, B, C, and so on, paid and received the equivalent amounts, bureaucrats B₁, B₂, B₃, and so on, would be net tax-recipients, and in essence, would be paying no taxes at all. Their net incomes functioning in the bureaucracy will necessarily have to be subtracted from the net incomes of other members of society. And therefore the very existence and operation of government, as John C. Calhoun brilliantly pointed out, establishes at the very least a class struggle between the net tax-recipients and the net taxpayers. Calhoun’s analysis is worth quoting at length:

So deeply seated, indeed, is this tendency to conflict between the different interests or portions of the community that it would result from the action of the government itself, even though it were possible to find a community where the people were all of the same pursuits, placed in the same condition of life, and in every respect so situated as to be without inequality of condition or diversity of interests. The advantages of possessing the control of the powers of the government, and thereby of its honors and emoluments, are, of themselves, exclusive of all other considerations, ample to divide even such a community into two great hostile parties. . . . And what makes this evil remediless through the right of suffrage of itself . . . is the fact that, as far as the honors and emoluments of the government and its fiscal action are concerned, it is impossible to equalize it. The reason is obvious. Its honors and
emoluments, however great, can fall to the lot of but a few, compared to the entire number of the community and the multitude who will seek to participate in them. But without this there is a reason which renders it impossible to equalize the action of the government so far as its fiscal operation extends. . . .

Few, comparatively, as they are, the agents and employees of the government constitute that portion of the community who are the exclusive recipients of the proceeds of the taxes. Whatever amount is taken from the community in the form of taxes, if not lost, goes to them in the shape of expenditures or disbursements. The two—disbursement and taxation—constitute the fiscal action of the government. They are correlatives. What the one take from the community under the name of taxes is transferred to the portion of the community who are the recipients under that of disbursements. But as the recipients constitute only a portion of the community, it follows, taking the two parts of the fiscal process together, that its action must be unequal between the payers of the taxes and the recipients of their proceeds. Nor can it be otherwise; unless what is collected from each individual in the shape of taxes shall be returned to him in that of disbursements, which would make the process nugatory and absurd. Taxation may, indeed, be made equal, regarded separately from disbursement. Even this is no easy task; but the two united cannot possibly be made equal.

Such being the case, it must necessarily follow that some one portion of the community must pay in taxes more than it receives back in disbursements, while another receives in disbursements more than it pays in taxes. It is, then, manifest, taking the whole process together, that taxes must be, in effect, bounties to that portion of the community which receives more in disbursements than it pays in taxes, while to the other which pays in taxes more than it receives in disbursements they are taxes in reality—burdens instead of bounties. This consequence is unavoidable. It results from the nature of the process, by the taxes ever so equally laid. . . .

Nor would it be less a bounty to the portion of the community which received back in disbursements more than it paid in taxes because received as salaries for official services, or payments to persons employed in executing the works required by the government, or furnishing it with its various supplies, or any other description of public employment—instead of being bestowed gratuitously. It is the disbursements which give additional and, usually, very profitable and honorable employments to the portion of the community where they are made . . . and hence, to the extent that the disbursements exceed the taxes, it may be fairly regarded as a bounty.
The very reverse is the case in reference to the portion which pays in taxes more than it receives in disbursements. With them profitable employments are diminished to the same extent, and population and wealth correspondingly decreased.

The necessary result, then, of the unequal fiscal action of the government is to divide the community into two great classes: one consisting of those who, in reality, pay the taxes and, of course, bear exclusively the burden of supporting the government; and the other, of those who are the recipients of their proceeds through disbursements, and who are, in fact, supported by the government; or in fewer words, to divide it into taxpayers and tax-consumers.

But the effect of this is to place them in antagonistic relations in reference to the fiscal action of the government and the entire course of policy therewith connected. For the greater the taxes and disbursements, the greater the gain of the one and the loss of the other, and vice versa; and consequently, the more the policy of the government is calculated to increase taxes and disbursements, the more it will be favored by the one and opposed by the other.

The effect, then, of every increase is to enrich and strengthen the one, and impoverish and weaken the other.73

Thus if a bureaucrat receives an income of $30,000 per year, and pays $10,000 to the government in taxes, he is in reality not paying taxes at all. His tax payment is a bookkeeping fiction; in reality, he is simply a net tax-consumer to the tune of $20,000.

Calhoun has thus shown that the very existence of taxation creates at least two conflicting classes: the ruling and the ruled, and that the ruling class are the net tax-consumers and the ruled the net taxpayers. The ruling classes comprise the full-time politicians and bureaucrats receiving government salaries, as well as the private sellers of goods and services to the governments or recipients of outright government subsidy. There is hence no way for government or for taxation to be neutral. Moreover, the greater the amount and degree of taxation/expenditures by government, the more important will be this unneutrality, this diversion of output and income from producers on the market to the State and the receivers of its largess. The greater the extent of government operation, therefore, the greater the class conflict in the society.

Proportional Taxation

Setting aside for a moment the problem of inherent nonneutral-
ity stemming from the existence of taxation and expenditures, let us
examine further the specific types or forms of taxes. Is there any form
that might be called neutral to the market? Many economists have
assumed that proportional taxation for each taxpayer (whether on
incomes, property, or intangible “sacrifice”) will leave the distribu-
tion of income or wealth the same as before, and therefore be neu-
tral to the market. Thus to Edwin Cannan proportional property tax-
atation serves as a “sufficiently accurate standard” of neutrality, so that
“the distribution of wealth between individuals” is the same as “it
would be in the absence of State action.”74 To Blum and Kalven, pro-
portional sacrifice, presuming this intangible could be measured, has
“the virtue . . . that it remains neutral as to the relative distribution
of satisfactions among taxpayers. Under it they are all equally ‘worse
off’ after taxes.”75

At first blush, proportionality appears to leave market distribu-
tion the same. If, for example, a tax of 10 percent is levied on all
incomes, is not the distribution of incomes left the same (setting
aside the above insoluble problem of net tax-consumers)? It is true
that if A earns $30,000 a year, B earns $20,000, and C earns $10,000,
and each pays 10 percent, the relative proportions of their income
after taxes will remain the same as before ($27,000, $18,000, and
$9,000). But this question misconceives the very idea of the neutral
tax. The point of a tax neutral to the market is not to leave the
income distribution the same as if a tax had not been imposed. The
point of a neutral tax is to affect the income “distribution” and all
other aspects of the economy in the same way as if the tax were a
free-market price. Only if a tax has the effect of a surrogate free-mar-
ket price, only if, in a profound sense, it is part of the market, could it
be neutral to that market. And it should be evident that no free-mar-
ket price leaves income distribution the same. If every market price

74Edwin Cannan, “Minutes of Royal Commission on Local Taxation,”
1899,” in Readings in the Economics of Taxation, Richard Musgrave and Carl
Shoup, eds. (Homewood, Ill.: Irwin, 1959), pp. 182–83.

75Walter Blum and Harry Kalven, Jr., The Uneasy Case for Progressive
were proportional to the income of the purchaser, if David Rockefeller had to pay $1,000,000 for a box of Wheaties, then there would be no point in having a higher income, and we would have an extraordinarily complex and unworkable form of compulsory equality of incomes.

The market does not form prices proportional to incomes; the market is characterized by uniform pricing, by a strong tendency toward the same price for the same good or service regardless of the income or personality of the buyer.76

**Taxation and Benefits**

If the market charges all consumers the same price for a particular service, it would seem that some form of equal (rather than equiproportional) taxation might be neutral to the market. One time-honored criterion attempting to arrive at such neutrality is the “benefit” principle: that each should pay taxes in accordance with the benefits he receives from the State. Those receiving the same benefits would pay the same amount of tax. There are many grave problems with this approach, however. First, in contrast to the marketplace, there is no way whatever for an external observer to gauge anyone’s benefits as derived from government. Since “benefits” are subjective, we cannot measure anyone’s benefit on the market either, but we can conclude, from a person’s voluntary purchase, that his (expected) benefit was greater than the value to him of the money given up in exchange. If I buy a newspaper for 25 cents, we can conclude that my expected benefit is greater than a quarter. But since taxes are compulsory and not voluntary, we can conclude nothing about the alleged benefits that are paid for with them. Suppose, in analogy, that I am forced at gunpoint to contribute 25 cents for a newspaper and that that newspaper is then forcibly hurled at my door. We would be able to conclude nothing about my alleged benefit from the newspaper. Not only might I be willing to pay no more than 5 cents for the paper, or even nothing on some days, I might positively detest the newspaper and would demand payment to accept it. From the fact of coercion there is no way of telling. Except that we can conclude that many people are not getting 25 cents’

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76 A similar critique could be leveled against any form of proportional tax, for example, on sales or property.
worth from the paper or indeed are positively suffering from this coerced “exchange.” Otherwise, why the need to exercise coercion? Which is all that we can conclude about the “benefits” of taxation.77

To Adam Smith, the benefit principle dictated proportional income taxation: “The subjects of every state ought to contribute toward the support of government, as nearly as possible . . . in proportion to the revenue which they respectively enjoy under protection of the state.”78

Other writers have even used the benefit principle to justify progressive taxation. Yet there is no warrant whatever for assuming equi-, or even more than, proportional benefit from government. In one model the alleged benefit from government is to be simply deduced from one’s income, and it is claimed that this indicates a proportionately greater “benefit from society.” But there are many flaws with this approach. For first, since everyone benefits from participating in society, the fact that A earns more than B must be attributed to individual differences in ability or productivity rather than to the benefits of society. And second, “society”—the pattern of voluntary exchanges of goods and services—is most emphatically not identical to the State, the coercive extractor of taxation.

77In contrast to benefit theory, which naively assumes that people “purchase” government services in much the same way as they purchase goods and services on the market, at least sacrifice theory assumes in the words of Blum and Kalven, “that the taxes are a necessary evil falling up on a distribution of money, and therefore upon a distribution of satisfactions, which is otherwise acceptable.” Uneasy Case for Progressive Taxation, p. 44. The basic problem with sacrifice theory is that it doesn’t explain why people must bear the burdens or sacrifices of taxation, why that is, we must turn from talk of benefits and free choice on the market to talk to burden and sacrifice in the sphere of government.

78Adam Smith, The Wealth of Nations (New York: Modern Library, 1937), p. 777. Smith added immediately that “the expense of government to the individuals of a great nation, is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute to their respective interest in the estate.” Presumably, however, these tenants also get benefits from the estate greater than their pro-rata expenses, and if they do not, or even if they do, they can sell their share and leave—an option not available to the taxpayer.
If, indeed, we are to tax people in accordance with their benefit from government, we would have to tax all the net tax-consumers to the amount of their subsidies. We would have to tax 100 percent of the salaries of bureaucrats, of the incomes of welfare recipients and of defense contractors, and so on. We would then have our ideal model of the neutral tax where all recipients of government funds would systematically repay them to the taxpayers—an absurd if rather charming state of affairs. If we leave subsidies to concentrate only on supposedly common services such as police protection, then we would have to conclude that the poor benefit far more from police protection than the wealthy, since the wealthy could far better afford to pay for their own protection. We would therefore have to conclude, not that the rich benefit as much as or more than the poor, but far less. We would have to conclude that the poor and the infirm, far more in need of protection than the rich, should be taxed far more heavily than the rich and the able-bodied.

Moreover, the market is misconstrued by the benefit principle. For on the market people do not pay in accordance with benefits received. The chess addict and the indifferent players pay the same price for the same chess set, and the opera enthusiast and the novice pay the same price for the same ticket. On the market, people tend to pay the same price for the same good, regardless of benefit. The poor and the weak might be the most eager for protection, but, in contrast to the benefit principle, they would not pay more for the same degree of protection on the market. And finally, everyone on the market enjoys a net benefit from exchange. If the entire benefit were taxed away (assuming this subjective concept could be measured), then this

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79 Mill put the case very well: “If we wanted to estimate the degrees of benefit from the protection of government we should have to consider who would suffer most if that protection were withdrawn: to which question if any answer could be made, it must be, that those would suffer most who were weakest in mind or body, either by nature or by position. Indeed, such persons would almost infallibly be slaves. If there were any justice, therefore, in the theory of justice now under consideration, those who are least capable of helping or defending themselves, being those to whom the protection of government is the most indispensable, ought to pay the greatest share of its price.” John Stuart Mill, Principles of Political Economy (New York: D. Appleton, 1901), vol. 2, pp. 398.
practice would totally violate market principles, where net benefits from exchange are always maintained.

The Equal Tax

If the market means having everyone pay the same price for the same service, perhaps then each person should pay the same tax, equal in absolute amount? The equal tax, or “poll tax,” is surely a far closer approximation to neutral taxation than any of the more common forms of taxation. It would indeed preserve the market principle of same price for same service. It would also be particularly appropriate for a democratic polity, where one person, one vote prevails, or for a regime that attempts to adhere to the principle of “equality before the law.”

But even the equal tax cannot be said to be neutral to the market. In the first place, it is impossible for observers outside the market, such as government, to gauge what service is “equal” to another service. Equality of service is not technological identity but similarity in the minds of the consumers. Only the free market, then, can determine different qualities or degrees of a service. Second, and even more important, there is no indication that for a particular taxpayer, the government is supplying a “service” at all. Since the tax is compulsory, it may well be that the “service” has zero or even negative value for individual taxpayers. Thus, a pacifist, philosophically opposed to any use of violence, would not consider a tax levied for his and others’ police protection to be a positive service; instead, he finds that he is being compelled, against his will, to pay for the provision of a “service” that he detests. In short, equal pricing on the market reflects demands by consumers who are voluntarily paying the price, who, in short, believe that they are gaining more from the good or service than they are giving up in exchange. But taxation is

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80 In recent years, the poll tax was used to designate a voting requirement, in effect a tax on voting, in the southern states. But originally, the poll tax was simply an equal tax per head, and the payment for voting was simply one method of enforcing the tax. On poll taxes, see Merlin H. Hunter and Harry K. Allen, Principles of Public Finance (New York: Harper and Bros., 1940), pp. 265–70. Many early poll taxes were graduated rather than uniform. C.F. Bastable, Public Finance (London: Macmillan, 1895), pp. 433–34.
imposed on all people, regardless of whether they would be willing to pay such a price (the equal tax) voluntarily, or indeed whether they would voluntarily purchase any of this service at all.

The poll tax works particular hardship on those who would not ordinarily be participating in the market economy. Hence it (as well as the income tax) is payable in money and has been used as a fearsome whip to force natives in undeveloped countries out of subsistence or barter production and into working for money wages. Working for capitalists becomes the only way these natives can pay the tax. Thus Sir Percy Girouard, the British governor of Kenya, freely admitted, in the early twentieth century, that taxation was levied on the native to force him to go to work for British employers. The hut tax “is the only method,” opined Sir Percy, “of compelling the native to leave his reserve for the purpose of seeking work. Only in this way can the cost of living be increased for the native.”

In the Congo Free State, the problem in that Belgian colony, as Parker Moon put it, was: “Would the natives willingly go out into the jungle to collect rubber and tusks for the State?” For, “little appreciating the dignity of labor, the Congo negroes evinced a marked distaste for the task which their humane sovereign expected them to perform. Accordingly, another civilized innovation was introduced—taxes.” Moon illuminates the relationship between taxation and forced labor in colonial countries:

In tropical Africa . . . the problem is how to make the natives work at all, for Europeans. Actual slavery is everywhere condemned, and vanishing. . . . Compulsory labor, once the fashion in Central

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Many of the natives, of course, were too poor to pay any such tax, and consequently in four months over one hundreds members of the Bondelzwarts tribe along were condemned, for non-payment of the tax, to pay a fine of two pounds or spend two weeks in jail. To obtain the money for tax and fines, the natives would have to work for white ranchers and mine-owners. (Ibid., p. 504)

82 Ibid., p. 86.
Africa, is falling more and more under censure, though it is still utilized by governments when they need natives for railroad or road construction, or other public works. . . .

Taxation is a favorite method of stimulating native industry. In many African colonies hut and poll taxes are imposed, ranging from fifty cents to several dollars per capita. The amount seems small enough, by our standards, but to the negro without money it is a large sum. He can earn it by working on a plantation or in a mine, for white employers, at wages that vary from five cents a day, or less, in Congo, Northern Rhodesia, and other regions, to six or seven cents in Kenya, perhaps twenty cents in the interior of Nigeria, and fifty cents or more in South Africa. At such wages it takes a native months to save enough to pay the tax for his family. 83

**CONCLUSION**

Free-market economists have successfully extended their critical analyses of government to all areas of State operation and intervention—all except one. Taxation, the heart and soul of government, has escaped unscathed. Free-market economists have either avoided the topic of taxation altogether or have provided concepts that, while claiming to help limit government, have in reality offered apologies for the extension of State power. The view that income taxes are “better” than excise taxes; the call for proportional or regressive income taxation; the Friedman negative income tax; the Buchanan-Tullock Unanimity Principle; and the collective-goods, external-benefits, and transaction costs arguments for government and taxation, have all served to place the *imprimatur* of economics on the status quo or on extensions of government rather than to limit or roll back State power. All this has followed the course traced by Bertrand de Jouvenel three decades ago: From the idea of divine right down to modern times concepts originally meant to limit State power have been turned by the State and its advocates into rationales for its further extension. 84

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83Ibid., p. 563.
Much the same thing has happened to the noble concept of neutral taxation. The idea that taxation, and therefore government’s fiscal operation, should be neutral to the market—should not disturb the operations of the market nor divert it from its free course—is a noble but impossible one. As we have seen here, taxation can never be neutral to the market, and the impossibility of this dream is rooted in the very nature of taxation and government. Neutral taxation is merely a chimera. It is perhaps because of this impossibility that this concept, in the hands of the modern public-choice theorists and others, has so quickly become yet another device for ratifying the status quo of State power.

We are forced, then, to the realization of crucial points from which free-market economists seem to have been fleeing as from the very plague. That neutral taxation is an oxymoron; that the free market and taxation are inherently incompatible; and therefore either the goal of neutrality must be forsaken, or else we must abandon the institution of taxation itself.
Session 5
The Incidence of Taxation

- *Power and Market*
  Chapter 4: Binary Intervention: Taxation

- *Economic Controversies*
  The Consumption Tax: A Critique
The Alleged Superiority of the Income Tax

Orthodox neoclassical economics has long maintained that, from the point of view of the taxed themselves, an income tax is “better than” an excise tax on a particular form of consumption, since, in addition to the total revenue extracted, which is assumed to be the same in both cases, the excise tax weights the levy heavily against a particular consumer good. In addition to the total amount levied, therefore, an excise tax skews and distorts spending and resources away from the consumers’ preferred consumption patterns. Indifference curves are trotted out with a flourish to lend the scientific patina of geometry to this demonstration.

As in many other cases when economists rush to judge various courses of action as “good,” “superior” or “optimal,” however, the ceteris paribus assumptions underlying such judgments—in this case, for example, that total revenue remains the same—do not always hold up in real life. Thus, it is certainly possible, for political or other reasons, that one particular form of tax is not likely to result in the same total revenue as another. The nature of a particular tax might lead to less or more revenue than another tax. Suppose, for example, that all present taxes are abolished and that the same total is to be raised from a new capitation, or head, tax, which requires that every inhabitant of the United States pay an equal amount to the support of federal, state, and local government. This would mean that the existing total government revenue of the United States, which we estimate at 1 trillion, 380 million dollars—and here exact figures are

not important—would have to be divided between an approximate total of 243 million people. Which would mean that every man, woman, and child in America would be required to pay to government each and every year, $5,680. Somehow, I don’t believe that anything like this large a sum could be collectible by the authorities, no matter how many enforcement powers are granted the IRS. A clear example where the ceteris paribus assumption flagrantly breaks down.

But a more important, if less dramatic, example is nearer at hand. Before World War II, Internal Revenue collected the full amount, in one lump sum, from every taxpayer, on March 15 of each year. (A month’s extension was later granted to the long-suffering taxpayers.) During World War II, in order to permit an easier and far smoother collection of the far higher tax rates for financing the war effort, the federal government instituted a plan conceived by the ubiquitous Beardsley Ruml of R.H. Macy & Co., and technically implemented by a bright young economist at the Treasury Department, Milton Friedman. This plan, as all of us know only too well, coerced every employer into the unpaid labor of withholding the tax each month from the employee’s paycheck and delivering it to the Treasury. As a result, there was no longer a need for the taxpayer to cough up the total amount in a lump sum each year. We were assured by one and all, at the time, that this new withholding tax was strictly limited to the wartime emergency, and would disappear at the arrival of peace. The rest, alas, is history. But the point is that no one can seriously maintain that an income tax deprived of withholding power, could be collected at its present high levels.

One reason, therefore, that an economist cannot claim that the income tax, or any other tax, is better from the point of view of the taxed person, is that total revenue collected is often a function of the type of tax imposed. And it would seem, that from the point of view of the taxed person, the less extracted from him the better. Even indifference curve analysis would have to confirm that conclusion. If someone wishes to claim that a taxed person is disappointed at how little tax he is asked to pay, that person is always free to make up the alleged deficiency by making a voluntary gift to the bewildered but happy taxing authorities.¹

¹In 1619, Father Pedro Fernandez Navarrete, “Canonist Chaplain and Secretary of his High Majesty,” published a book of advice to the Spanish
A second insuperable problem with an economist’s recommending any form of tax from the alleged point of view of the taxee, is that the taxpayer may well have particular subjective evaluations of the form of tax, apart from the total amount levied. Even if the total revenue extracted from him is the same for tax A and tax B, he may have very different subjective evaluations of the two taxing processes. Let us return, for example, to our case of the income as compared to an excise tax. Income taxes are collected in the course of a coercive and even brutal examination of virtually every aspect of every taxpayer’s life by the all-seeing, all-powerful Internal Revenue Service. Each taxpayer furthermore is obliged by law to keep accurate records of his income and deductions and then, painstakingly and truthfully, to fill out and submit the very forms that will tend to incriminate him into tax liability. An excise tax, say on whiskey or on movie admissions will intrude directly on no one’s life and income, but only into the sales of the movie theater or liquor store. I venture to judge that, in evaluating the “superiority” or “inferiority” of different modes of taxation, even the most determined imbiber or moviegoer would cheerfully pay far higher prices for whiskey or movies than neoclassical economists contemplate, in order to avoid the long arm of the IRS.²

**The Forms of Consumption Tax**

In recent years, the old idea of a consumption tax in contrast to an income tax has been put forward by many economists, particularly by allegedly pro-free market conservatives. Before turning to a critique of the consumption tax as a substitute for the income tax, it should be noted that current proposals for a consumption tax would

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²It is particularly poignant, on or near any April 15, to contemplate the dictum of Father Navarrete, that “the only agreeable country is the one where no one is afraid of tax collectors,” ibid., p. 73. Also see Murray N. Rothbard “Review of A. Chafuen, Christians for Freedom: Late Scholastic Economics,” *International Philosophical Quarterly* 28 (March 1988): 112–14.
deprive taxpayers of the psychic joy of eradicating the IRS. For while the discussion is often couched in either-or terms, the various proposals really amount to adding a new consumption tax on top of the current massive armamentarium of taxing power; in short, seeing that income tax levels may have reached their political limits for the time being, our tax consultants and theoreticians are suggesting a shining new tax weapon for the government to wield. Or, in the immortal words of that exemplary economic czar and servant of absolutism, Jean-Baptiste Colbert, the task of the taxing authorities is to “so pluck the goose as to obtain the largest amount of feathers with the least amount of hissing.” We the taxpayers, of course, are the geese.

But let us put the best face on the consumption tax proposal, and deal with it as a complete replacement of the income tax by a consumption tax, with total revenue remaining the same. Our first point is that one venerable form of consumption tax not only retains existing IRS despotism, but makes it even worse. This is the consumption tax first prominently proposed by Irving Fisher. The Fisher tax would retain the IRS, as well as the requirement that everyone keep detailed and faithful records and truthfully estimate his own taxes. But it would add something else. In addition to reporting one’s income and deductions, everyone would be required to report his additions to or subtractions from capital assets (including cash) over the year. Then, everyone would pay the designated tax rate on his income minus his addition to capital assets, or net consumption. Or, contrarily, if he spent more than he earned over the year, he would pay a tax on his income plus his reduction of capital assets, again equalling his net consumption. Whatever the other merits or demerits of the Fisherine tax, it would add to IRS power over every individual, since the state of his capital assets, including his stock of cash, would now be examined with the same care as his income.

A second proposed consumption tax, the VAT, or value-added tax, imposes a curious hierarchical tax on the “value added” by each firm and business. Here, instead of every individual, every business

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A firm would be subjected to intense bureaucratic scrutiny, for each firm would be obliged to report its income and its expenditures, paying a designated tax on the net income. This would tend to distort the structure of business. For one thing, there would be an incentive for uneconomic vertical integration, since the fewer the number of times a sale takes place, the fewer the imposed taxes. Also, as has been happening in European countries with experience of the VAT, a flourishing industry may arise in issuing phony vouchers, so that businesses can overinflate their alleged expenditures, and reduce their reported value added. Surely a sales tax, other things being equal, is manifestly both simpler, less distorting of resources, and enormously less bureaucratic and despotic than the VAT. Indeed the VAT seems to have no clear advantage over the sales tax, except of course, if multiplying bureaucracy and bureaucratic power is considered a benefit.

The third type of consumption tax is the familiar percentage tax on retail sales. Of the various forms of consumption tax, the sales tax surely has the great advantage, for most of us, of eliminating the despotic power of the government over the life of every individual, as in the income tax, or over each business firm, as in the VAT. It would not distort the production structure as would the VAT, and it would not skew individual preferences as would specific excise taxes.

Let us now consider the merits or demerits of a consumption as against an income tax, setting aside the question of bureaucratic power. It should first be noted that the consumption tax and the income tax each carry distinct philosophical implications. The income tax rests necessarily on the ability-to-pay principle, namely the principle that if a goose has more feathers it is more ripe for the plucking. The ability-to-pay principle is precisely the creed of the highwayman of taking where the taking is good, of extracting as much as the victims can bear. The ability-to-pay principle is the philosophical embodiment of the memorable answer of Willie Sutton when he was asked, perhaps by a psychological social worker, why he robbed banks. “Because,” answered Willie, “that’s where the money is.”

The consumption tax, on the other hand, can only be regarded as a payment for permission to live. It implies that a man will not be allowed to advance or even sustain his own life, unless he pays, off the top, a fee to the State for permission to do so. The consumption
tax does not strike me, in its philosophical implications, as one whit more noble, or less presumptuous, than the income tax.

**Proportionality and Progressivity: Who? Whom?**

One of the suggested virtues of the consumption tax advanced by conservatives is that, while the income tax can be and generally is progressive, the consumption tax is virtually automatically proportional. It is also claimed that progressive taxation is tantamount to theft, with the poor robbing the rich, whereas proportionality is the fair and ideal tax. In the first place, however, the Fisher-type consumption tax could well be every bit as progressive as the income tax. Even the sales tax is scarcely free from progressivity. For most sales taxes in practice exempt such products as food, exemptions that distort individual market preferences and also introduce progressivity of taxation.

But is progressivity really the problem? Let us take two individuals, one who makes $10,000 a year and another who makes $100,000. Let us posit two alternative tax systems: one proportional, the other steeply progressive. In the progressive tax system, income tax rates range from 1 percent for the $10,000 a year man, to 15 percent for the man with the higher income. In the succeeding proportional system, let us assume, everyone, regardless of income, pays the same 30 percent of his income. In the progressive system, the low-income man pays $100 a year in taxes, and the wealthier pays $15,000, whereas in the allegedly fairer proportional system, the poorer man pays $3,000 instead of $100, while the wealthier pays $30,000 instead of $15,000. It is, however, small consolation to the higher-income person that the poorer man is paying the same percentage of income in tax as he, for the wealthier person is being mulcted far more than before. It is unconvincing, therefore, to the richer man to be told that he is now no longer being “robbed” by the poor, since he is losing far more than before. If it is objected that the total level of taxation is far higher under our posited proportional than progressive system, we reply that that is precisely the point. For what the higher income person is really objecting to is not the mythical robbery inflicted upon him by “the poor”; his problem is the very real amount being extracted from him by the State. The wealthier man’s real complaint, then, is not how badly he is being treated relative to someone else, but how much money is being extracted from his own hard-earned assets. We sub-
mit that progressivity of taxes is a red herring; that the real problem and proper focus should be on the amount that any given individual is obliged to surrender to the State.  

The State, of course, spends the money it receives on various groups, and those who claim that progressive taxation mulcts the rich on behalf of the poor argue by comparing the income status of the taxpayers with those on the receiving end of the State’s largess. Similarly, the Chicago School claims that the tax system is a process by which the middle class exploits both the rich and the poor, while the New Left insists that taxes are a process by which the rich exploit the poor. All of these attempts misfire by unjustifiably bracketing as one class the payers to, and recipients from, the State. Those who pay taxes to the State, be they wealthy, middle class or poor, are certainly on net, a different set of people than those wealthy, middle-class, or poor, who receive money from State coffers, which notably includes politicians and bureaucrats as well as those who receive favors from these members of the State apparatus. It makes no sense to lump these groups together. It makes far more sense to realize that the process of tax-and-expenditures creates two and only two separate, distinct, antagonistic social classes, what Calhoun brilliantly identified as the (net) taxpayers and the (net) tax-consumers, those who pay taxes and those who live off them. I submit that, looked at in this perspective, it also becomes particularly important to minimize the burdens which the State and its privileged tax-consumers place on the productivity of the taxpayers.

THE PROBLEM OF TAXING SAVINGS

The major argument for replacing an income by a consumption tax is that savings would no longer be taxed. A consumption tax, its advocates assert, would tax consumption and not savings. The fact

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that this argument is generally advanced by free-market economists, in our day mainly by the supply-siders, strikes one immediately as rather peculiar. For individuals on the free market, after all, each decide their own allocation of income to consumption or to savings. This proportion of consumption to savings, as Austrian economics teaches us, is determined by each individual’s rate of time preference, the degree by which he prefers present to future goods. For each person is continually allocating his income between consumption now, as against saving to invest in goods that will bring an income in the future. And each person decides the allocation on the basis of his time preference. To say, therefore, that only consumption should be taxed and not savings, is to challenge the voluntary preferences and choices of individuals on the free market, and to say that they are saving far too little and consuming too much, and therefore that taxes on savings should be removed and all the burdens placed on present as compared to future consumption. But to do that is to challenge free-market expressions of time preference, and to advocate government coercion to forcibly alter the expression of those preferences, so as to coerce a higher saving to consumption ratio than desired by free individuals.

We must, then, ask: by what standards do the supply-siders and other advocates of consumption taxes decide why and to what extent savings are too low and consumption too high? What are their criteria of “too low” or “too much,” on which they base their proposed coercion over individual choice? And what is more, by what right do they call themselves advocates of the “free-market” when they propose to dictate choices in such a vital realm as the proportion between present and future consumption?

Supply-siders consider themselves heirs of Adam Smith, and in one sense they are right. For Smith, too, driven in his case by a deep-seated Calvinist hostility to luxurious consumption, sought to use government to raise the social proportion of investment to consumption beyond the desires of the free market. One method he advocated was high taxes on luxurious consumption; another was usury laws, to drive interest rates below the free market level, and thereby coercively channel or ration savings and credit into the hands of sober, industrious prime business borrowers, and out of the hands of “projectors” and “prodigal” consumers who would be willing to pay high interest charges. Indeed, through the device of the ghostly Impartial Spectator, who, in contrast to real human beings, is
indifferent to the time at which he will receive goods, Smith virtually held a zero rate of time preference to be the ideal.\(^6\)

The only coherent argument offered by advocates of consumption against income taxation is that of Irving Fisher, based on suggestions in John Stuart Mill.\(^7\) Fisher argued that, since the goal of all production is consumption, and since all capital goods are only way-stations on the way to consumption, the only genuine income is consumption spending. The conclusion is quickly drawn that therefore only consumption income, not what is generally called “income,” should be subject to tax.

More specifically, savings and consumption, it is alleged, are not really symmetrical. All saving is directed toward enjoying more consumption in the future. Potential present consumption is foregone in return for an expected increase in future consumption. The argument concludes that therefore any return on investment can only be considered a “double-counting” of income, in the same way that a repeated counting of the gross sales of, say, a case of Wheaties from manufacturer to jobber to wholesaler to retailer as part of net income or product would be a multiple counting of the same good.

This reasoning is correct as far as it goes in explaining the consumption-savings process, and is quite helpful in leveling a critique of conventional national income or product statistics. For these statistics carefully leave out all double or multiple counting in order to arrive at total net product, yet they arbitrarily include in total net income, investment in all capital goods lasting longer than one year—a clear example itself of double counting. Thus, the current practice absurdly excludes from net income a merchant’s investment in inventory lasting eleven months before sale, but includes in net income investment in inventory lasting for thirteen months. The cogent conclusion is that an estimate of social or national income should include only consumer spending.\(^8\)


\(^7\)See Rothbard, *Power and Market*, pp. 98–100.

\(^8\)We omit here the fascinating question of how government’s activities should be treated in national income statistics. See Rothbard, *Man, Economy, and State*, vol. 2, pp. 815–20; idem, *Power and Market*, pp. 199–201;
Despite the many virtues of the Fisher analysis, however, it is impermissible to leap to the conclusion that only consumption should be taxed rather than income. It is true that savings leads to a greater supply of consumer goods in the future. But this fact is known to all persons; that is precisely why people save. The market, in short, knows all about the productive power of savings for the future, and allocates its expenditures accordingly. Yet even though people know that savings will yield them more future consumption, why don’t they save all their current income? Clearly, because of their time preferences for present as against future consumption. These time preferences govern people’s allocation between present and future. Every individual, given his money “income”—defined in conventional terms—and his value scales, will allocate that income in the most desired proportion between consumption and investment. Any other allocation of such income, any different proportions, would therefore satisfy his wants and desires to a lesser extent and lower his position on his value scale. It is therefore incorrect to say that an income tax levies an extra burden on savings and investment; it penalizes an individual’s entire standard of living, present and future. An income tax does not penalize saving per se any more than it penalizes consumption.

Hence, the Fisher analysis, for all its sophistication, simply shares the other consumption tax advocates’ prejudices against the voluntary free-market allocations between consumption and investment. The argument places greater weight on savings and investment than the market does. A consumption tax is just as disruptive of voluntary time preferences and market allocations as is a tax on savings. In most or all other areas of the market, free market economists understand that allocations on the market tend always to be optimal with respect to satisfying consumers’ desires. Why then do they all too often make an exception of consumption-savings allocations, refusing to respect time-preference rates on the market?

Perhaps the answer is that economists are subject to the same temptations as anyone else. One of these temptations is to call loudly for you, him, and the other guy to work harder, and save and invest more, thereby increasing one’s own present and future standards of living. A follow-up temptation is to call for the gendarmes to enforce that desire. Whatever we may call this temptation, economic science has nothing to do with it.

THE IMPOSSIBILITY OF TAXING ONLY CONSUMPTION

Having challenged the merits of the goal of taxing only consumption and freeing savings from taxation, we now proceed to deny the very possibility of achieving that goal, i.e., we maintain that a consumption tax will devolve, willy-nilly, into a tax on income and therefore on savings as well. In short, that even if, for the sake of argument, we should want to tax only consumption and not income, we should not be able to do so.

Let us take, first, the Fisher plan, which, seemingly straightforward, would exempt saving and tax only consumption. Let us take Mr. Jones, who earns an annual income of $100,000. His time preferences lead him to spend 90 percent of his income on consumption, and save-and-invest the other 10 percent. On this assumption, he will spend $90,000 a year on consumption, and save-and-invest the other $10,000. Let us assume now that the government levies a 20 percent tax on Jones’s income, and that his time-preference schedule remains the same. The ratio of his consumption to savings will still be 90:10, and so, after-tax income now being $80,000, his consumption spending will be $72,000 and his saving-investment $8,000 per year.9

Suppose now that instead of an income tax, the government follows the Irving Fisher scheme, and levies a 20 percent annual tax on Jones’s consumption. Fisher maintained that such a tax would fall only on consumption, and not on Jones’s savings. But this claim is incorrect, since Jones’s entire savings-investment is based solely on

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9We set aside the fact that, at the lower amount of money assets left to him, Jones’s time preference rate, given his time preference schedule, will be higher, so that his consumption will be higher, and his savings lower, than we have assumed.
the possibility of his future consumption, which will be taxed equally. Since future consumption will be taxed, we assume, at the same rate as consumption at present, we cannot conclude that savings in the long run receives any tax exemption or special encouragement. There will therefore be no shift by Jones in favor of savings-and-investment due to a consumption tax.\footnote{In fact, per note 9, supra, there will be a shift in favor of consumption because a diminished amount of money will shift the taxpayer’s time preference rate in the direction of consumption. Hence, paradoxically, a pure tax on consumption will end up taxing savings more than consumption! See Rothbard, \textit{Power and Market}, pp. 108–11.} In sum, any payment of taxes to the government, whether they be consumption or income, necessarily reduces Jones’s net income. Since his time preference schedule remains the same, Jones will therefore reduce his consumption and his savings proportionately. The consumption tax will be shifted by Jones until it becomes equivalent to a lower rate of tax on his own income. If Jones still spends 90 percent of his net income on consumption, and 10 percent on savings-investment, his net income will be reduced by $15,000, instead of $20,000, and his consumption will now total $76,000, and his savings-investment $9,000. In other words, Jones’s 20 percent consumption tax will become equivalent to a 15 percent tax on his income, and he will arrange his consumption-savings proportions accordingly.\footnote{If net income is defined as gross income minus amount paid in taxes, and for Jones, consumption is 90 percent of net income, a 20 percent consumption tax on $100,000 income will be tantamount to a 15 percent tax on this income. Rothbard, \textit{Power and Market}, pp. 108–11. The basic formula is that net income,}

\[ N = \frac{G}{1 + tc} \]

where $G$ = gross income, $t$ = the tax rate on consumption, and $c$, consumption as percent of net income, are givens of the problem, and $N = G - T$ by definition, where $T$ is the amount paid in consumption tax.

We saw at the beginning of this paper that an excise tax skewing resources away from more desirable goods does not necessarily mean we can recommend an alternative, such as an income tax. But how about a general sales tax, assuming that one can be levied politically with no exemptions of goods or services? Wouldn’t such a tax burden be only on consumption and not income?
In the first place, a sales tax would be subject to the same problems as the Fisher consumption tax. Since future and present consumption would be taxed equally, there would again be shifting by each individual so that future as well as present consumption would be reduced. But, furthermore, the sales tax is subject to an extra complication: the general assumption that a sales tax can be readily shifted forward to the consumer is totally fallacious. In fact, the sales tax cannot be shifted forward at all!

Consider: all prices are determined by the interaction of supply, the stock of goods available to be sold, and by the demand schedule for that good. If the government levies a general 20 percent tax on all retail sales, it is true that retailers will now incur an additional 20 percent cost on all sales. But how can they raise prices to cover these costs? Prices, at all times, tend to be set at the maximum net revenue point for each seller. If the sellers can simply pass the 20 percent increase in costs onto the consumers, why did they have to wait until a sales tax to raise prices? Prices are already at highest net income levels for each firm. Any increase in cost, therefore, will have to be absorbed by the firm; it cannot be passed forward to the consumers. Put another way: the levy of a sales tax has not changed the stock already available to the consumers; that stock has already been produced. Demand curves have not changed, and there is no reason for them to do so. Since supply and demand have not changed, neither will price. Or, looking at the situation from the point of the demand and supply of money, which help determine general price levels, the supply of money has remained as given, and there is also no reason to assume a change in the demand for cash balances either. Hence, prices will remain the same.

It might be objected that, even though shifting forward to higher prices cannot occur immediately, it can do so in the longer run, when factor and resources owners will have a chance to lower their supply at a later point in time. It is true that a partial excise can be shifted forward in this way, in the long run, by resources leaving, let us say, the liquor industry and shifting into other untaxed industries. After a while, then, the price of liquor can be raised by a liquor tax, but only by reducing the future supply, the stock of liquor available for sale at a future date. But such “shifting” is not a painless and prompt passing on of a higher price to consumers; it can only be accomplished in a longer run by a reduction in the supply of a good.
The burden of a sales tax cannot be shifted forward in the same way, however. For resources cannot escape a sales tax as they can an excise tax: by leaving the liquor industry and moving to another. We are assuming that the sales tax is general and uniform; it cannot therefore, be escaped by resources except by fleeing into idleness. Hence, we cannot maintain that the sales tax will be shifted forward in the long run by all supplies of goods falling by something like 20 percent (depending on elasticities). General supplies of goods will fall, and hence prices rise, only to the relatively modest extent that labor, seeing a rise in the opportunity cost of leisure because of a drop in wage incomes, will leave the labor force and become voluntarily idle (or more generally will lower the number of hours worked).\footnote{Rothbard, \textit{Power and Market}, pp. 88–93. Also see the notable article by Harry Gunnison Brown, “The Incidence of a General Sales Tax,” in \textit{Readings in the Economics of Taxation}, R. Musgrave and C. Shoup, eds. (Homewood, Ill.: Irwin, 1959), pp. 330–39.}

In the long run, of course, and that run is not very long, the retail firms will not be able to absorb a sales tax; they are not unlimited pools of wealth ready to be confiscated. As the retail firms suffer losses, their demand curves for all intermediate goods, and then for all factors of production, will shift sharply downward, and these declines in demand schedules will be rapidly transmitted to all the ultimate factors of production: labor, land, and interest income. And since all firms tend to earn a uniform interest return determined by social time preference, the incidence of the fall in demand curves will rest rather quickly on the two ultimate factors of production: land and labor.

Hence, the seemingly common-sense view that a retail sales tax will readily be shifted forward to the consumer is totally incorrect. In contrast, the initial impact of the tax will be on the net incomes of retail firms. Their severe losses will lead to a rapid downward shift in demand curves, backward to land and labor, i.e., to wage rates and ground rents. Hence, instead of the retail sales tax being quickly and painlessly shifted forward, it will, in a longer-run, be painfully shifted backward to the incomes of labor and landowners. Once again, an alleged tax on consumption has been transmuted by the processes of the market into a tax on incomes.
The general stress on forward shifting, and neglect of backward-shifting, in economics, is due to the disregard of the Austrian theory of value, and its insight that market price is determined only by the interaction of an already produced stock, with the subjective utilities and demand schedules of consumers for that stock. The market supply curve, therefore, should be vertical in the usual supply-demand diagram. The standard Marshallian forward-sloping supply curve illegitimately incorporates a time dimension within it, and it therefore cannot interact with an instantaneous, or freeze-frame, market demand curve. The Marshallian curve sustains the illusion that higher cost can directly raise prices, and not only indirectly by reducing supply. And while we may arrive at the same conclusion as Marshallian supply-curve analysis for a particular excise tax, where partial equilibrium can be used, this standard method breaks down for general sales taxation.

**Conclusion:**

**The Amount vs. the Form of Taxation**

We conclude with the observation that there has been far too much concentration on the form, the type of taxation, and not enough on its total amount. The result has been endless tinkering with kinds of taxes, coupled with neglect of a far more critical question: how much of the social product should be siphoned away from the producers? Or, how much income should be retained by the producers and how much income and resources coercively diverted for the benefit of non-producers?

It is particularly odd that economists who proudly refer to themselves as advocates of the free market have in recent years led the way in this mistaken path. It was allegedly free market economists for example, who pioneered in and propagated for, the alleged Tax Reform Act of 1986. This massive change was supposed to bring us “simplification” of our income taxes. The result, of course, was so simple that even the IRS, let alone the fleet of tax lawyers and tax accountants, has had great difficulty in understanding the new dispensation. Peculiarly, moreover, in all the maneuverings that led to the Tax Reform Act, the standard held up by these economists, a standard apparently so self-evident as to need no justification, was that the sum of tax changes be “revenue neutral.” But they never told us what is so great about revenue neutrality. And of course, by
cleeving to such a standard, the crucial question of total revenue was deliberately precluded from the discussion.

Even more egregious was an early doctrine of another group of supposed free-market advocates, the supply-siders. In their original Laffer-curve manifestation, now happily consigned to the dustbin of history, the supply-siders maintained that the tax rate that maximizes tax revenue is the “voluntary” rate, and a rate that should be diligently pursued. It was never pointed out in what sense such a tax rate is “voluntary,” or what in the world the concept of “voluntary” has to do with taxation in the first place. Much less did the supply-siders in their Lafferite form ever instruct us why we must all uphold maximizing government revenue as our beau ideal. Surely, for free-market proponents, one might think that minimizing government depredation of the private product would be a bit more appealing.

It is with relief that one turns for a realistic as well as a genuine free-market approach to Jean-Baptiste Say, who contributed considerably more to economics than Say’s Law. Say was under no illusion that taxation is voluntary nor that government spending contributes productive services to the economy. Say pointed out that, in taxation, “The government exacts from a taxpayer the payment of a given tax in the shape of money. To meet this demand, the taxpayer exchanges part of the products at his disposal for coin, which he pays to the tax-gatherers.” Eventually, the government spends the money on its own needs, so that “in the end . . . this value is consumed; and then the portion of wealth, which passes from the hands of the taxpayer into those of the tax-gatherer, is destroyed and annihilated.” Note, that as in the case of the later Calhoun, Say sees that taxation creates two conflicting classes, the taxpayers and the tax-gatherers. Were it not for taxes, the taxpayer would have spent his money on his own consumption. As it is, “The state . . . enjoys the satisfaction resulting from that consumption.”

Say proceeds to denounce the “prevalent notion, that the values, paid by the community for the public service, return it again . . .; that what government and its agents receive, is refunded again by their expenditures.” Say angrily comments that this “gross fallacy . . . has been productive of infinite mischief, inasmuch as it has been the pretext for a great deal of shameless waste and dilapidation.” On the contrary, Say declares, “the value paid to government by the taxpayer is given without equivalent or return; it is expended by the
government in the purchase of personal service, of objects of consump-

Say goes on to denounce the “false and dangerous conclusion” of
economic writers that government consumption increases wealth.
Say noted bitterly that “if such principles were to be found only in
books, and had never crept into practice one might suffer them with-
out care or regret to swell the monstrous heap of printed absurdity.”
But unfortunately, he noted, these notions have been put into “prac-
tice by the agents of public authority, who can enforce error and
absurdity at the point of a bayonet or mouth of the cannon.”

Taxation, then, for Say is

the transfer of a portion of the national products from the hands of
individuals to those of the government, for the purpose of meeting
the public consumption of expenditure. . . . It is virtually a burthen
imposed upon individuals, either in a separate or corporate char-
acter, by the ruling power . . . for the purpose of supplying the con-
sumption it may think proper to make at their expense.

But taxation, for Say, is not merely a zero-sum game. By levying
a burden on the producers, he points out, taxes, over time, cripple
production itself. Writes Say:

Taxation deprives the producer of a product, which he would oth-

J.B. Say’s policy recommendation was crystal clear and consis-
tent with his analysis and that of the present paper. “The best scheme
of public finance is, to spend as little as possible; and the best tax is
always the lightest.” What conclusion can be more fitting for April

13Jean-Baptiste Say, A Treatise on Political Economy, 6th ed. (Philadel-
phia: Claxton, Remsen and Heffelinger, 1880), pp. 412–15. Also see Mur-
ray N. Rothbard, “The Myth of Neutral Taxation,” Cato Journal 1 (Fall,
1981): 551–54; included in this volume as chapter 24.
14Say, Treatise, pp. 4–6.
15Ibid., p. 449.
Session 6
Government Spending

- Power and Market
  Chapter 5: Binary Intervention: Government Expenditures

- Economic Controversies
  The Politics of Political Economists

- Economic Controversies
  Statistics: Achilles’s Heel of Government
In the course of his interesting discussion of “The Politics of Political Economists,” Professor Stigler challenges the alleged view of Professor Mises that “economic statistics, or more generally quantitative—economics, generates a radical political viewpoint.” Stigler asserts that the empirical student acquires a “real feeling” for the functioning of an economic system, and “has had the complexities of the economy burned into his soul.” Without going into the question of Mises’s precise viewpoint on this issue, I think it important to note that Stigler has overlooked several fundamental considerations.

In the first place, statistics are desperately needed for any sort of government planning of the economic system. In a free market economy, the individual business firm has little or no need of statistics. It need only know its prices and costs. Costs are largely discovered internally within the firm and are not the general data of the economy which we usually refer to as “statistics.” The “automatic” market, then, requires virtually no gathering of statistics; government intervention, on the other hand, whether piecemeal or fully socialist, could do literally nothing without extensive ingathering of masses of statistics. Statistics are the bureaucrat’s only form of economic knowledge, replacing the intuitive, “qualitative” knowledge of the entrepreneur, guided only by the quantitative profit-and-loss test.2

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2 On the type of knowledge required of the entrepreneur in the market economy, see F.A. Hayek, Individualism and the Economic Order (Chicago: University of Chicago Press, 1948), chaps. 4 and 2.
Accordingly, the drive for government intervention, and the drive for more statistics, have gone hand in hand.³

The enormous expansion of governmental activity in the gathering and disseminating of statistics in the last twenty-five years, is surely more than coincidentally related to the similar expansion of the role of government in regulating and manipulating the economy. One of the leading authorities on the growth of government expenditures has put it this way:

Advance in economic science and statistics improved our knowledge of interstate and intrastate differences in needs and capacities and may have helped stimulate the system of state and federal grants-in-aid. It strengthened belief in the possibilities of dealing with social problems by collective action. It made for increase in the statistical and other fact-finding activities of government.⁴

We need not detail here the extensive use that has been made of national income and gross national product statistics, as well as other statistical measures, in the attempts of the federal government at combating business cycles or unemployment.

Nor is this just a contemporary story. An authoritative work on British government puts the case thus:

the minor role of government during the nineteenth century reflects more than the absence of violent economic disruption; it also reflects the infancy of the economic and social sciences. Compared with recent decades, the volume of systematic information about social conditions was very small, which meant that the existence of problems was hard to establish persuasively. . . . If the volume of unemployment is unknown, the gravity of the problem is in doubt. . . .

³In this connection, we may note Professor Hutchison’s distinction between Carl Menger’s stress on the beneficent, unplanned, “unreflected” phenomena of society (which, of course, include the free market), and the growth of “social self-consciousness” and government planning. To Hutchison, a prominent component of “social self-consciousness” is social and economic statistics. T.W. Hutchison, A Review of Economic Doctrines, 1870–1929 (Oxford: The Clarendon Press, 1953), pp. 150–51, 427.

The accumulation of factual information about social conditions and the development of economics and the social sciences increased the pressure for government intervention. . . . Surveys like Charles Booth’s *Life and Labour of the People in London* revealed conditions which shocked public opinion in the late eighties and nineties. As statistics improved and students of social conditions multiplied, the continued existence of such conditions was kept before the public. Increasing knowledge of them aroused influential circles and furnished working class movements with factual weapons.5

Surely the role of the Fabian Society’s industrious empirical studies in furthering the cause of socialism in Great Britain is too well known to need stressing here.

On the continent and in America in the late nineteenth century, it is well known that the rebels against *laissez-faire* and the classical political economy stressed their replacement with induction from economic history and statistics. That was the goal of the German Historical School and its Verein für Sozialpolitik, and of the young German-trained exponents of the “new political economy” of government intervention in the 1870s and 1880s.6 One of their leaders, Richard T. Ely, who called the new approach the “look and see”

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6Thus, the new school found the deductive method of reasoning inadequate for its purposes. It championed the inductive method. . . . It rejected all a priori principles and looked to history and statistics to provide the facts of economic life. With the information thus obtained, the young economists approached economic problems in a pragmatic spirit, judging each case on its individual merits. In this way, they sought to prevent economic science from degenerating into a few abstract formulas, divorced from the realities of the age. (Sidney Fine, *Laissez-Faire and the General-Welfare State* [Ann Arbor: University of Michigan Press, 1956], p. 204)

method, made it clear that the aim of fact-gathering was to “mold the forces at work in society and to improve existing conditions”; they believed that as economists they had a responsibility for “shaping the character of the national economy.” And let us not overlook the eminent interventionist sociologist Lester Frank Ward, whose proposed “scientific,” “positive,” planned economy, would consist of a “social engineering” based on statistical information fed from all parts of the country into a central bureau of statistics.

Nor was it only abstract speculators who expressed such views. Statisticians themselves participated in this movement. As early as 1863, Samuel B. Ruggles, American delegate to the International Statistical Congress in Berlin, declared that “statistics are the very eyes of the statesman, enabling him to survey and scan with clear and comprehensive vision the whole structure and economy of the body politic.” One of the founders of the Verein für Sozialpolitik was the famous statistician Ernst Engel, head of the Royal Statistical Bureau of Prussia. And Carroll D. Wright, one of the early Commissioners of Labor in the United States and a man greatly influenced by Engel, urged the collection of statistics of unemployment because he wanted to find a remedy (presumably via government action). Wright hailed the new German School as including men of all lands “who seek by legitimate means, and without revolution, the

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amelioration of unfortunate industrial and social relations.” Henry Carter Adams, a student of Engel’s, who established the Statistical Bureau of the Interstate Commerce Commission, believed that “ever-increasing statistical activity by the government was essential not only for the sake of controlling naturally monopolistic industries, but also for the efficient functioning of competition wherever possible.”\(^{10}\) And certainly one of the great spurs toward constructing index numbers of wholesale and other prices was the desire to have government stabilize the price level.\(^{11}\)

Unquestionably one of the prime founders of modern statistical inquiry in economics was Wesley C. Mitchell. There is no doubt that Mitchell aspired to lay the basis for “scientific” government planning. Thus:

[quoting from Mitchell] . . . clearly the type of social invention most needed today is one that offers definite techniques through which the social system can be controlled and operated to the optimum advantage of its members.” To this end he [Mitchell] constantly sought to extend, improve, and refine the gathering and compilation of data. . . . Mitchell believed that business-cycle analysis might indicate the means to the achievement of orderly social control of business activity.\(^{12}\)

And:

\(^{10}\)Joseph Dorfman, *The Economic Mind in American Civilization* (New York: The Viking Press, 1949), vol. 3, pp. 172, 123. Dorfman notes that the accounting system of the Bureau devised by Adams “served as a model for the regulation of public utilities here and throughout the world.” Dorfman, “The Role of the German Historical School in American Economic Thought,” p. 23. We might also add that the first professor of statistics in the United States, Roland P. Falkner, was a devoted student of Engel’s and a translator of the works of Engel’s assistant, August Meitzen.

\(^{11}\)“One of the greatest obstacles then standing in the way of stabilization was the prevalent idea that index numbers were unreliable. Until this difficulty could be met, stabilization could scarcely be expected to become a reality. In order to do my bit toward solving this problem, I wrote *The Making of Index Numbers* . . .” Irving Fisher, *Stabilised Money* (London: George Allen and Unwin, 1935), p. 383.

he [Mitchell] envisaged the great contribution that government could make to the understanding of economic and social problems if the statistical data gathered independently by various Federal agencies were systematized and planned so that the interrelationships among them could be studied. The idea of developing social statistics, *not merely as a record but as a basis for planning*, emerged early in his own work.\(^\text{13}\)

The federal government’s own account of the growth of its statistical agencies differs little from the above examples. The Bureau of the Budget, during President Eisenhower’s not rabidly socialistic administration, explained the continued growth of federal statistics as follows:

National growth and prosperity demanded an enlightened conduct of public affairs with the aid of factual information. The ultimate responsibility of the Federal Government for underwriting the health of the national economy has always been implicit in the American system.\(^\text{14}\)

Then, speaking of the New Deal era after 1933, the Bureau added:

A realization grew in the Congress and in high administration circles that sound and positive proposals to combat the depression required analysis based upon reliable information. As a result . . . statistical expansion was resumed at an accelerated pace.\(^\text{15}\)

Suffice it then to say that a leading cause of the proliferation of governmental statistics is the need for statistical data in government economic planning. But the relationship works also in reverse: the growth of statistics, often developed originally for its own sake, ends by multiplying the avenues of government intervention and planning. In short, statistics do not have to be developed originally for politico-economic ends; their own autonomous development, directly or indirectly, opens up new fields for interventionists to


\(^{15}\)Ibid.
Each new statistical technique, whether it be flow of funds, inter-industry economics, or activity analysis, soon acquires its own subdivision and application in government. A particular example is input-output analysis, which began as a purely theoretical attempt to lend empirical content to the Walrasian system of general equilibrium. It has now advanced to the point where its champions hail it as providing:

an integrated picture of the industrial mechanism. They believe it can measure with fair accuracy the changes in inter-industry relations . . . that would follow assumed changes in the “final bill of goods. . . .” In practice, the most important change in the bill of goods is that called for by way of large-scale rearmament. It is hardly astonishing, therefore, that most of the development and application of input-output studies have been connected with industrial mobilization.16

There are other reasons why the statistically-oriented will tend to become interventionists. For one thing, the economic statistician will tend to be impatient of all theory as “armchair speculation,” and hence will tend to advocate piecemeal, pragmatic, decide-every-case-on-its-“merits” type of government planning. It is perhaps true, as Stigler declares, that few empirical economists have become outright socialists or communists; such a course would be much too theoretical for them. But neither do they become adherents of laisser-


Another example of input-output analysis as a spur to statistics-gathering and government planning: “while there may be systematic thinking among economists about economic analysis as applied to regions, they can offer little guidance to policy-making unless the latter are prepared to make it easier to obtain statistical raw material.” A.T. Peacock and D.G.M. Dosser, “Regional Input-Output Analysis and Government Spending,” Scottish Journal of Political Economy (November 1959): 236.
faire; instead, a case-by-case ad hoc approach drives them down the path of a muddled government interventionism. I do not know whether, as Stigler asserts, “the most radical wing of the new dealers was not distinguished for its empirical knowledge of the American economy.” But certainly the Tugwells and the Stuart Chases and the Veblenians proclaimed their empiricism often enough. And historians of the New Deal generally praise it highly for its flexible, pragmatic approach.

Another reason why statistics and political pragmatism are mutually congenial is that the very hallmark of the pragmatic approach is to begin by looking for problems or “problem areas” in the society. The pragmatist looks for areas where the economy and society fall short of the Garden of Eden, and these, of course, abound. Poverty, unemployment, old people with scurvy, young people with cavities—the list is indeed endless. And as each problem multiplies under the care of his eager research, the pragmatist calls ever more stridently for government to do something—quickly—to solve the problem. Only hard-headed, deductive, a prioristic, economic theory can teach him about ends and means, allocation of resources, opportunity cost, and the other rigors of the economic discipline.

Considering the above discussion, it is no wonder that conservative members of Congress, in the days before they were indoctrinated in the modern economic niceties by the Joint Committee on the Economic Report, were very suspicious of the seemingly harmless expansion of federal statistical activities. Thus, in 1945, Representative Frank Keefe, conservative Republican Congressman from Wisconsin was in the process of questioning Dr. A. Ford Hinrichs, head of the Bureau of Labor Statistics, on the latter’s request for increased appropriations. In the course of the questioning Keefe’s misgivings about government statistics emerged as a cry from the heart—unSophisticated perhaps, but at least of sound conservative instinct:

There is no doubt but what it would be nice to have a whole lot of statistics. . . . I am just wondering whether we are not embarking on a program that is dangerous when we keep adding and adding and adding to this thing. . . .

We have been Planning and getting statistics ever since 1932 to try to meet a situation that was domestic in character, but were never able to even meet that question. . . . Now we are involved in
an international question. . . . It looks to me as though we spend a tremendous amount of time with graphs and charts and statistics and planning. What my people are interested in is, what is it all about? Where are we going, and where are you going?\(^{17}\)

I think we can conclude that the nub of the difference between Stigler and myself is this: to him a radical or nonconservative is essentially a socialist or a communist. To me, a nonconservative is someone who advocates intervention rather than \textit{laissez faire}. The difference is one of frame of reference If we define conservatism as Stigler does, then it is true that most economists are conservatives; if we define it as believing in \textit{laissez faire}, then the conclusion must be very different. For the key then becomes not so much economics and noneconomics as theory versus empiricism. Empiricists will tend less to be full-scale socialists, but will also drift generally toward intervention.\(^{18}\)

Still, when all is said and done, it is probably true that even the proportion of believers in \textit{laissez faire} is much greater among economists than in other academic disciplines, and that the “average” point on the ideological spectrum in economics is considerably “to the right” of the average in other fields of study. It appears that the economic discipline, \textit{per se}, imposes a rightward shift in ideological belief. And this, after all, is the main point of Stigler’s article.


\(^{18}\)There are also profound epistemological reasons for empiricism in the “social sciences” tending toward statism. This involves the whole problem of positivism and “scientism.” On this, see F.A. Hayek, \textit{The Counter-Revolution of Science} (Glencoe, Ill.: The Free Press, 1952).
22

Statistics: Achilles’s Heel of Government

Our is truly an Age of Statistics. In a country and an era that worships statistical data as super-“scientific,” as offering us the keys to all knowledge, a vast supply of data of all shapes and sizes pours forth upon us. Mostly, it pours forth from government. While private agencies and trade associations do gather and issue some statistics, they are limited to specific wants of specific industries. The vast bulk of statistics is gathered and disseminated by government. The over-all statistics of the economy, the popular “gross national product” data that permits every economist to be a soothsayer of business conditions, come from government. Furthermore, many statistics are by-products of other governmental activities: from the Internal Revenue bureau come tax data, from unemployment insurance departments come estimates of the unemployed, from customs offices come data on foreign trade, from the Federal Reserve flow statistics on banking, and so on. And as new statistical techniques are developed, new divisions of government departments are created to refine and use them.

The burgeoning of government statistics offers several obvious evils to the libertarian. In the first place, it is clear that too many resources are being channeled into statistics-gathering and statistics-production. Given a wholly free market, the amount of labor, land, and capital resources devoted to statistics would dwindle to a small fraction of the present total. It has been estimated that the federal government alone spends over $48,000,000 on statistics, and that

statistical work employs the services of over 10,000 full-time civilian employees of the government.¹

**Hidden Costs of Reporting**

Second, the great bulk of statistics is gathered by government coercion. This not only means that they are products of unwelcome activities; it also means that the true cost of these statistics to the American public is much greater than the mere amount of tax money spent by the government agencies. Private industry, and the private consumer, must bear the burdensome costs of record-keeping, filing, and the like, that these statistics demand. Not only that; these fixed costs impose a relatively great burden on small business firms, which are ill-equipped to handle the mountains of red tape. Hence, these seemingly innocent statistics cripple small business enterprise and help to rigidify the American business system. A Hoover Commission task force found, for example, that:

No one knows how much it costs American industry to compile the statistics that the Government demands. The chemical industry alone reports that each year it spends $8,850,000 to supply statistical reports demanded by three departments of the Government. The utility industry spends $32,000,000 a year in preparing reports for Government agencies . . .

All industrial users of peanuts must report their consumption to the Department of Agriculture. . . . Upon the intervention of the Task Force, the Department of Agriculture agreed that henceforth only those that consume more than ten thousand pounds a year need report . . .

If small alterations are made in two reports, the Task Force says one industry alone can save $800,000 a year in statistical reporting.

Many employees of private industry are occupied with the collection of Government statistics. This is especially burdensome to small businesses. A small hardware store owner in Ohio estimated that 29 per cent of his time is absorbed in filling out such reports.

Not infrequently people dealing with the Government have to keep several sets of books to fit the diverse and dissimilar requirements of Federal agencies.²

**OTHER OBJECTIONS**

But there are other important, and not so obvious, reasons for the libertarian to regard government statistics with dismay. Not only do statistics-gathering and producing go beyond the governmental function of defense of persons and property; not only are economic resources wasted and misallocated, and the taxpayers, industry, small business, and the consumer burdened. But, furthermore, statistics are, in a crucial sense, critical to all interventionist and socialist activities of government. The individual consumer, in his daily rounds, has little need of statistics; through advertising, through the information of friends, and through his own experience, he finds out what is going on in the markets around him. The same is true of the business firm. The businessman must also size up his particular market, determine the prices he has to pay for what he buys and charge for what he sells, engage in cost accounting to estimate his costs, and so on. But none of this activity is really dependent upon the *omnia gatherum* of statistical facts about the economy ingested by the federal government. The businessman, like the consumer, knows and learns about his particular market through his daily experience.

**A SUBSTITUTE FOR MARKET DATA**

Bureaucrats as well as statist reformers, however, are in a completely different state of affairs. They are decidedly outside the market. Therefore, in order to get “into” the situation that they are trying to plan and reform, they must obtain knowledge that is not personal, day-to-day experience; the only form that such knowledge can take is statistics.³ Statistics are the eyes and ears of the bureaucrat, the politician, the socialistic reformer. Only by statistics can they know, or at

least have any idea about, what is going on in the economy. Only by statistics can they find out how many old people have rickets, or how many young people have cavities, or how many Eskimos have defective sealskins—and therefore only by statistics can these interventionists discover who “needs” what throughout the economy, and how much federal money should be channeled in what directions.

**THE MASTER PLAN**

Certainly, only by statistics, can the federal government make even a fitful attempt to plan, regulate, control, or reform various industries—or impose central planning and socialization on the entire economic system. If the government received no railroad statistics, for example, how in the world could it even start to regulate railroad rates, finances, and other affairs? How could the government impose price controls if it didn't even know what goods have been sold on the market, and what prices were prevailing? Statistics, to repeat, are the eyes and ears of the interventionists: of the intellectual reformer, the politician, and the government bureaucrat. Cut off those eyes and ears, destroy those crucial guidelines to knowledge, and the whole threat of government intervention is almost completely eliminated.

4 As early as 1863, Samuel B. Ruggles, American delegate to the International Statistical Congress in Berlin, declared: “Statistics are the very eyes of the statesmen, enabling him to survey and scan with clear and comprehensive vision the whole structure and economy of the body politic.” For more on the interrelation of statistics—and statisticians—and the government, see Murray N. Rothbard, “The Politics of Political Economists: Comment,” *Quarterly Journal of Economics* (November 1960): 659–65; included in this volume as chapter 18. Also see Dobbs, *On Planning the Earth*.

5 Government policy depends upon much detailed knowledge about the Nation's employment, production, and purchasing power. The formulation of legislation and administrative progress . . . supervision . . . regulation . . . and control . . . must be guided by knowledge of a wide range of relevant facts. Today as never before, statistical data play a major role in the supervision of Government activities. Administrators not only make plans in the light of known facts in their field of interest, but also they must have reports on the actual progress achieved in accomplishing their goals. *(Report on Budgeting and Accounting, pp. 91–92)*

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WITHOUT STATISTICS BUREAUCRACY WOULD WITHER AWAY

It is true, of course, that even deprived of all statistical knowledge of the nation’s affairs, the government could still try to intervene, to tax and subsidize, to regulate and control. It could try to subsidize the aged even without having the slightest idea of how many aged there are and where they are located; it could try to regulate an industry without even knowing how many firms there are or any other basic facts of the industry; it could try to regulate the business cycle without even knowing whether prices or business activity are going up or down. It could try, but it would not get very far. The utter chaos would be too patent and too evident even for the bureaucracy, and certainly for the citizens. And this is especially true since one of the major reasons put forth for government intervention is that it “corrects” the market, and makes the market and the economy more rational. Obviously, if the government were deprived of all knowledge whatever of economic affairs, there could not even be a pretense of rationality in government intervention. Surely, the absence of statistics would absolutely and immediately wreck any attempt at socialist planning. It is difficult to see what, for example, the central planners at the Kremlin could do to plan the lives of Soviet citizens if the planners were deprived of all information, of all statistical data, about these citizens. The government would not even know to whom to give orders, much less how to try to plan an intricate economy.

Thus, in all the host of measures that have been proposed over the years to check and limit government or to repeal its interventions, the simple and unspectacular abolition of government statistics would probably be the most thorough and most effective. Statistics, so vital to statism, its namesake, is also the State’s Achilles’s heel.
Session 7

Inflation and the Business Cycle

- *Man, Economy, and State*

- *America’s Great Depression*
  Chapter 1: The Positive Theory of the Cycle

A. Inflation and Credit Expansion

In chapter 11, we depicted the workings of the monetary system of a purely free market. A free money market adopts specie, either gold or silver or both parallel, as the “standard” or money proper. Units of money are simply units of weight of the money-stuff. The total stock of the money commodity increases with new production (mining) and decreases from wear and tear and use in industrial employments. Generally, there will be a gradual secular rise in the money stock, with effects as analyzed above. The wealth of some people will increase and of others will decline, and no social usefulness will accrue from an increased supply of money—in its monetary use. However, an increased stock will raise the social standard of living and well-being by further satisfying nonmonetary demands for the monetary metal.

Intervention in this money market usually takes the form of issuing pseudo warehouse receipts as money-substitutes. As we saw in chapter 11, demand liabilities such as deposits or paper notes may come into use in a free market, but may equal only the actual value, or weight, of the specie deposited. The demand liabilities are then genuine warehouse receipts, or true money certificates, and they pass on the market as representatives of the actual money, i.e., as money-substitutes. Pseudo warehouse receipts are those issued in excess of the actual weight of specie on deposit. Naturally, their issue can be a very lucrative business. Looking like the genuine certificates, they serve also as money-substitutes, even though not covered by specie. They are fraudulent, because they promise to redeem in specie at face value, a promise that could not possibly be met were all the deposit-holders to ask for their own property at the same time. Only the complacency and ignorance of the public permit the situation to continue.\(^\text{105}\)

\(^{105}\)Although it has obvious third-person effects, this type of intervention is essentially binary because the issuer, or intervener, gains at
Broadly, such intervention may be effected either by the government or by private individuals and firms in their role as “banks” or money-warehouses. The process of issuing pseudo warehouse receipts or, more exactly, the process of issuing money beyond any increase in the stock of specie, may be called inflation.\textsuperscript{106} A contraction in the money supply outstanding over any period (aside from a possible net decrease in specie) may be called deflation. Clearly, inflation is the primary event and the primary purpose of monetary intervention. There can be no deflation without an inflation having occurred in some previous period of time. \textit{A priori}, almost all intervention will be inflationary. For not only must all monetary intervention begin with inflation; the great gain to be derived from inflation comes from the issuer’s putting new money into circulation. The profit is practically costless, because, while all other people must either sell goods and services and buy or mine gold, the government or the commercial banks are literally creating money out of thin air. They do not have to buy it. Any profit from the use of this magical money is clear gain to the issuers.

As happens when new specie enters the market, the issue of “uncovered” money-substitutes also has a diffusion effect: the first receivers of the new money gain the most, the next gain slightly less, etc., until the midpoint is reached, and then each receiver loses more and more as he waits for the new money. For the first individuals’ selling prices soar while buying prices remain almost the same; but later, buying prices have risen while selling prices remain unchanged. A crucial circumstance,\textsuperscript{106}Inflation, in this work, is explicitly defined to exclude increases in the stock of specie. While these increases have such similar effects as raising the prices of goods, they also differ sharply in other effects: \((a)\) simple increases in specie do not constitute an intervention in the free market, penalizing one group and subsidizing another; and \((b)\) they do not lead to the processes of the business cycle.

the expense of individual holders of legitimate money. The “lines of force” radiate from the interveners to each of those who suffer losses.
however, differentiates this from the case of increasing specie. The new paper or new demand deposits have no social function whatever; they do not demonstrably benefit some without injuring others in the market society. The increasing money supply is only a social waste and can only advantage some at the expense of others. And the benefits and burdens are distributed as just outlined: the early-comers gaining at the expense of later-comers. Certainly, the business and consumer borrowers from the bank—its clientele—benefit greatly from the new money (at least in the short run), since they are the ones who first receive it.

If inflation is any increase in the supply of money not matched by an increase in the gold or silver stock available, the method of inflation just depicted is called credit expansion—the creation of new money-substitutes, entering the economy on the credit market. As will be seen below, while credit expansion by a bank seems far more sober and respectable than outright spending of new money, it actually has far graver consequences for the economic system, consequences which most people would find especially undesirable. This inflationary credit is called circulating credit, as distinguished from the lending of saved funds—called commodity credit. In this book, the term “credit expansion” will apply only to increases in circulating credit.

Credit expansion has, of course, the same effect as any sort of inflation: prices tend to rise as the money supply increases. Like any inflation, it is a process of redistribution, whereby the inflators, and the part of the economy selling to them, gain at the expense of those who come last in line in the spending process. This is the charm of inflation—for the beneficiaries—and the reason why it has been so popular, particularly since modern banking processes have camouflaged its significance for those losers who are far removed from banking operations. The gains to the inflators are visible and dramatic; the losses to others hidden and unseen, but just as effective for all that. Just as half the economy are taxpayers and half tax-consumers, so half the economy are inflation-payers and the rest inflation-consumers.
Most of these gains and losses will be “short-run” or “one-shot”; they will occur during the process of inflation, but will cease after the new monetary equilibrium is reached. The inflators make their gains, but after the new money supply has been diffused throughout the economy, the inflationary gains and losses are ended. However, as we have seen in chapter 11, there are also permanent gains and losses resulting from inflation. For the new monetary equilibrium will not simply be the old one multiplied in all relations and quantities by the addition to the money supply. This was an assumption that the old “quantity theory” economists made. The valuations of the individuals making temporary gains and losses will differ. Therefore, each individual will react differently to his gains and losses and alter his relative spending patterns accordingly. Moreover, the new money will form a high ratio to the existing cash balance of some and a low ratio to that of others, and the result will be a variety of changes in spending patterns. Therefore, all prices will not have increased uniformly in the new equilibrium; the purchasing power of the monetary unit has fallen, but not equiproportionally over the entire array of exchange-values. Since some prices have risen more than others, therefore, some people will be permanent gainers, and some permanent losers, from the inflation.107

Particularly hard hit by an inflation, of course, are the relatively “fixed” income groups, who end their losses only after a long period or not at all. Pensioners and annuitants who have contracted for a fixed money income are examples of permanent as well as short-run losers. Life insurance benefits are permanently slashed. Conservative anti-inflationists’ complaints about “the widows and orphans” have often been ridiculed, but they are no laughing matter nevertheless. For it is precisely the widows and orphans who bear a main part of

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the brunt of inflation. Also suffering losses are creditors who have already extended their loans and find it too late to charge a purchasing-power premium on their interest rates.

Inflation also changes the market’s consumption/investment ratio. Superficially, it seems that credit expansion greatly increases capital, for the new money enters the market as equivalent to new savings for lending. Since the new “bank money” is apparently added to the supply of savings on the credit market, businesses can now borrow at a lower rate of interest; hence inflationary credit expansion seems to offer the ideal escape from time preference, as well as an inexhaustible fount of added capital. Actually, this effect is illusory. On the contrary, inflation reduces saving and investment, thus lowering society’s standard of living. It may even cause large-scale capital consumption. In the first place, as we just have seen, existing creditors are injured. This will tend to discourage lending in the future and thereby discourage saving-investment. Secondly, as we have seen in chapter 11, the inflationary process inherently yields a purchasing-power profit to the businessman, since he purchases factors and sells them at a later time when all prices are higher. The businessman may thus keep abreast of the price increase (we are here exempting from variations in price increases the terms-of-trade component), neither losing nor gaining from the inflation. But business accounting is traditionally geared to a world where the value of the monetary unit is stable. Capital goods purchased are entered in the asset column “at cost,” i.e., at the price paid for them. When the firm later sells the product, the extra inflationary gain is not really a gain at all; for it must be absorbed in purchasing the replaced capital good at a higher price. Inflation, therefore, tricks the businessman: it

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108 The avowed goal of Keynes’ inflationist program was the “euthanasia of the rentier.” Did Keynes realize that he was advocating the not-so-merciful annihilation of some of the most unfit-for-labor groups in the entire population—groups whose marginal value productivity consisted almost exclusively in their savings? Keynes, General Theory, p. 376.
destroys one of his main signposts and leads him to believe that he has gained extra profits when he is just able to replace capital. Hence, he will undoubtedly be tempted to consume out of these profits and thereby unwittingly consume capital as well. Thus, inflation tends at once to repress saving-investment and to cause consumption of capital.

The accounting error stemming from inflation has other economic consequences. The firms with the greatest degree of error will be those with capital equipment bought more preponderantly when prices were lowest. If the inflation has been going on for a while, these will be the firms with the oldest equipment. Their seemingly great profits will attract other firms into the field, and there will be a completely unjustified expansion of investment in a seemingly high-profit area. Conversely, there will be a deficiency of investment elsewhere. Thus, the error distorts the market’s system of allocating resources and reduces its effectiveness in satisfying the consumer. The error will also be greatest in those firms with a greater proportion of capital equipment to product, and similar distorting effects will take place through excessive investment in heavily “capitalized” industries, offset by underinvestment elsewhere.109

B. CREDIT EXPANSION AND THE BUSINESS CYCLE

We have already seen in chapter 8 what happens when there is net saving-investment: an increase in the ratio of gross investment to consumption in the economy. Consumption expenditures fall, and the prices of consumers’ goods fall. On the other hand, the production structure is lengthened, and the prices of

original factors specialized in the higher stages rise. The prices of capital goods change like a lever being pivoted on a fulcrum at its center; the prices of consumers’ goods fall most, those of first-order capital goods fall less; those of highest-order capital goods rise most, and the others less. Thus, the price differentials between the stages of production all diminish. Prices of original factors fall in the lower stages and rise in the higher stages, and the nonspecific original factors (mainly labor) shift partly from the lower to the higher stages. Investment tends to be centered in lengthier processes of production. The drop in price differentials is, as we have seen, equivalent to a fall in the natural rate of interest, which, of course, leads to a corollary drop in the loan rate. After a while the fruit of the more productive techniques arrives; and the real income of everyone rises.

Thus, an increase in saving resulting from a fall in time preferences leads to a fall in the interest rate and another stable equilibrium situation with a longer and narrower production structure. What happens, however, when the increase in investment is not due to a change in time preference and saving, but to credit expansion by the commercial banks? Is this a magic way of expanding the capital structure easily and costlessly, without reducing present consumption? Suppose that six million gold ounces are being invested, and four million consumed, in a certain period of time. Suppose, now, that the banks in the economy expand credit and increase the money supply by two million ounces. What are the consequences? The new money is loaned to businesses.\textsuperscript{110} These businesses, now able to acquire the money at a lower rate of interest, enter the capital goods’ and original factors’ market to bid resources away from the other firms. At any given time, the stock of goods is fixed, and the two million new ounces are therefore employed in raising the prices of producers’ goods. The rise in prices of capital goods will be imputed to rises in original factors.

\textsuperscript{110}To the extent that the new money is loaned to consumers rather than businesses, the cycle effects discussed in this section do not occur.
The credit expansion reduces the market rate of interest. This means that price differentials are lowered, and, as we have seen in chapter 8, lower price differentials raise prices in the highest stages of production, shifting resources to these stages and also increasing the number of stages. As a result, the production structure is lengthened. The borrowing firms are led to believe that enough funds are available to permit them to embark on projects formerly unprofitable. On the free market, investment will always take place first in those projects that satisfy the most urgent wants of the consumers. Then the next most urgent wants are satisfied, etc. The interest rate regulates the temporal order of choice of projects in accordance with their urgency. A lower rate of interest on the market is a signal that more projects can be undertaken profitably. Increased saving on the free market leads to a stable equilibrium of production at a lower rate of interest. But not so with credit expansion: for the original factors now receive increased money income. In the free-market example, total money incomes remained the same. The increased expenditure on higher stages was offset by decreased expenditure in the lower stages. The “increased length” of the production structure was compensated by the “reduced width.” But credit expansion pumps new money into the production structure: aggregate money incomes increase instead of remaining the same. The production structure has lengthened, but it has also remained as wide, without contraction of consumption expenditure.

The owners of the original factors, with their increased money income, naturally hasten to spend their new money. They allocate this spending between consumption and investment in accordance with their time preferences. Let us assume that the time-preference schedules of the people remain unchanged. This is a proper assumption, since there is no reason to assume that they have changed because of the inflation. Production now no longer reflects voluntary time preferences. Business has been led by credit expansion to invest in higher stages, as if more savings were available. Since they are not,
business has overinvested in the higher stages and underinvested in the lower. Consumers act promptly to re-establish their time preferences—their preferred investment/consumption proportions and price differentials. The *differentials* will be re-established at the old, higher amount, i.e., the rate of interest will return to its free-market magnitude. As a result, the prices at the higher stages of production will fall drastically, the prices at the lower stages will rise again, and the entire new investment at the higher stages will have to be abandoned or sacrificed.

Altering our oversimplified example, which has treated only two stages, we see that the highest stages, believed profitable, have proved to be unprofitable. The pure rate of interest, reflecting consumer desires, is shown to have really been higher all along. The banks’ credit expansion had tampered with that indispensable “signal”—the interest rate—that tells businessmen how much savings are available and what length of projects will be profitable. In the free market the interest rate is an indispensable guide, in the time dimension, to the urgency of consumer wants. But bank intervention in the market disrupts this free price and renders entrepreneurs unable to satisfy consumer desires properly or to estimate the most beneficial time structure of production. As soon as the consumers are able, i.e., as soon as the increased money enters their hands, they take the opportunity to re-establish their time preferences and therefore the old differentials and investment-consumption ratios. *Over-investment* in the highest stages, and *underinvestment* in the lower stages are now revealed in all their starkness. The situation is analogous to that of a contractor misled into believing that he has more building material than he really has and then awakening to find that he has used up all his material on a capacious foundation (the higher stages), with no material left to complete the house.111 Clearly, bank credit expansion cannot

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increase capital investment by one iota. Investment can still come only from savings.

It should not be surprising that the market tends to revert to its preferred ratios. The same process, as we have seen, takes place in all prices after a change in the money stock. Increased money always begins in one area of the economy, raising prices there, and filters and diffuses eventually over the whole economy, which then roughly returns to an equilibrium pattern conforming to the value of the money. If the market then tends to return to its preferred price-ratios after a change in the money supply, it should be evident that this includes a return to its preferred saving-investment ratio, reflecting social time preferences.

It is true, of course, that time preferences may alter in the interim, either for each individual or as a result of the redistribution during the change. The gainers may save more or less than the losers would have done. Therefore, the market will not return precisely to the old free-market interest rate and investment/consumption ratio, just as it will not return to its precise pattern of prices. It will revert to whatever the free-market interest rate is now, as determined by current time preferences. Some advocates of coercing the market into saving and investing more than it wishes have hailed credit expansion as leading to “forced saving,” thereby increasing the capital-goods structure. But this can happen, not as a direct consequence of credit expansion, but only because effective time preferences have changed in that direction (i.e., time-preference schedules have shifted, or relatively more money is now in the hands of those with low time preferences). Credit expansion may well lead to the opposite effect: the gainers may have higher time preferences, in which case the free-market interest rate will be higher than before. Because these effects of credit expansion are completely uncertain and depend on the concrete data of each particular case, it is clearly far more cogent for advocates of forced saving to use the taxation process to make their redistribution.
The market therefore reacts to a distortion of the free-market interest rate by proceeding to revert to that very rate. The distortion caused by credit expansion deceives businessmen into believing that more savings are available and causes them to \textit{malinvest}—to invest in projects that will turn out to be unprofitable when consumers have a chance to reassert their true preferences. This reassertion takes place fairly quickly—as soon as owners of factors receive their increased incomes and spend them.

This theory permits us to resolve an age-old controversy among economists: whether an increase in the money supply can lower the market rate of interest. To the mercantilists—and to the Keynesians—it was obvious that an increased money stock permanently lowered the rate of interest (given the demand for money). To the classicists it was obvious that changes in the money stock could affect only the value of the monetary unit, and not the rate of interest. The answer is that an increase in the supply of money \textit{does} lower the rate of interest when it enters the market as credit expansion, but only temporarily. In the long run (and this long run is not very “long”), the market re-establishes the free-market time-preference interest rate and eliminates the change. In the long run a change in the money stock affects only the value of the monetary unit.

This process—by which the market reverts to its preferred interest rate and eliminates the distortion caused by credit expansion—is, moreover, \textit{the business cycle!} Our analysis therefore permits the solution, not only of the theoretical problem of the relation between money and interest, but also of the problem that has plagued society for the last century and a half and more—the dread business cycle. And, furthermore, the theory of the business cycle can now be explained as a subdivision of our general theory of the economy.

Note the hallmarks of this distortion-reversion process. First, the money supply increases through credit expansion; then businesses are tempted to malinvest—overinvesting in
higher-stage and durable production processes. Next, the prices and incomes of original factors increase and consumption increases, and businesses realize that the higher-stage investments have been wasteful and unprofitable. The first stage is the chief landmark of the “boom”; the second stage—the discovery of the wasteful malinvestments—is the “crisis.” The depression is the next stage, during which malinvested businesses become bankrupt, and original factors must suddenly shift back to the lower stages of production. The liquidation of unsound businesses, the “idle capacity” of the malinvested plant, and the “frictional” unemployment of original factors that must suddenly and en masse shift to lower stages of production—these are the chief hallmarks of the depression stage.

We have seen in chapter 11 that the major unexplained features of the business cycle are the mass of error and the concentration of error and disturbance in the capital-goods industries. Our theory of the business cycle solves both of these problems. The cluster of error suddenly revealed by entrepreneurs is due to the interventionary distortion of a key market signal—the interest rate. The concentration of disturbance in the capital-goods industries is explained by the spur to unprofitable higher-order investments in the boom period. And we have just seen that other characteristics of the business cycle are explained by this theory.

One point should be stressed: the depression phase is actually the recovery phase. Most people would be happy to keep the boom period, where the inflationary gains are visible and the losses hidden and obscure. This boom euphoria is heightened by the capital consumption that inflation promotes through illusory accounting profits. The stages that people complain about are the crisis and depression. But the latter periods, it should be clear, do not cause the trouble. The trouble occurs during the boom, when malinvestments and distortions take place; the crisis-depression phase is the curative period, after people have been forced to recognize the malinvestments that have occurred. The depression period, therefore, is the necessary recovery
period; it is the time when bad investments are liquidated and
mistaken entrepreneurs leave the market—the time when “con-
sumer sovereignty” and the free market reassert themselves and
establish once again an economy that benefits every participant
to the maximum degree. The depression period ends when the
free-market equilibrium has been restored and expansionary dis-
tortion eliminated.

It should be clear that any governmental interference with
the depression process can only prolong it, thus making things
worse from almost everyone’s point of view. Since the depre-
sion process is the recovery process, any halting or slowing
down of the process impedes the advent of recovery. The
depression readjustments must work themselves out before
recovery can be complete. The more these readjustments are
delayed, the longer the depression will have to last, and the
longer complete recovery is postponed. For example, if the gov-
ernment keeps wage rates up, it brings about permanent unem-
ployment. If it keeps prices up, it brings about unsold surplus.
And if it spurs credit expansion again, then new malinvestment
and later depressions are spawned.

Many nineteenth-century economists referred to the busi-
ness cycle in a biological metaphor, likening the depression to a
painful but necessary curative of the alcoholic or narcotic jag
which is the boom, and asserting that any tampering with the
depression delays recovery. They have been widely ridiculed by
present-day economists. The ridicule is misdirected, however,
for the biological analogy is in this case correct.

One obvious conclusion from our analysis is the absurdity of
the “underconsumptionist” remedies for depression—the idea
that the crisis is caused by underconsumption and that the way
to cure the depression is to stimulate consumption expendi-
tures. The reverse is clearly the truth. What has brought about
the crisis is precisely the fact that entrepreneurial investment
erroneously anticipated greater savings, and that this error is
revealed by consumers’ re-establishing their desired proportion
of consumption. “Overconsumption” or “undersaving” has brought about the crisis, although it is hardly fair to pin the guilt on the consumer, who is simply trying to restore his preferences after the market has been distorted by bank credit. The only way to hasten the curative process of the depression is for people to save and invest more and consume less, thereby finally justifying some of the malinvestments and mitigating the adjustments that have to be made.

One problem has been left unexplained. We have seen that the reversion period is short and that factor incomes increase rather quickly and start restoring the free-market consumption/saving ratios. But why do booms, historically, continue for several years? What delays the reversion process? The answer is that as the boom begins to peter out from an injection of credit expansion, the banks inject a further dose. In short, the only way to avert the onset of the depression-adjustment process is to continue inflating money and credit. For only continual doses of new money on the credit market will keep the boom going and the new stages profitable. Furthermore, only ever increasing doses can step up the boom, can lower interest rates further, and expand the production structure, for as the prices rise, more and more money will be needed to perform the same amount of work. Once the credit expansion stops, the market ratios are re-established, and the seemingly glorious new investments turn out to be malinvestments, built on a foundation of sand.

How long booms can be kept up, what limits there are to booms in different circumstances, will be discussed below. But it is clear that prolonging the boom by ever larger doses of credit expansion will have only one result: to make the inevitably ensuing depression longer and more grueling. The larger the scope of malinvestment and error in the boom, the greater and longer the task of readjustment in the depression. The way to prevent a depression, then, is simple: avoid starting a boom. And to avoid starting a boom all that is necessary is to pursue a truly free-market policy in money, i.e., a policy of 100-percent specie reserves for banks and governments.
Credit expansion always generates the business cycle process, even when other tendencies cloak its workings. Thus, many people believe that all is well if prices do not rise or if the actually recorded interest rate does not fall. But prices may well not rise because of some counteracting force—such as an increase in the supply of goods or a rise in the demand for money. But this does not mean that the boom-depression cycle fails to occur. The essential processes of the boom—distorted interest rates, malinvestments, bankruptcies, etc.—continue unchecked. This is one of the reasons why those who approach business cycles from a statistical point of view and try in that way to arrive at a theory are in hopeless error. Any historical-statistical fact is a complex resultant of many causal influences and cannot be used as a simple element with which to construct a causal theory. The point is that credit expansion raises prices beyond what they would have been in the free market and thereby creates the business cycle. Similarly, credit expansion does not necessarily lower the interest rate below the rate previously recorded; it lowers the rate below what it would have been in the free market and thus creates distortion and malinvestment. Recorded interest rates in the boom will generally rise, in fact, because of the purchasing-power component in the market interest rate. An increase in prices, as we have seen, generates a positive purchasing-power component in the natural interest rate, i.e., the rate of return earned by businessmen on the market. In the free market this would quickly be reflected in the loan rate, which, as we have seen above, is completely dependent on the natural rate. But a continual influx of circulating credit prevents the loan rate from catching up with the natural rate, and thereby generates the business-cycle process.\footnote{Since Knut Wicksell is one of the fathers of this business-cycle approach, it is important to stress that our usage of “natural rate” differs from his. Wicksell’s “natural rate” was akin to our “free-market rate”; our “natural rate” is the rate of return earned by businesses on the existing market without considering loan interest. It corresponds to what has been}
corollary of this bank-created discrepancy between the loan rate and the natural rate is that creditors on the loan market suffer losses for the benefit of their debtors: the capitalists on the stock market or those who own their own businesses. The latter gain during the boom by the differential between the loan rate and the natural rate, while the creditors (apart from banks, which create their own money) lose to the same extent.

After the boom period is over, what is to be done with the malinvestments? The answer depends on their profitability for further use, i.e., on the degree of error that was committed. Some malinvestments will have to be abandoned, since their earnings from consumer demand will not even cover the current costs of their operation. Others, though monuments of failure, will be able to yield a profit over current costs, although it will not pay to replace them as they wear out. Temporarily working them fulfills the economic principle of always making the best of even a bad bargain.

Because of the malinvestments, however, the boom always leads to general *impoverishment*, i.e., reduces the standard of living below what it would have been in the absence of the boom. For the credit expansion has caused the squandering of scarce resources and scarce capital. Some resources have been completely wasted, and even those malinvestments that continue in use will satisfy consumers less than would have been the case without the credit expansion.

C. SECONDARY DEVELOPMENTS OF THE BUSINESS CYCLE

In the previous section we have presented the basic process of the business cycle. This process is often accentuated by other or “secondary” developments induced by the cycle. Thus, the expanding money supply and rising prices are likely to lower the demand for money. Many people begin to anticipate higher

misleadingly called the “normal profit rate,” but is actually the basic rate of interest. See chapter 6 above.
prices and will therefore hoard. The lowered demand for money raises prices further. Since the impetus to expansion comes first in expenditure on capital goods and later in consumption, this “secondary effect” of a lower demand for money may take hold first in producers’-goods industries. This lowers the price-and-profit differentials further and hence widens the distance that the rate of interest will fall below the free-market rate during the boom. The effect is to aggravate the need for readjustment during the depression. The adjustment would cause some fall in the prices of producers’ goods anyway, since the essence of the adjustment is to raise price differentials. The extra distortion requires a steeper fall in the prices of producers’ goods before recovery is completed.

As a matter of fact, the demand for money generally rises at the beginning of an inflation. People are accustomed to thinking of the value of the monetary unit as inviolate and of prices as remaining at some “customary” level. Hence, when prices first begin to rise, most people believe this to be a purely temporary development, with prices soon due to recede. This belief mitigates the extent of the price rise for a time. Eventually, however, people realize that credit expansion has continued and undoubtedly will continue, and their demand for money dwindles, becoming lower than the original level.

After the crisis arrives and the depression begins, various secondary developments often occur. In particular, for reasons that will be discussed further below, the crisis is often marked not only by a halt to credit expansion, but by an actual deflation—a contraction in the supply of money. The deflation causes a further decline in prices. Any increase in the demand for money will speed up adjustment to the lower prices. Furthermore, when deflation takes place first on the loan market, i.e., as credit contraction by the banks—and this is almost always the case—this will have the beneficial effect of speeding up the depression-adjustment process. For credit contraction creates higher price differentials. And the essence of the required adjustment is to return to higher price differentials, i.e., a higher “natural”
rate of interest. Furthermore, deflation will hasten adjustment in yet another way: for the accounting error of inflation is here reversed, and businessmen will think their losses are more, and profits less, than they really are. Hence, they will save more than they would have with correct accounting, and the increased saving will speed adjustment by supplying some of the needed deficiency of savings.

It may well be true that the deflationary process will overshoot the free-market equilibrium point and raise price differentials and the interest rate above it. But if so, no harm will be done, since a credit contraction can create no malinvestments and therefore does not generate another boom-bust cycle. And the market will correct the error rapidly. When there is such excessive contraction, and consumption is too high in relation to savings, the money income of businessmen is reduced, and their spending on factors declines—especially in the higher orders. Owners of original factors, receiving lower incomes, will spend less on consumption, price differentials and the interest rate will again be lowered, and the free-market consumption/investment ratios will be speedily restored.

Just as inflation is generally popular for its narcotic effect, deflation is always highly unpopular for the opposite reason. The contraction of money is visible; the benefits to those whose buying prices fall first and who lose money last remain hidden.

113If some readers are tempted to ask why credit contraction will not lead to the opposite type of malinvestment to that of the boom—overinvestment in lower-order capital goods and underinvestment in higher-order goods—the answer is that there is no arbitrary choice open of investing in higher-order or lower-order goods. Increased investment must be made in the higher-order goods—in lengthening the structure of production. A decreased amount of investment simply cuts down on higher-order investment. There will thus be no excess of investment in the lower orders, but simply a shorter structure than would otherwise be the case. Contraction, unlike expansion, does not create positive malinvestments.
And the illusory accounting losses of deflation make businesses believe that their losses are greater, or profits smaller, than they actually are, and this will aggravate business pessimism.

It is true that deflation takes from one group and gives to another, as does inflation. Yet not only does credit contraction speed recovery and counteract the distortions of the boom, but it also, in a broad sense, takes away from the original coercive gainers and benefits the original coerced losers. While this will certainly not be true in every case, in the broad sense much the same groups will benefit and lose, but in reverse order from that of the redistributive effects of credit expansion. Fixed-income groups, widows and orphans, will gain, and businesses and owners of original factors previously reaping gains from inflation will lose. The longer the inflation has continued, of course, the less the same individuals will be compensated.¹¹⁴

Some may object that deflation “causes” unemployment. However, as we have seen above, deflation can lead to continuing unemployment only if the government or the unions keep wage rates above the discounted marginal value products of labor. If wage rates are allowed to fall freely, no continuing unemployment will occur.

Finally, deflationary credit contraction is, necessarily, severely limited. Whereas credit can expand (barring various economic limits to be discussed below) virtually to infinity, circulating credit can contract only as far down as the total amount of specie in circulation. In short, its maximum possible limit is the eradication of all previous credit expansion.

The business-cycle analysis set forth here has essentially been that of the “Austrian” School, originated and developed by

¹¹⁴If the economy is on a gold or silver standard, then many advocates of a free market will argue for credit contraction for the following additional reasons: (a) to preserve the principle of paying one’s contractual obligations and (b) to punish the banks for their expansion and force them back toward a 100-percent-specie reserve policy.
Ludwig von Mises and some of his students. A prominent criticism of this theory is that it “assumes the existence of full employment” or that its analysis holds only after “full employment” has been attained. Before that point, say the critics, credit expansion will beneficently put these factors to work and not generate further malinvestments or cycles. But, in the first place, inflation will put no unemployed factors to work unless their owners, though holding out for a money price higher than their marginal value product, are blindly content to accept the necessarily lower real price when it is camouflaged as a rise in the “cost of living.” And credit expansion generates further cycles whether or not there are unemployed factors. It creates more distortions and malinvestments, delays indefinitely the process of recovery from the previous boom, and makes necessary an eventually far more grueling recovery to adjust to the new malinvestments as well as to the old. If idle capital goods are now set to work, this “idle capacity” is the hangover effect of previous wasteful malinvestments, and hence is really submarginal and not worth bringing into production. Putting the capital to work again will only redouble the distortions.

D. THE LIMITS OF CREDIT EXPANSION

Having investigated the consequences of credit expansion, we must discuss the important question: If fractional-reserve banking is legal, are there any natural limits to credit expansion

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115 Mises first presented the “Austrian theory” in a notable section of his Theory of Money and Credit, pp. 346–66. For a more developed statement, see his Human Action, pp. 547–83. For F.A. Hayek’s important contributions, see especially his Prices and Production, and also his Monetary Theory and the Trade Cycle (London: Jonathan Cape, 1933), and Profits, Interest, and Investment. Other works in the Misesian tradition include Robbins, The Great Depression, and Fritz Machlup, The Stock Market, Credit, and Capital Formation (New York: Macmillan & Co., 1940).

116 See Mises, Human Action, pp. 577–78; and Hayek, Prices and Production, pp. 96–99.
by the banks? The one basic limit, of course, is the necessity of the banks to redeem their money-substitutes on demand. Under a gold or silver standard, they must redeem in specie; under a government fiat paper standard (see below), the banks have to redeem in government paper. In any case, they must redeem in standard money or its virtual equivalent. Therefore, every fractional reserve bank depends for its very existence on persuading the public—specifically its clients—that all is well and that it will be able to redeem its notes or deposits whenever the clients demand. Since this is palpably not the case, the continuance of confidence in the banks is something of a psychological marvel. It is certain, at any rate, that a wider knowledge of praxeology among the public would greatly weaken confidence in the banking system. For the banks are in an inherently weak position. Let just a few of their clients lose confidence and begin to call on the banks for redemption, and this will precipitate a scramble by other clients to make sure that they get their money while the banks’ doors are still open. The obvious—and justifiable—panic of the banks should any sort of “run” develop encourages other clients to do the same and aggravates the run still further. At any rate, runs on banks can wreak havoc, and, of course, if pursued consistently, could close every bank in the country in a few days.

Runs, therefore, and the constant underlying threat of their occurrence, are one of the prime limits to credit expansion. Runs often develop during a business cycle crisis, when debts

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117 Perhaps one reason for continuing confidence in the banking system is that people generally believe that fraud is prosecuted by the government and that, therefore, any practice not so prosecuted must be sound. Governments, indeed (as we shall see below), always go out of their way to bolster the banking system.

118 All this, of course, assumes no further government intervention in banking than permitting fractional-reserve banking. Since the advent of deposit “insurance” during the New Deal, for example, the bank-run limitation has been virtually eliminated by this act of special privilege.
are being defaulted and failures become manifest. Runs and the fear of runs help to precipitate deflationary credit contraction.

Runs may be an ever-present threat, but, as effective limitations, they are not generally active. When they do occur, they usually wreck the banks. The fact that a bank is in existence at all signifies that a run has not developed. A more active, everyday limitation is the relatively narrow range of a bank’s clientele. The clientele of a bank consists of those people willing to hold its deposits or notes (its money-substitutes) in lieu of money proper. It is an empirical fact, in almost all cases, that one bank does not have the patronage of all people in the market society or even of all those who prefer to use bank money rather than specie. It is obvious that the more banks exist, the more restricted will be the clientele of any one bank. People decide which bank to use on many grounds; reputation for integrity, friendliness of service, price of service, and convenience of location may all play a part.

How does the narrow range of a bank’s clientele limit its potentiality for credit expansion? The newly issued money-substitutes are, of course, loaned to a bank’s clients. The client then spends the new money on goods and services. The new money begins to be diffused throughout the society. Eventually—usually very quickly—it is spent on the goods or services of people who use a different bank. Suppose that the Star Bank has expanded credit; the newly issued Star Bank’s notes or deposits find their way into the hands of Mr. Jones, who uses the City Bank. Two alternatives may occur, either of which has the same economic effect: (a) Jones accepts the Star Bank’s notes or deposits, and deposits them in the City Bank, which calls on the Star Bank for redemption; or (b) Jones refuses to accept the Star Bank’s notes and insists that the Star client—say Mr. Smith—who bought something from Jones, redeem the note himself and pay Jones in acceptable standard money.

Thus, while gold or silver is acceptable throughout the market, a bank’s money-substitutes are acceptable only to its own clientele. Clearly, a single bank’s credit expansion is limited,
and this limitation is stronger (a) the narrower the range of its clientele, and (b) the greater its issue of money-substitutes in relation to that of competing banks. In illustration of the first point, let us assume that each bank has only one client. Then it is obvious that there will be very little room for credit expansion. At the opposite extreme, if one bank is used by everybody in the economy, there will be no demands for redemption resulting from its clients’ purchasing from nonclients. It is obvious that, *ceteris paribus*, a numerically smaller clientele is more restrictive of credit expansion.

As regards the second point, the greater the degree of relative credit expansion by any one bank, the sooner will the day of redemption—and potential bankruptcy—be at hand. Suppose that the Star Bank expands credit, while none of the competing banks do. This means that the Star Bank’s clientele have added considerably to their cash balances; as a result the marginal utility to them of each unit of money to hold declines, and they are impelled to spend a great proportion of the new money. Some of this increased spending will be on one another’s goods and services, but it is clear that the greater the credit expansion, the greater will be the tendency for their spending to “spill over” onto the goods and services of nonclients. This tendency to spill over, or “drain,” is greatly enhanced when increased spending by clients on the goods and services of other clients raises their prices. In the meanwhile, the prices of the goods sold by nonclients remain the same. As a consequence, clients are impelled to buy more from nonclients and less from one another; while nonclients buy less from clients and more from one another. The result is an “unfavorable” balance of trade from clients to nonclients.119 It is clear that this tendency of money to seek a

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119In the consolidated balance of payments of the clients, money income from sales to nonclients (exports) will decline, and money expenditures on the goods and services of nonclients (imports) will increase. The excess cash balances of the clients are transferred to nonclients.
uniform level of exchange value throughout the entire market is an example of the process by which new money (in this case, new money-substitutes) is diffused through the market. The greater the relative credit expansion by the bank, then, the greater and more rapid will be the drain and consequent pressure on an expanding bank for redemption.

The purpose of banks’ keeping any specie reserves in their vaults (assuming no legal reserve requirements) now becomes manifest. It is not to meet bank runs—since no fractional-reserve bank can be equipped to withstand a run. It is to meet the demands for redemption which will inevitably come from nonclients.

Mises has brilliantly shown that a subdivision of this process was discovered by the British Currency School and by the classical “international trade” theorists of the nineteenth century. These older economists assumed that all the banks in a certain region or country expanded credit together. The result was a rise in the prices of goods produced in that country. A further result was an “unfavorable” balance of trade, i.e., an outflow of standard specie to other countries. Since other countries did not patronize the expanding country’s banks, the consequence was a “specie drain” from the expanding country and increased pressure for redemption on its banks.

Like all parts of the overstressed and overelaborated theory of “international trade,” this analysis is simply a special subdivision of “general” economic theory. And cataloging it as “international trade” theory, as Mises has shown, underestimates its true significance.120,121

Thus, the more freely competitive and numerous are the banks, the less they will be able to expand fiduciary media, even

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120 Older economists also distinguished an “internal drain” as well as the “external drain,” but included in the former only the drain from bank users to those who insist on standard money.

121 See Human Action, pp. 434–35.
if they are left free to do so. As we have noted in chapter 11, such a system is known as “free banking.” 122 A major objection to this analysis of free banking has been the problem of bank “cartels.” If banks get together and agree to expand their credits simultaneously, the clientele limitation vis-à-vis competing banks will be removed, and the clientele of each bank will, in effect, increase to include all bank users. Mises points out, however, that the sounder banks with higher fractional reserves will not wish to lose the goodwill of their own clients and risk bank runs by entering into collusive agreements with weaker banks. 123 This consideration, while placing limits on such agreements, does not rule them out altogether. For, after all, no fractional-reserve banks are really sound, and if the public can be led to believe that, say, an 80-percent-specie reserve is sound, it can believe the same about 60-percent- or even 10-percent-reserve banks. Indeed, the fact that the weaker banks are allowed by the public to exist at all demonstrates that the more conservative banks may not lose much good will by agreeing to expand with them.

As Mises has demonstrated, there is no question that, from the point of view of opponents of inflation and credit expansion, free banking is superior to a central banking system (see below). But, as Amasa Walker stated:

> Much has been said, at different times, of the desirability of free banking. Of the propriety and rightfulness of allowing any person who chooses to carry on banking, as freely as farming or any other branch of business, there can be no doubt. But, while banking, as at present, means the issuing of inconvertible paper, the more it is guarded and restricted the better. But when such issues are entirely forbidden, and

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122 For various views on free and central banking, see Vera C. Smith, *The Rationale of Central Banking* (London: P.S. King and Son, 1936).
only notes equivalent to certificates of so much coin
are issued, banking may be as free as brokerage. The
only thing to be secured would be that no issues
should be made except upon specie in hand.124

E. THE GOVERNMENT AS PROMOTER OF CREDIT EXPANSION

Historically, governments have fostered and encouraged
credit expansion to a great degree. They have done so by weakening the limitations that the market places on bank credit expansion. One way of weakening is to anesthetize the bank against the threat of bank runs. In nineteenth-century America, the government permitted banks, when they got into trouble in a business crisis, to suspend specie payment while continuing in operation. They were temporarily freed from their contractual obligation of paying their debts, while they could continue lending and even force their debtors to repay in their own bank notes. This is a powerful way to eradicate limitations on credit expansion, since the banks know that if they overreach themselves, the government will permit them blithely to avoid payment of their contractual obligations.

Under a fiat money standard, governments (or their central banks) may obligate themselves to bail out, with increased issues of standard money, any bank or any major bank in distress. In the late nineteenth century, the principle became accepted that the central bank must act as the “lender of last resort,” which will lend money freely to banks threatened with failure. Another recent American device to abolish the confidence limitation on bank credit is “deposit insurance,” whereby the government guarantees to furnish paper money to redeem the banks’ demand liabilities. These and similar devices remove the market brakes on rampant credit expansion.

A second device, now so legitimized that any country lacking it is considered hopelessly “backward,” is the central bank.

The central bank, while often nominally owned by private individuals or banks, is run directly by the national government. Its purpose, not always stated explicitly, is to remove the competitive check on bank credit provided by a multiplicity of independent banks. Its aim is to make sure that all the banks in the country are co-ordinated and will therefore expand or contract together—at the will of the government. And we have seen that co-ordination of expansion greatly weakens the market's limits.

The crucial way by which governments have established central bank control over the commercial banking system is by granting the bank a monopoly of the note issue in the country. As we have seen, money-substitutes may be issued in the form of notes or book deposits. Economically, the two forms are identical. The State has found it convenient, however, to distinguish between the two and to outlaw all note issue by private banks. Such nationalizing of the note-issue business forces the commercial banks to go to the central bank whenever their customers desire to exchange demand deposits for paper notes. To obtain notes to furnish their clients, commercial banks must buy them from the central bank. Such purchases can be made only by selling their gold coin or other standard money or by drawing on the banks’ deposit accounts with the central bank.

Since the public always wishes to hold some of its money in the form of notes and some in demand deposits, the banks must establish a continuing relationship with the central bank to be assured a supply of notes. Their most convenient procedure is to establish demand deposit accounts with the central bank, which thereby becomes the “bankers’ bank.” These demand deposits (added to the gold in their vaults) become the reserves of the banks. The central bank can also more freely create demand liabilities not backed 100 percent by gold, and these increased liabilities add to the reserves and demand deposits held by banks or else increase central bank notes outstanding. The rise in reserves of banks throughout the country will spur
them to expand credit, while any decrease in these reserves will induce a general contraction in credit.

The central bank can increase the reserves of a country’s banks in three ways: (a) by simply lending them reserves; (b) by purchasing their assets, thereby adding directly to the banks’ deposit accounts with the central bank; or (c) by purchasing the I.O.U.’s of the public, which will then deposit the drafts on the central bank in the various banks that serve the public directly, thereby enabling them to use the credits on the central bank to add to their own reserves. The second process is known as discounting; the latter as open market purchase. A lapse in discounts as the loans mature will lower reserves, as will open market sales. In open market sales, the people will pay the central bank for its assets, purchased with checks drawn on their accounts at the banks; and the central bank exacts payment by reducing bank reserves on its books. In most cases, the assets purchased or sold on the open market are government I.O.U.’s.\textsuperscript{125}

Thus, the banking system becomes co-ordinated under the aegis of the government. The central bank is always accorded a great deal of prestige by its creator government. Often the government makes its notes legal tender. Under the gold standard, the wide resources which it commands, added to the fact that the whole country is its clientele, usually make negligible any trouble the bank may have in redeeming its liabilities in gold. Furthermore, it is certain that no government will let its own central bank (i.e., itself) go bankrupt; the central bank will always be permitted to suspend specie payment in times of serious difficulty. It can therefore inflate and expand credit itself (through rediscounts and open market purchases) and, by

\textsuperscript{125}There is a fourth way by which a central bank may increase bank reserves: in countries, such as the United States, where banks must keep a legally required minimum ratio of reserves to deposits, the bank may simply lower the required ratio.
adding to bank reserves, spur a multiple bank credit expansion throughout the country. The effect is multiple because banks will generally keep a certain proportion of reserves to liabilities—based on estimates of nonclient redemption—and a general increase in their reserves will induce a multiple expansion of fiduciary media. In fact, the multiple will even increase, for the knowledge that all the banks are co-ordinated and expanding together decreases the possibility of nonclient redemption and therefore the proportion of reserves that each bank will wish to keep.

When the government “goes off” the gold standard, central bank notes then become legal tender and virtually the standard money. It then cannot possibly fail, and this, of course, practically eliminates limitations on its credit expansion. In the present-day United States, for example, the current basically fiat standard (also known as a “restricted international gold bullion standard”) virtually eliminates pressure for redemption, while the central bank’s ready provision of reserves as well as deposit insurance eliminates the threat of bank failure. In order to insure centralized control by the government over bank credit, the United States enforces on banks a certain minimum ratio of reserves (almost wholly deposits with the central bank) to deposits.

So long as a country is in any sense “on the gold standard,” the central bank and the banking system must worry about an external drain of specie should the inflation become too great. Under an unrestricted gold standard, it must also worry about an internal drain resulting from the demands of those who do not use the banks. A shift in public taste from deposits to notes

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126Foreign central banks and governments are still permitted to redeem in gold bullion, but this is hardly a consolation for either foreign citizens or Americans. The result is that gold is still an ultimate “balancing” item between national governments, and therefore a kind of medium of exchange for governments and central banks in international transactions.
will embarrass the commercial banks, though not the central bank. Assiduous propaganda on the conveniences of banking, however, has reduced the ranks of those not using banks to a few malcontents. As a result, the only limitation on credit expansion is now external. Governments, of course, are always anxious to remove all checks on their powers of inducing monetary expansion. One way of removing the external threat is to foster international cooperation, so that all governments and central banks expand their money supply at a uniform rate. The “ideal” condition for unlimited inflation is, of course, a world fiat paper money, issued by a world central bank or other governmental authority. Pure fiat money on a national scale would serve almost as well, but there would then be the embarrassment of national moneys depreciating in terms of other moneys, and imports becoming much more expensive.\footnote{The transition from gold to fiat money will be greatly smoothed if the State has previously abandoned ounces, grams, grains, and other units of weight in naming its monetary units and substituted unique names, such as dollar, mark, franc, etc. It will then be far easier to eliminate the public’s association of monetary units with weight and to teach the public to value the names themselves. Furthermore, if each national government sponsors its own unique name, it will be far easier for each State to control its own fiat issue absolutely.}

F. The Ultimate Limit: The Runaway Boom

With the establishment of fiat money by a State or by a World State, it would seem that all limitations on credit expansion, or on any inflation, are eliminated. The central bank can issue limitless amounts of nominal units of paper, unchecked by any necessity of digging a commodity out of the ground. They may be supplied to banks to bolster their credit at the pleasure of the government. No problems of internal or external drain exist. And if there existed a World State, or a co-operating cartel of States, with a world bank and world paper money, and gold and silver money were outlawed, could not the World State then
expand the money supply at will with no foreign exchange or foreign trade difficulties, permanently redistributing wealth from the market’s choice to its own favorites, from voluntary producers to the ruling castes?

Many economists and most other people assume that the State could accomplish this goal. Actually, it could not, for there is an ultimate limit on inflation, a very wide one, to be sure, but a terrible limit that will in the end conquer any inflation. Paradoxically, this is the phenomenon of *runaway inflation*, or *hyperinflation*.

When the government and the banking system begin inflating, the public will usually aid them unwittingly in this task. The public, not cognizant of the true nature of the process, believes that the rise in prices is transient and that prices will soon return to “normal.” As we have noted above, people will therefore hoard more money, i.e., keep a greater proportion of their income in the form of cash balances. The social demand for money, in short, increases. As a result, prices tend to increase less than proportionately to the increase in the quantity of money. The government obtains *more real* resources from the public than it had expected, since the public’s demand for these resources has declined.

Eventually, the public begins to realize what is taking place. It seems that the government is attempting to use inflation as a permanent form of taxation. But the public has a weapon to combat this depredation. Once people realize that the government will continue to inflate, and therefore that prices will continue to rise, they will step up their purchases of goods. For they will realize that they are gaining by buying now, instead of waiting until a future date when the value of the monetary unit will be lower and prices higher. In other words, the social demand for money falls, and prices now begin to rise more rapidly than the increase in the supply of money. When this happens, the confiscation by the government, or the “taxation” effect of inflation, will be lower than the government had expected, for the increased money will be reduced in purchasing power by
the greater rise in prices. This stage of the inflation is the beginning of hyperinflation, of the runaway boom.\textsuperscript{128}

The lower demand for money allows fewer resources to be extracted by the government, but the government can still obtain resources so long as the market continues to use the money. The accelerated price rise will, in fact, lead to complaints of a “scarcity of money” and stimulate the government to greater efforts of inflation, thereby causing even more accelerated price increases. This process will not continue long, however. As the rise in prices continues, the public begins a “flight from money,” getting rid of money as soon as possible in order to invest in real goods—almost \textit{any} real goods—as a store of value for the future. This mad scramble away from money, lowering the demand for money to hold practically to zero, causes prices to rise upward in astronomical proportions. The value of the monetary unit falls practically to zero. The devastation and havoc that the runaway boom causes among the populace is enormous. The relatively fixed-income groups are wiped out. Production declines drastically (sending up prices further), as people lose the incentive to work—since they must spend much of their time getting rid of money. The main desideratum becomes getting hold of real goods, whatever they may be, and spending money as soon as received. When this runaway stage is reached, the economy in effect breaks down, the market is virtually ended, and society reverts to a state of virtual barter and complete impoverishment.\textsuperscript{129} Commodities are then slowly built up as media of exchange. The public has rid itself of the inflation burden by its ultimate weapon: lowering the demand for money to such an extent that the government’s money has become worthless. When all other limits and

\textsuperscript{128}Cf. the analysis by John Maynard Keynes in his \textit{A Tract on Monetary Reform} (London: Macmillan & Co., 1923), chap. ii, section 1.

\textsuperscript{129}On runaway inflation, see Mises, \textit{Theory of Money and Credit}, pp. 227–31.
forms of persuasion fail, this is the only way—through chaos and economic breakdown—for the people to force a return to the “hard” commodity money of the free market.

The most famous runaway inflation was the German experience of 1923. It is particularly instructive because it took place in one of the world’s most advanced industrial countries. The chaotic events of the German hyperinflation and other accelerated booms, however, are only a pale shadow of what would happen under a World State inflation. For Germany was able to recover and return to a full monetary market economy quickly, since it could institute a new currency based on exchanges with other pre-existing moneys (gold or foreign paper). As we have seen, however, Mises’ regression theorem shows that no money can be established on the market except as it can be exchanged for a previously existing money (which in turn must have ultimately related back to a commodity in barter). If a World State outlaws gold and silver and establishes a unitary fiat money, which it proceeds to inflate until a runaway boom destroys it, there will be no pre-existing money on the market. The task of reconstruction will then be enormously more difficult.

G. INFLATION AND COMPENSATORY FISCAL POLICY

Inflation, in recent years, has been generally defined as an increase in prices. This is a highly unsatisfactory definition. Prices are highly complex phenomena, activated by many different causal factors. They may increase or decrease from the goods side—i.e., as a result of a change in the supply of goods on the market. They may increase or decrease because of a change in the social demand for money to hold; or they may rise or fall from a change in the supply of money. To lump all of these causes together is misleading, for it glosses over the

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130 Costantino Bresciani-Turroni, The Economics of Inflation (London: George Allen & Unwin, 1937), is a brilliant and definitive work on the German inflation.
separate influences, the isolation of which is the goal of science. Thus, the money supply may be increasing, while at the same time the social demand for money is increasing from the goods side, in the form of increased supplies of goods. Each may offset the other, with no general price changes occurring. Yet both processes perform their work nevertheless. Resources will still shift as a result of inflation, and the business cycle caused by credit expansion will still appear. It is, therefore, highly inexpedient to define inflation as a rise in prices.

Movements in the supply-of-goods and in the demand-for-money schedules are all the results of voluntary changes of preferences on the market. The same is true for increases in the supply of gold or silver. But increases in fiduciary or fiat media are acts of fraudulent intervention in the market, distorting voluntary preferences and the voluntarily determined pattern of income and wealth. Therefore, the most expedient definition of “inflation” is one we have set forth above: an increase in the supply of money beyond any increase in specie.131

The absurdity of the various governmental programs for “fighting inflation” now becomes evident. Most people believe that government officials must constantly pace the ramparts, armed with a huge variety of “control” programs designed to combat the inflation enemy. Yet all that is really necessary is that the government and the banks (nowadays controlled almost completely by the government) cease inflating.132 The absurdity of the term “inflationary pressure” also becomes clear. Either

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131 Inflation is here defined as any increase in the money supply greater than an increase in specie, not as a big change in that supply. As here defined, therefore, the terms “inflation” and “deflation” are praxeological categories. See Mises, *Human Action*, pp. 419–20. But also see Mises’ remarks in Aaron Director, ed., *Defense, Controls, and Inflation* (Chicago: University of Chicago Press, 1952), p. 3 n.

the government and banks are inflating or they are not; there is no such thing as “inflationary pressure.”  

The idea that the government has the duty to tax the public in order to “sop up excess purchasing power” is particularly ludicrous. If inflation has been under way, this “excess purchasing power” is precisely the result of previous governmental inflation. In short, the government is supposed to burden the public twice: once in appropriating the resources of society by inflating the money supply, and again, by taxing back the new money from the public. Rather than “checking inflationary pressure,” then, a tax surplus in a boom will simply place an additional burden upon the public. If the taxes are used for further government spending, or for repaying debts to the public, then there is not even a deflationary effect. If the taxes are used to redeem government debt held by the banks, the deflationary effect will not be a credit contraction and therefore will not correct maladjustments brought about by the previous inflation. It will, indeed, create further dislocations and distortions of its own.

Keynesian and neo-Keynesian “compensatory fiscal policy” advocates that government deflate during an “inflationary” period and inflate (incur deficits, financed by borrowing from the banks) to combat a depression. It is clear that government inflation can relieve unemployment and unsold stocks only if the process dupes the owners into accepting lower real prices or wages. This “money illusion” relies on the owners’ being too ignorant to realize when their real incomes have declined—a slender basis on which to ground a cure. Furthermore, the inflation will benefit part of the public at the expense of the rest, and any credit expansion will only set a further “boom-bust” cycle into motion. The Keynesians depict the free market’s monetary-fiscal system as minus a steering wheel, so that the economy,

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133See Mises in Director, Defense, Controls, and Inflation, p. 334.
134See section 8F above.
though readily adjustable in other ways, is constantly walking a precarious tightrope between depression and unemployment on the one side and inflation on the other. It is then necessary for the government, in its wisdom, to step in and steer the economy on an even course. After our completed analysis of money and business cycles, however, it should be evident that the true picture is just about the reverse. The free market, unhampered, would not be in danger of suffering inflation, deflation, depression, or unemployment. But the intervention of government *creates* the tightrope for the economy and is constantly, if sometimes unwittingly, pushing the economy into these pitfalls.

12. Conclusion: The Free Market and Coercion

We have thus concluded our analysis of voluntary and free action and its consequences in the free market, and of violent and coercive action and *its* consequences in economic intervention. Superficially, it looks to many people as if the free market is a chaotic and anarchic place, while government intervention imposes order and community values upon this anarchy. Actually, praxeology—economics—shows us that the truth is quite the reverse. We may divide our analysis into the direct, or palpable, effects, and the indirect, hidden effects of the two principles. Directly, voluntary action—free exchange—leads to the mutual benefit of both parties to the exchange. Indirectly, as our investigations have shown, the network of these free exchanges in society—known as the “free market”—creates a delicate and even awe-inspiring mechanism of harmony, adjustment, and precision in allocating productive resources, deciding upon prices, and gently but swiftly guiding the economic system toward the greatest possible satisfaction of the desires of all the consumers. In short, not only does the free market *directly* benefit all parties and leave them free and uncoerced; it also creates a mighty and efficient instrument of social *order*. Proudhon, indeed, wrote better than he knew when he called “Liberty, the Mother, not the Daughter, of Order.”
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The Positive Theory of the Cycle

Study of business cycles must be based upon a satisfactory cycle theory. Gazing at sheaves of statistics without “pre-judgment” is futile. A cycle takes place in the economic world, and therefore a usable cycle theory must be integrated with general economic theory. And yet, remarkably, such integration, even attempted integration, is the exception, not the rule. Economics, in the last two decades, has fissured badly into a host of airtight compartments—each sphere hardly related to the others. Only in the theories of Schumpeter and Mises has cycle theory been integrated into general economics.¹

The bulk of cycle specialists, who spurn any systematic integration as impossibly deductive and overly simplified, are thereby (wittingly or unwittingly) rejecting economics itself. For if one may forge a theory of the cycle with little or no relation to general economics, then general economics must be incorrect, failing as it does to account for such a vital economic phenomenon. For institutionalists—the pure data collectors—if not for others, this is a welcome conclusion. Even institutionalists, however, must use theory sometimes, in analysis and recommendation; in fact, they end by using a concoction of ad hoc hunches, insights, etc.,

¹Various neo-Keynesians have advanced cycle theories. They are integrated, however, not with general economic theory, but with holistic Keynesian systems—systems which are very partial/indeed.
plucked unsystematically from various theoretical gardens. Few, if any, economists have realized that the Mises theory of the trade cycle is not just another theory: that, in fact, it meshes closely with a general theory of the economic system. The Mises theory is, in fact, the economic analysis of the necessary consequences of intervention in the free market by bank credit expansion. Followers of the Misesian theory have often displayed excessive modesty in pressing its claims; they have widely protested that the theory is “only one of many possible explanations of business cycles,” and that each cycle may fit a different causal theory. In this, as in so many other realms, eclecticism is misplaced. Since the Mises theory is the only one that stems from a general economic theory, it is the only one that can provide a correct explanation. Unless we are prepared to abandon general theory, we must reject all proposed explanations that do not mesh with general economics.

**Business Cycles and Business Fluctuations**

It is important, first, to distinguish between business cycles and ordinary business fluctuations. We live necessarily in a society of continual and unending change, change that can never be precisely charted in advance. People try to forecast and anticipate changes as best they can, but such forecasting can never be reduced to an exact science. Entrepreneurs are in the business of forecasting changes on the market, both for conditions of demand and of supply. The more successful ones make profits pari passu with their accuracy of judgment, while the unsuccessful forecasters fall by the wayside. As a result, the successful entrepreneurs on the free market will be the ones most adept at anticipating future business conditions. Yet, the forecasting can never be perfect, and entrepreneurs will continue to differ in the success of their judgments. If this were not so, no profits or losses would ever be made in business.

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2 There is, for example, not a hint of such knowledge in Haberler’s well-known discussion. See Gottfried Haberler, *Prosperity and Depression* (2nd ed., Geneva, Switzerland: League of Nations, 1939).
Changes, then, take place continually in all spheres of the economy. Consumer tastes shift; time preferences and consequent proportions of investment and consumption change; the labor force changes in quantity, quality, and location; natural resources are discovered and others are used up; technological changes alter production possibilities; vagaries of climate alter crops, etc. All these changes are typical features of any economic system. In fact, we could not truly conceive of a changeless society, in which everyone did exactly the same things day after day, and no economic data ever changed. And even if we could conceive of such a society, it is doubtful whether many people would wish to bring it about.

It is, therefore, absurd to expect every business activity to be “stabilized” as if these changes were not taking place. To stabilize and “iron out” these fluctuations would, in effect, eradicate any rational productive activity. To take a simple, hypothetical case, suppose that a community is visited every seven years by the seven-year locust. Every seven years, therefore, many people launch preparations to deal with the locusts: produce anti-locust equipment, hire trained locust specialists, etc. Obviously, every seven years there is a “boom” in the locust-fighting industry, which, happily, is “depressed” the other six years. Would it help or harm matters if everyone decided to “stabilize” the locust-fighting industry by insisting on producing the machinery evenly every year, only to have it rust and become obsolete? Must people be forced to build machines before they want them; or to hire people before they are needed; or, conversely, to delay building machines they want—all in the name of “stabilization”? If people desire more autos and fewer houses than formerly, should they be forced to keep buying houses and be prevented from buying the autos, all for the sake of stabilization? As Dr. F.A. Harper has stated:

This sort of business fluctuation runs all through our daily lives. There is a violent fluctuation, for instance, in the harvest of strawberries at different times during the year. Should we grow enough strawberries in greenhouses so as to stabilize that part of our economy throughout the year.3

We may, therefore, expect specific business fluctuations all the time. There is no need for any special “cycle theory” to account for them. They are simply the results of changes in economic data and are fully explained by economic theory. Many economists, however, attribute general business depression to “weaknesses” caused by a “depression in building” or a “farm depression.” But declines in specific industries can never ignite a general depression. Shifts in data will cause increases in activity in one field, declines in another. There is nothing here to account for a general business depression—a phenomenon of the true “business cycle.” Suppose, for example, that a shift in consumer tastes, and technologies, causes a shift in demand from farm products to other goods. It is pointless to say, as many people do, that a farm depression will ignite a general depression, because farmers will buy less goods, the people in industries selling to farmers will buy less, etc. This ignores the fact that people producing the other goods now favored by consumers will prosper; their demands will increase.

The problem of the business cycle is one of general boom and depression; it is not a problem of exploring specific industries and wondering what factors make each one of them relatively prosperous or depressed. Some economists—such as Warren and Pearson or Dewey and Dakin—have believed that there are no such things as general business fluctuations—that general movements are but the results of different cycles that take place, at different specific time-lengths, in the various economic activities. To the extent that such varying cycles (such as the 20-year “building cycle” or the seven-year locust cycle) may exist, however, they are irrelevant to a study of business cycles in general or to business depressions in particular. What we are trying to explain are general booms and busts in business.

In considering general movements in business, then, it is immediately evident that such movements must be transmitted through the general medium of exchange—money. Money forges the connecting link between all economic activities. If one price goes up and another down, we may conclude that demand has shifted from one industry to another; but if all prices move up or down together, some change must have occurred in the monetary sphere. Only
changes in the demand for, and/or the supply of, money will cause general price changes. An increase in the supply of money, the demand for money remaining the same, will cause a fall in the purchasing power of each dollar, i.e., a general rise in prices; conversely, a drop in the money supply will cause a general decline in prices. On the other hand, an increase in the general demand for money, the supply remaining given, will bring about a rise in the purchasing power of the dollar (a general fall in prices); while a fall in demand will lead to a general rise in prices. Changes in prices in general, then, are determined by changes in the supply of and demand for money. The supply of money consists of the stock of money existing in the society. The demand for money is, in the final analysis, the willingness of people to hold cash balances, and this can be expressed as eagerness to acquire money in exchange, and as eagerness to retain money in cash balance. The supply of goods in the economy is one component in the social demand for money; an increased supply of goods will, other things being equal, increase the demand for money and therefore tend to lower prices. Demand for money will tend to be lower when the purchasing power of the money-unit is higher, for then each dollar is more effective in cash balance. Conversely, a lower purchasing power (higher prices) means that each dollar is less effective, and more dollars will be needed to carry on the same work.

The purchasing power of the dollar, then, will remain constant when the stock of, and demand for, money are in equilibrium with each other: i.e., when people are willing to hold in their cash balances the exact amount of money in existence. If the demand for money exceeds the stock, the purchasing power of money will rise until the demand is no longer excessive and the market is cleared; conversely, a demand lower than supply will lower the purchasing power of the dollar, i.e., raise prices.

Yet, fluctuations in general business, in the “money relation,” do not by themselves provide the clue to the mysterious business cycle. It is true that any cycle in general business must be transmitted through this money relation: the relation between the stock of, and the demand for, money. But these changes in themselves explain little. If the money supply increases or demand falls, for
example, prices will rise; but why should this generate a “business cycle”? Specifically, why should it bring about a depression? The early business cycle theorists were correct in focusing their attention on the crisis and depression: for these are the phases that puzzle and shock economists and laymen alike, and these are the phases that most need to be explained.

**The Problem: The Cluster of Error**

The explanation of depressions, then, will not be found by referring to specific or even general business fluctuations *per se*. The main problem that a theory of depression must explain is: *why is there a sudden general cluster of business errors?* This is the first question for any cycle theory. Business activity moves along nicely with most business firms making handsome profits. Suddenly, without warning, conditions change and the bulk of business firms are experiencing losses; they are suddenly revealed to have made grievous errors in forecasting.

A general review of entrepreneurship is now in order. Entrepreneurs are largely in the business of forecasting. They must invest and pay costs in the present, in the expectation of recouping a profit by sale either to consumers or to other entrepreneurs further down in the economy’s structure of production. The better entrepreneurs, with better judgment in forecasting consumer or other producer demands, make profits; the inefficient entrepreneurs suffer losses. The market, therefore, provides a training ground for the reward and expansion of successful, far-sighted entrepreneurs and the weeding out of inefficient businessmen. As a rule only some businessmen suffer losses at any one time; the bulk either break even or earn profits. How, then, do we explain the curious phenomenon of the crisis when almost all entrepreneurs suffer sudden losses? In short, how did all the country’s astute businessmen come to make such errors together, and why were they all suddenly revealed at this particular time? This is the great problem of cycle theory.

It is not legitimate to reply that sudden changes in the data are responsible. It is, after all, the business of entrepreneurs to forecast
future changes, some of which are sudden. Why did their forecasts fail so abysmally?

Another common feature of the business cycle also calls for an explanation. It is the well-known fact that capital-goods industries fluctuate more widely than do the consumer-goods industries. The capital-goods industries—especially the industries supplying raw materials, construction, and equipment to other industries—expand much further in the boom, and are hit far more severely in the depression.

A third feature of every boom that needs explaining is the increase in the quantity of money in the economy. Conversely, there is generally, though not universally, a fall in the money supply during the depression.

THE EXPLANATION: BOOM AND DEPRESSION

In the purely free and unhampered market, there will be no cluster of errors, since trained entrepreneurs will not all make errors at the same time.² The “boom-bust” cycle is generated by monetary intervention in the market, specifically bank credit expansion to business. Let us suppose an economy with a given supply of money. Some of the money is spent in consumption; the rest is saved and invested in a mighty structure of capital, in various orders of production. The proportion of consumption to saving or investment is determined by people’s time preferences—the degree to which they prefer present to future satisfactions. The less they prefer them in the present, the lower will their time preference


Under conditions of free competition . . . the market is . . . dependent upon supply and demand . . . there could [not] develop a disproportionality in the production of goods, which could draw in the whole economic system . . . such a disproportionality can arise only when, at some decisive point, the price structure does not base itself upon the play of only free competition, so that some arbitrary influence becomes possible.

Kuznets himself criticizes the Austrian theory from his empiricist, anti-cause and effect-standpoint, and also erroneously considers this theory to be “static.”
rate be, and the lower therefore will be the pure interest rate, which is determined by the time preferences of the individuals in society. A lower time-preference rate will be reflected in greater proportions of investment to consumption, a lengthening of the structure of production, and a building-up of capital. Higher time preferences, on the other hand, will be reflected in higher pure interest rates and a lower proportion of investment to consumption. The final market rates of interest reflect the pure interest rate plus or minus entrepreneurial risk and purchasing power components. Varying degrees of entrepreneurial risk bring about a structure of interest rates instead of a single uniform one, and purchasing power components reflect changes in the purchasing power of the dollar, as well as in the specific position of an entrepreneur in relation to price changes. The crucial factor, however, is the pure interest rate. This interest rate first manifests itself in the “natural rate” or what is generally called the going “rate of profit.” This going rate is reflected in the interest rate on the loan market, a rate which is determined by the going profit rate.  

Now what happens when banks print new money (whether as bank notes or bank deposits) and lend it to business? The new money pours forth on the loan market and lowers the loan rate of interest. It looks as if the supply of saved funds for investment has increased, for the effect is the same: the supply of funds for investment apparently increases, and the interest rate is lowered. Businessmen, in short, are misled by the bank inflation into believing that the supply of saved funds is greater than it really is. Now, when saved funds increase, businessmen invest in “longer processes of production,” i.e., the capital structure is lengthened, especially in the “higher orders” most remote from the consumer.


6 “Banks,” for many purposes, include also savings and loan associations, and life insurance companies, both of which create new money via credit expansion to business. See below for further discussion of the money and banking question.
Businessmen take their newly acquired funds and bid up the prices of capital and other producers’ goods, and this stimulates a shift of investment from the “lower” (near the consumer) to the “higher” orders of production (furthest from the consumer)—from consumer goods to capital goods industries.\(^7\)

If this were the effect of a genuine fall in time preferences and an increase in saving, all would be well and good, and the new lengthened structure of production could be indefinitely sustained. But this shift is the product of bank credit expansion. Soon the new money percolates downward from the business borrowers to the factors of production: in wages, rents, interest. Now, unless time preferences have changed, and there is no reason to think that they have, people will rush to spend the higher incomes in the old consumption-investment proportions. In short, people will rush to reestablish the old proportions, and demand will shift back from the higher to the lower orders. Capital goods industries will find that their investments have been in error: that what they thought profitable really fails for lack of demand by their entrepreneurial customers. Higher orders of production have turned out to be wasteful, and the malinvestment must be liquidated.

A favorite explanation of the crisis is that it stems from “under-consumption”—from a failure of consumer demand for goods at prices that could be profitable. But this runs contrary to the commonly known fact that it is capital goods, and not consumer goods, industries that really suffer in a depression. The failure is one of entrepreneurial demand for the higher order goods, and this in turn is caused by the shift of demand back to the old proportions.

In sum, businessmen were misled by bank credit inflation to invest too much in higher-order capital goods, which could only be prosperously sustained through lower time preferences and greater savings and investment; as soon as the inflation permeates to the mass

of the people, the old consumption–investment proportion is reestablished, and business investments in the higher orders are seen to have been wasteful. Businessmen were led to this error by the credit expansion and its tampering with the free-market rate of interest.

The “boom,” then, is actually a period of wasteful misinvestment. It is the time when errors are made, due to bank credit’s tampering with the free market. The “crisis” arrives when the consumers come to reestablish their desired proportions. The “depression” is actually the process by which the economy adjusts to the wastes and errors of the boom, and reestablishes efficient service of consumer desires. The adjustment process consists in rapid liquidation of the wasteful investments. Some of these will be abandoned altogether (like the Western ghost towns constructed in the boom of 1816–1818 and deserted during the Panic of 1819); others will be shifted to other uses. Always the principle will be not to mourn past errors, but to make most efficient use of the existing stock of capital. In sum, the free market tends to satisfy voluntarily-expressed consumer desires with maximum efficiency, and this includes the public’s relative desires for present and future consumption. The inflationary boom hobbles this efficiency, and distorts the structure of production, which no longer serves consumers properly. The crisis signals the end of this inflationary distortion, and the depression is the process by which the economy returns to the efficient service of consumers. In short, and this is a highly important point to grasp, the depression is the “recovery” process, and the end of the depression heralds the return to normal, and to optimum efficiency. The depression, then, far from being an evil scourge, is the necessary and beneficial return of the economy to normal after the distortions imposed by the boom. The boom, then, requires a “bust.”

Since it clearly takes very little time for the new money to filter down from business to factors of production, why don’t all booms come quickly to an end? The reason is that the banks come to the rescue. Seeing factors bid away from them by consumer goods

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8“Inflation” is here defined as an increase in the money supply not consisting of an increase in the money metal.
industries, finding their costs rising and themselves short of funds, the borrowing firms turn once again to the banks. If the banks expand credit further, they can again keep the borrowers afloat. The new money again pours into business, and they can again bid factors away from the consumer goods industries. In short, continually expanded bank credit can keep the borrowers one step ahead of consumer retribution. For this, we have seen, is what the crisis and depression are: the restoration by consumers of an efficient economy, and the ending of the distortions of the boom. Clearly, the greater the credit expansion and the longer it lasts, the longer will the boom last. The boom will end when bank credit expansion finally stops. Evidently, the longer the boom goes on the more wasteful the errors committed, and the longer and more severe will be the necessary depression readjustment.

Thus, bank credit expansion sets into motion the business cycle in all its phases: the inflationary boom, marked by expansion of the money supply and by malinvestment; the crisis, which arrives when credit expansion ceases and malinvestments become evident; and the depression recovery, the necessary adjustment process by which the economy returns to the most efficient ways of satisfying consumer desires.9

What, specifically, are the essential features of the depression-recovery phase? Wasteful projects, as we have said, must either be abandoned or used as best they can be. Inefficient firms, buoyed up by the artificial boom, must be liquidated or have their debts scaled down or be turned over to their creditors. Prices of producers' goods must fall, particularly in the higher orders of production—this includes capital goods, lands, and wage rates. Just as the boom was marked by a fall in the rate of interest, i.e., of price differentials between stages of production (the "natural rate" or going rate of

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9This "Austrian" cycle theory settles the ancient economic controversy on whether or not changes in the quantity of money can affect the rate of interest. It supports the "modern" doctrine that an increase in the quantity of money lowers the rate of interest (if it first enters the loan market); on the other hand, it supports the classical view that, in the long run, quantity of money does not affect the interest rate (or can only do so if time preferences change). In fact, the depression-readjustment is the market's return to the desired free-market rate of interest.
profit) as well as the loan rate, so the depression-recovery consists of a rise in this interest differential. In practice, this means a fall in the prices of the higher-order goods relative to prices in the consumer goods industries. Not only prices of particular machines must fall, but also the prices of whole aggregates of capital, e.g., stock market and real estate values. In fact, these values must fall more than the earnings from the assets, through reflecting the general rise in the rate of interest return.

Since factors must shift from the higher to the lower orders of production, there is inevitable “frictional” unemployment in a depression, but it need not be greater than unemployment attending any other large shift in production. In practice, unemployment will be aggravated by the numerous bankruptcies, and the large errors revealed, but it still need only be temporary. The speedier the adjustment, the more fleeting will the unemployment be. Unemployment will progress beyond the “frictional” stage and become really severe and lasting only if wage rates are kept artificially high and are prevented from falling. If wage rates are kept above the free-market level that clears the demand for and supply of labor, laborers will remain permanently unemployed. The greater the degree of discrepancy, the more severe will the unemployment be.

**SECONDARY FEATURES OF DEPRESSION: DEFLATIONARY CREDIT CONTRACTION**

The above are the essential features of a depression. Other secondary features may also develop. There is no need, for example, for deflation (lowering of the money supply) during a depression. The depression phase begins with the end of inflation, and can proceed without any further changes from the side of money. Deflation has almost always set in, however. In the first place, the inflation took place as an expansion of bank credit; now, the financial difficulties and bankruptcies among borrowers cause banks to pull in their horns and contract credit. Under the gold standard,

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10 It is often maintained that since business firms can find few profitable opportunities in a depression, business demand for loans falls off, and hence loans
banks have another reason for contracting credit—if they had ended inflation because of a gold drain to foreign countries. The threat of this drain forces them to contract their outstanding loans. Furthermore the rash of business failures may cause questions to be raised about the banks; and banks, being inherently bankrupt anyway, can ill afford such questions.\textsuperscript{11} Hence, the money supply will contract because of actual bank runs, and because banks will tighten their position in fear of such runs.

Another common secondary feature of depressions is an increase in the demand for money. This “scramble for liquidity” is the result of several factors: (1) people expect falling prices, due to the depression and deflation, and will therefore hold more money and spend less on goods, awaiting the price fall; (2) borrowers will try to pay off their debts, now being called by banks and by business creditors, by liquidating other assets in exchange for money; (3) the rash of business losses and bankruptcies makes businessmen cautious about investing until the liquidation process is over.

With the supply of money falling, and the demand for money increasing, generally falling prices are a consequent feature of most and money supply will contract. But this argument overlooks the fact that the banks, if they want to, can purchase securities, and thereby sustain the money supply by increasing their investments to compensate for dwindling loans. Contractionist pressure therefore always stems from banks and not from business borrowers.

\textsuperscript{11}Banks are “inherently bankrupt” because they issue far more warehouse receipts to cash (nowadays in the form of “deposits” redeemable in cash on demand) than they have cash available. Hence, they are always vulnerable to bank runs. These runs are not like any other business failures, because they simply consist of depositors claiming their own rightful property, which the banks do not have. “Inherent bankruptcy,” then, is an essential feature of any “fractional reserve” banking system. As Frank Graham stated:

The attempt of the banks to realize the inconsistent aims of lending cash, or merely multiplied claims to cash, and still to represent that cash is available on demand is even more preposterous than . . . eating one’s cake and counting on it for future consumption. . . . The alleged convertibility is a delusion dependent upon the right’s not being unduly exercised.

depressions. A general price fall, however, is caused by the secondary, rather than by the inherent, features of depressions. Almost all economists, even those who see that the depression adjustment process should be permitted to function unhampered, take a very gloomy view of the secondary deflation and price fall, and assert that they unnecessarily aggravate the severity of depressions. This view, however, is incorrect. These processes not only do not aggravate the depression, they have positively beneficial effects.

There is, for example, no warrant whatever for the common hostility toward “hoarding.” There is no criterion, first of all, to define “hoarding”; the charge inevitably boils down to mean that A thinks that B is keeping more cash balances than A deems appropriate for B. Certainly there is no objective criterion to decide when an increase in cash balance becomes a “hoard.” Second, we have seen that the demand for money increases as a result of certain needs and values of the people; in a depression, fears of business liquidation and expectations of price declines particularly spur this rise. By what standards can these valuations be called “illegitimate”? A general price fall is the way that an increase in the demand for money can be satisfied; for lower prices mean that the same total cash balances have greater effectiveness, greater “real” command over goods and services. In short, the desire for increased real cash balances has now been satisfied.

Furthermore, the demand for money will decline again as soon as the liquidation and adjustment processes are finished. For the completion of liquidation removes the uncertainties of impending bankruptcy and ends the borrowers’ scramble for cash. A rapid unhampered fall in prices, both in general (adjusting to the changed money-relation), and particularly in goods of higher orders (adjusting to the malinvestments of the boom) will speedily end the realignment processes and remove expectations of further declines. Thus, the sooner the various adjustments, primary and secondary, are carried out, the sooner will the demand for money fall once again. This, of course, is just one part of the general economic “return to normal.”

Neither does the increased “hoarding” nor the fall of prices at all interfere with the primary depression-adjustment. The important
feature of the primary adjustment is that the prices of producers’
goods fall more rapidly than do consumer good prices (or, more
accurately, that higher order prices fall more rapidly than do those of
lower order goods); it does not interfere with the primary adjust-
ment if all prices are falling to some degree. It is, moreover, a com-
mon myth among laymen and economists alike, that falling prices
have a depressing effect on business. This is not necessarily true.
What matters for business is not the general behavior of prices, but
the price differentials between selling prices and costs (the “natural
rate of interest”). If wage rates, for example, fall more rapidly than
product prices, this stimulates business activity and employment.

**Deflation** of the money supply (via credit contraction) has fared
as badly as hoarding in the eyes of economists. Even the Misesian
theorists deplore deflation and have seen no benefits accruing from
it. Yet, deflationary credit contraction greatly helps to speed up
the adjustment process, and hence the completion of business
recovery, in ways as yet unrecognized. The adjustment consists, as
we know, of a return to the desired consumption-saving pattern.
Less adjustment is needed, however, if time preferences **themselves**
change: i.e., if savings increase and consumption relatively declines.
In short, what can help a depression is not more consumption, but,
on the contrary, less consumption and more savings (and, con-
comitantly, more investment). Falling prices encourage greater
savings and decreased consumption by fostering an accounting
illusion. Business accounting records the value of assets at their
original cost. It is well known that general price increases distort
the accounting-record: what seems to be a large “profit” may only
be just sufficient to replace the now higher-priced assets. During
an inflation, therefore, business “profits” are greatly overstated,
and consumption is greater than it would be if the accounting illu-
sion were not operating—perhaps capital is even consumed without
the individual’s knowledge. In a time of deflation, the accounting
illusion is reversed: what seem like losses and capital consumption,

\[12\text{In a gold standard country (such as America during the 1929 depression). Austrian economists accepted credit contraction as a perhaps necessary price to pay for remaining on gold. But few saw any remedial virtues in the deflation process itself.}\]
may actually mean profits for the firm, since assets now cost much less to be replaced. This overstatement of losses, however, restricts consumption and encourages saving; a man may merely think he is replacing capital, when he is actually making an added investment in the business.

Credit contraction will have another beneficial effect in promoting recovery. For bank credit expansion, we have seen, distorts the free market by lowering price differentials (the “natural rate of interest” or going rate of profit) on the market. Credit contraction, on the other hand, distorts the free market in the reverse direction. Deflationary credit contraction’s first effect is to lower the money supply in the hands of business, particularly in the higher stages of production. This reduces the demand for factors in the higher stages, lowers factor prices and incomes, and increases price differentials and the interest rate. It spurs the shift of factors, in short, from the higher to the lower stages. But this means that credit contraction, when it follows upon credit expansion, speeds the market’s adjustment process. Credit contraction returns the economy to free-market proportions much sooner than otherwise.

But, it may be objected, may not credit contraction overcompensate the errors of the boom and itself cause distortions that need correction? It is true that credit contraction may overcompensate, and, while contraction proceeds, it may cause interest rates to be higher than free-market levels, and investment lower than in the free market. But since contraction causes no positive mal-investments, it will not lead to any painful period of depression and adjustment. If businessmen are misled into thinking that less capital is available for investment than is really the case, no lasting damage in the form of wasted investments will ensue.13 Furthermore, in

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13 Some readers may ask: why doesn’t credit contraction lead to malinvestment, by causing overinvestment in lower-order goods and underinvestment in higher-order goods, thus reversing the consequences of credit expansion? The answer stems from the Austrian analysis of the structure of production. There is no arbitrary choice of investing in lower or higher-order goods. Any increased investment must be made in the higher-order goods, must lengthen the structure of production. A decreased amount of investment in the economy simply reduces higher-order capital. Thus, credit contraction will cause not excess of investment
the nature of things, credit contraction is severely limited—it cannot progress beyond the extent of the preceding inflation. Credit expansion faces no such limit.

**Government Depression Policy: Laissez-Faire**

If government wishes to see a depression ended as quickly as possible, and the economy returned to normal prosperity, what course should it adopt? The first and clearest injunction is: *don’t interfere with the market’s adjustment process*. The more the government intervenes to delay the market’s adjustment, the longer and more grueling the depression will be, and the more difficult will be the road to complete recovery. Government hampering aggravates and perpetuates the depression. Yet, government depression policy has always (and would have even more today) aggravated the very evils it has loudly tried to cure. If, in fact, we list logically the various ways that government could *hamper* market adjustment, we will find that we have precisely listed the favorite “anti-depression” arsenal of government policy. Thus, here are the ways the adjustment process can be hobbled:

1. **Prevent or delay liquidation.** Lend money to shaky businesses, call on banks to lend further, etc.

2. **Inflate further.** Further inflation blocks the necessary fall in prices, thus delaying adjustment and prolonging depression. Further credit expansion creates more malinvestments, which, in their turn, will have to be liquidated in some later depression. A government “easy money” policy prevents the market’s return to the necessary higher interest rates.

3. **Keep wage rates up.** Artificial maintenance of wage rates in a depression insures permanent mass unemployment. Furthermore, in a deflation, when prices are falling, keeping the same rate of

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in the lower orders, but simply a shorter structure than would otherwise have been established.

14 In a gold standard economy, credit contraction is limited by the total size of the gold stock.
money wages means that real wage rates have been pushed higher. In the face of falling business demand, this greatly aggravates the unemployment problem.

(4) *Keep prices up.* Keeping prices above their free-market levels will create unsalable surpluses, and prevent a return to prosperity.

(5) *Stimulate consumption and discourage saving.* We have seen that more saving and less consumption would speed recovery; more consumption and less saving aggravate the shortage of saved-capital even further. Government can encourage consumption by “food stamp plans” and relief payments. It can discourage savings and investment by higher taxes, particularly on the wealthy and on corporations and estates. As a matter of fact, any increase of taxes and government spending will discourage saving and investment and stimulate consumption, since government spending is *all consumption.* Some of the private funds would have been saved and invested; *all* of the government funds are consumed.\(^{15}\) Any increase in the relative size of government in the economy, therefore, shifts the societal consumption–investment ratio in favor of consumption, and prolongs the depression.

(6) *Subsidize unemployment.* Any subsidization of unemployment (via unemployment “insurance,” relief, etc.) will prolong unemployment indefinitely, and delay the shift of workers to the fields where jobs are available.

\(^{15}\)In recent years, particularly in the literature on the “under-developed countries,” there has been a great deal of discussion of government “investment.” There can be no such investment, however. “Investment” is defined as expenditures made not for the direct satisfaction of those who make it, but for other, ultimate consumers. Machines are produced not to serve the entrepreneur, but to serve the ultimate consumers, who in turn remunerate the entrepreneurs. But government acquires its funds by seizing them from private individuals; the spending of the funds, therefore, gratifies the desires of *government officials.* Government officials have forcibly shifted production from satisfying private consumers to satisfying themselves; their spending is therefore pure consumption and can by no stretch of the term be called “investment.” (Of course, to the extent that government officials do not realize this, their “consumption” is really waste-spending.)
These, then, are the measures which will delay the recovery process and aggravate the depression. Yet, they are the time-honored favorites of government policy, and, as we shall see, they were the policies adopted in the 1929–1933 depression, by a government known to many historians as a “laissez-faire” administration.

Since deflation also speeds recovery, the government should encourage, rather than interfere with, a credit contraction. In a gold-standard economy, such as we had in 1929, blocking deflation has further unfortunate consequences. For a deflation increases the reserve ratios of the banking system, and generates more confidence in citizen and foreigner alike that the gold standard will be retained. Fear for the gold standard will precipitate the very bank runs that the government is anxious to avoid. There are other values in deflation, even in bank runs, which should not be overlooked. Banks should no more be exempt from paying their obligations than is any other business. Any interference with their comeuppance via bank runs will establish banks as a specially privileged group, not obligated to pay their debts, and will lead to later inflations, credit expansions, and depressions. And if, as we contend, banks are inherently bankrupt and “runs” simply reveal that bankruptcy, it is beneficial for the economy for the banking system to be reformed, once and for all, by a thorough purge of the fractional-reserve banking system. Such a purge would bring home forcefully to the public the dangers of fractional-reserve banking, and, more than any academic theorizing, insure against such banking evils in the future.  

The most important canon of sound government policy in a depression, then, is to keep itself from interfering in the adjustment process. Can it do anything more positive to aid the adjustment? Some economists have advocated a government-decreed wage cut to spur employment, e.g., a 10 percent across-the-board reduction. But free-market adjustment is the reverse of any “across-the-board” policy. Not all wages need to be cut; the degree of required adjustments of prices and wages differs from case to case.

16For more on the problems of fractional-reserve banking, see below.
case, and can only be determined on the processes of the free and unhampered market.\textsuperscript{17} Government intervention can only distort the market further.

There is one thing the government can do positively, however: it can drastically lower its relative role in the economy, slashing its own expenditures and taxes, particularly taxes that interfere with saving and investment. Reducing its tax-spending level will automatically shift the societal saving-investment–consumption ratio in favor of saving and investment, thus greatly lowering the time required for returning to a prosperous economy.\textsuperscript{18} Reducing taxes that bear most heavily on savings and investment will further lower social time preferences.\textsuperscript{19} Furthermore, depression is a time of economic strain. Any reduction of taxes, or of any regulations interfering with the free market, will stimulate healthy economic activity; any increase in taxes or other intervention will depress the economy further.

In sum, the proper governmental policy in a depression is strict laissez-faire, including stringent budget slashing, and coupled perhaps with positive encouragement for credit contraction. For


\textsuperscript{18}I am indebted to Mr. Rae C. Heiple, II, for pointing this out to me.

\textsuperscript{19}Could government increase the investment–consumption ratio by raising taxes in any way? It could not tax only consumption even if it tried; it can be shown (and Prof. Harry Gunnison Brown has gone a long way to show) that any ostensible tax on “consumption” becomes, on the market, a tax on incomes, hurting saving as well as consumption. If we assume that the poor consume a greater proportion of their income than the rich, we might say that a tax on the poor used to subsidize the rich will raise the saving–consumption ratio and thereby help cure a depression. On the other hand, the poor do not necessarily have higher time preferences than the rich, and the rich might well treat government subsidies as special windfalls to be consumed. Furthermore, Harold Lubell has maintained that the effects of a change in income distribution on social consumption would be negligible, even though the absolute proportion of consumption is greater among the poor. See Harry Gunnison Brown, “The Incidence of a General Output or a General Sales Tax,” \textit{Journal of Political Economy} (April, 1939): 254–62; Harold Lubell, “Effects of Redistribution of Income on Consumers’ Expenditures,” \textit{American Economic Review} (March, 1947): 157–70.
decades such a program has been labelled “ignorant,” “reactionary,” or “Neanderthal” by conventional economists. On the contrary, it is the policy clearly dictated by economic science to those who wish to end the depression as quickly and as cleanly as possible.20

It might be objected that depression only began when credit expansion ceased. Why shouldn’t the government continue credit expansion indefinitely? In the first place, the longer the inflationary boom continues, the more painful and severe will be the necessary adjustment process. Second, the boom cannot continue indefinitely, because eventually the public awakens to the governmental policy of permanent inflation, and flees from money into goods, making its purchases while the dollar is worth more than it will be in future. The result will be a “runaway” or hyperinflation, so familiar to history, and particularly to the modern world.21 Hyperinflation, on any count, is far worse than any depression: it destroys the currency—the lifeblood of the economy; it ruins and shatters the middle class and all “fixed income groups”; it wreaks havoc unbounded. And furthermore, it leads finally to unemployment and lower living standards, since there is little point in working when earned income depreciates by the hour. More time is spent hunting goods to buy. To avoid such a calamity, then, credit expansion must stop sometime, and this will bring a depression into being.

**Preventing Depressions**

Preventing a depression is clearly better than having to suffer it. If the government’s proper policy during a depression is laissez-faire, what should it do to prevent a depression from beginning?

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20Advocacy of any governmental policy must rest, in the final analysis, on a system of ethical principles. We do not attempt to discuss ethics in this book. Those who wish to prolong a depression, for whatever reason, will, of course, enthusiastically support these governmental interventions, as will those whose prime aim is the accretion of power in the hands of the state.

21For the classic treatment of hyperinflation, see Costantino Bresciani-Turroni, *The Economics of Inflation* (London: George Allen and Unwin, 1937).
Obviously, since credit expansion necessarily sows the seeds of later depression, the proper course for the government is to stop any inflationary credit expansion from getting under way. This is not a very difficult injunction, for government’s most important task is to keep itself from generating inflation. For government is an inherently inflationary institution, and consequently has almost always triggered, encouraged, and directed the inflationary boom. Government is inherently inflationary because it has, over the centuries, acquired control over the monetary system. Having the power to print money (including the “printing” of bank deposits) gives it the power to tap a ready source of revenue. Inflation is a form of taxation, since the government can create new money out of thin air and use it to bid away resources from private individuals, who are barred by heavy penalty from similar “counterfeiting.” Inflation therefore makes a pleasant substitute for taxation for the government officials and their favored groups, and it is a subtle substitute which the general public can easily—and can be encouraged to—overlook. The government can also pin the blame for the rising prices, which are the inevitable consequence of inflation, upon the general public or some disliked segments of the public, e.g., business, speculators, foreigners. Only the unlikely adoption of sound economic doctrine could lead the public to pin the responsibility where it belongs: on the government itself.

Private banks, it is true, can themselves inflate the money supply by issuing more claims to standard money (whether gold or government paper) than they could possibly redeem. A bank deposit is equivalent to a warehouse receipt for cash, a receipt which the bank pledges to redeem at any time the customer wishes to take his money out of the bank’s vaults. The whole system of “fractional-reserve banking” involves the issuance of receipts which cannot possibly be redeemed. But Mises has shown that, by themselves, private banks could not inflate the money supply by a great deal.22 In the first place, each bank would find its newly

issued *uncovered*, or “pseudo,” receipts (uncovered by cash) soon transferred to the clients of other banks, who would call on the bank for redemption. The narrower the clientele of each bank, then, the less scope for its issue of pseudo-receipts. All the banks could join together and agree to expand at the same rate, but such agreement would be difficult to achieve. Second, the banks would be limited by the degree to which the public used bank deposits or notes as against standard cash; and third, they would be limited by the confidence of the clients in their banks, which could be wrecked by runs at any time.

Instead of preventing inflation by prohibiting fractional-reserve banking as fraudulent, governments have uniformly moved in the opposite direction, and have step-by-step removed these free-market checks to bank credit expansion, at the same time putting themselves in a position to direct the inflation. In various ways, they have artificially bolstered public confidence in the banks, encouraged public use of paper and deposits instead of gold (finally outlawing gold), and shepherded all the banks under one roof so that they can all expand together. The main device for accomplishing these aims has been Central Banking, an institution which America finally acquired as the Federal Reserve System in 1913. Central Banking permitted the centralization and absorption of gold into government vaults, greatly enlarging the national base for credit expansion; it also insured uniform action by the banks through basing their reserves on deposit accounts at the Central Bank instead of on gold. Upon establishment of a Central Bank, each private bank no longer gauges its policy according to its particular gold reserve; all banks are now tied together and regulated by Central Bank action. The Central Bank, furthermore, by proclaiming its function to be a “lender of last resort” to banks in trouble, enormously increases public confidence in the banking system.

23 When gold—formerly the banks’ reserves—is transferred to a newly established Central Bank, the latter keeps only a fractional reserve, and thus the total credit base and potential monetary supply are enlarged. See C.A. Phillips, T.F. McManus, and R.W. Nelson, *Banking and the Business Cycle* (New York: Macmillan, 1937), pp. 24ff.
For it is tacitly assumed by everyone that the government would never permit its own organ—the Central Bank—to fail. A Central Bank, even when on the gold standard, has little need to worry about demands for gold from its own citizens. Only possible drains of gold to foreign countries (i.e., by non-clients of the Central Bank) may cause worry.

The government assured Federal Reserve control over the banks by (1) granting to the Federal Reserve System (FRS) a monopoly over note issue; (2) compelling all the existing “national banks” to join the Federal Reserve System, and to keep all their legal reserves as deposits at the Federal Reserve; and (3) fixing the minimum reserve ratio of deposits at the Reserve to bank deposits (money owned by the public). The establishment of the FRS was furthermore inflationary in directly reducing existing reserve-ratio requirements. The Reserve could then control the volume of money by governing two things: the volume of bank reserves, and the legal reserve requirements. The Reserve can govern the volume of bank reserves (in ways which will be explained below), and the government sets the legal ratio, but admittedly control over the money supply is not perfect, as banks can keep “excess reserves.” Normally, however, reassured by the existence of a lender of last resort, and making profits by maximizing its assets and deposits, a bank will keep fully “loaned up” to its legal ratio.

While unregulated private banking would be checked within narrow limits and would be far less inflationary than Central Bank

24 Many “state banks” were induced to join the FRS by patriotic appeals and offers of free services. Even the banks that did not join, however, are effectively controlled by the System, for, in order to obtain paper money, they must keep reserves in some member bank.

25 The average reserve requirements of all banks before 1913 was estimated at approximately 21 percent. By mid-1917, when the FRS had fully taken shape, the average required ratio was 10 percent. Phillips et al. estimate that the inherent inflationary impact of the FRS (pointed out in footnote 23) increased the expansive power of the banking system three-fold. Thus, the two factors (the inherent impact, and the deliberate lowering of reserve requirements) combined to inflate the monetary potential of the American banking system six-fold as a result of the inauguration of the FRS. See Phillips, et al., Banking and the Business Cycle, pp. 23ff.
The Positive Theory of the Cycle

manipulation, the clearest way of preventing inflation is to outlaw fractional-reserve banking, and to impose a 100 percent gold reserve to all notes and deposits. Bank cartels, for example, are not very likely under unregulated, or “free” banking, but they could nevertheless occur. Professor Mises, while recognizing the superior economic merits of 100 percent gold money to free banking, prefers the latter because 100 percent reserves would concede to the government control over banking, and government could easily change these requirements to conform to its inflationist bias. But a 100 percent gold reserve requirement would not be just another administrative control by government; it would be part and parcel of the general libertarian legal prohibition against fraud. Everyone except absolute pacifists concedes that violence against person and property should be outlawed, and that agencies, operating under this general law, should defend person and property against attack. Libertarians, advocates of laissez-faire, believe that “governments” should confine themselves to being defense agencies only. Fraud is equivalent to theft, for fraud is committed when one part of an exchange contract is deliberately not fulfilled after the other’s property has been taken. Banks that issue receipts to non-existent gold are really committing fraud, because it is then impossible for all property owners (of claims to gold) to claim their rightful property. Therefore, prohibition of such practices would not be an act of government intervention in the free market; it would be part of the general legal defense of property against attack which a free market requires.

26 The horrors of “wildcat banking” in America before the Civil War stemmed from two factors, both due to government rather than free banking: (1) Since the beginnings of banking, in 1814 and then in every ensuing panic, state governments permitted banks to continue operating, making and calling loans, etc. without having to redeem in specie. In short, banks were privileged to operate without paying their obligations. (2) Prohibitions on interstate branch banking (which still exist), coupled with poor transportation, prevented banks from promptly calling on distant banks for redemption of notes.

27 Mises, Human Action, p. 440.

28 A common analogy states that banks simply count on people not redeeming all their property at once, and that engineers who build bridges operate also on
What, then, was the proper government policy during the 1920s? What should government have done to prevent the crash? Its best policy would have been to liquidate the Federal Reserve System, and to erect a 100 percent gold reserve money; failing that, it should have liquidated the FRS and left private banks unregulated, but subject to prompt, rigorous bankruptcy upon failure to redeem their notes and deposits. Failing these drastic measures, and given the existence of the Federal Reserve System, what should its policy have been? The government should have exercised full vigilance in not supporting or permitting any inflationary credit expansion. We have seen that the Fed—the Federal Reserve System—does not have complete control over money because it cannot force banks to lend up to their reserves; but it does have absolute anti-inflationary control over the banking system. For it does have the power to reduce bank reserves at will, and thereby force the banks to cease inflating, or even to contract if necessary. By lowering the volume of bank reserves and/or raising reserve requirements, the federal government, in the 1920s as well as today, has had the absolute power to prevent any increase in the total volume of money and credit. It is true that the FRS has no direct control over such money creators as savings banks, savings and loan associations, and life insurance companies, but any credit

the principle that not everyone in a city will wish to cross the bridge at once. But the cases are entirely different. The people crossing the bridge are simply requesting a service; they are not trying to take possession of their lawful property, as are the bank depositors. A more fitting analogy would defend embezzlers who would never have been caught if someone hadn’t fortuitously inspected the books. The crime comes when the theft or fraud is committed, not when it is finally revealed.

239 Perhaps a libertarian legal system would consider “general deposit warrants” (which allow a warehouse to return any homogeneous good to the depositor) as “specific deposit warrants,” which, like bills of lading, pawn tickets, dock-warrants, etc. establish ownership to specific, earmarked objects. As Jevons stated, “It used to be held as a general rule of law, that any present grant or assignment of goods not in existence is without operation.” See W. Stanley Jevons, *Money and the Mechanism of Exchange* (London: Kegan Paul, 1905), pp. 207–12. For an excellent discussion of the problems of a fractional-reserve money, see Amasa Walker, *The Science of Wealth* (3rd ed., Boston: Little, Brown, 1867), pp. 126–32, esp. pp. 139–41.
expansion from these sources could be offset by deflationary pressure upon the commercial banks. This is especially true because commercial bank deposits (1) form the monetary base for the credit extended by the other financial institutions, and (2) are the most actively circulating part of the money supply. Given the Federal Reserve System and its absolute power over the nation’s money, the federal government, since 1913, must bear the complete responsibility for any inflation. The banks cannot inflate on their own; any credit expansion can only take place with the support and acquiescence of the federal government and its Federal Reserve authorities. The banks are virtual pawns of the government, and have been since 1913. Any guilt for credit expansion and the consequent depression must be borne by the federal government and by it alone.\(^{30}\)

**Problems in the Austrian Theory of the Trade Cycle**

_The “Assumption” of Full Employment_

Before proceeding to discuss alternative business cycle theories, several problems and time-honored misconceptions should be cleared up. Two standard misconceptions have already been refuted by Professor Mises: (1) that the Austrian theory “assumes” the previous existence of “full employment,” and therefore does not apply if the credit expansion begins while there are unemployed factors, and (2) that the theory describes the boom as a period of “overinvestment.” On the first point, the unemployed factors can either be labor or capital-goods. (There will always be unemployed, submarginal, _land_ available.) Inflation will only put unemployed labor factors to work if their owners, though otherwise

\(^{30}\)Some writers make a great to-do over the legal fiction that the Federal Reserve System is “owned” by its member banks. In practice, this simply means that these banks are taxed to help pay for the support of the Federal Reserve. If the private banks really “own” the Fed, then how can its officials be appointed by the government, and the “owners” compelled to “own” the Federal Reserve Board by force of government statute? The Federal Reserve Banks should simply be regarded as governmental agencies.
holding out for a higher real wage than the free market can provide, stupidly settle for a lower real wage if it is camouflaged in the form of a rise in the cost of living. As for idle capital goods, these may have been totally and hopelessly malinvested in a previous boom (or at some other time) and hopelessly lost to profitable production for a long time or forever. A credit expansion may appear to render submarginal capital profitable once more, but this too will be malinvestment, and the now greater error will be exposed when this boom is over. Thus, credit expansion generates the business cycle regardless of the existence of unemployed factors. Credit expansion in the midst of unemployment will create more distortions and malinvestments, delay recovery from the preceding boom, and make a more grueling recovery necessary in the future. While it is true that the unemployed factors are not now diverted from more valuable uses as employed factors would be (since they were speculatively idle or malinvested instead of employed), the other complementary factors will be diverted into working with them, and these factors will be malinvested and wasted. Moreover, all the other distorting effects of credit expansion will still follow, and a depression will be necessary to correct the new distortion.\footnote{See Mises, \textit{Human Action}, pp. 576–78. Professor Hayek, in his well-known (and excellent) exposition of the Austrian theory, had early shown how the theory fully applies to credit expansion amidst unemployed factors. Hayek, \textit{Prices and Production}, pp. 96–99.}

\textit{"Overinvestment" or Malinvestment?}

The second misconception, given currency by Haberler in his famous \textit{Prosperity and Depression}, calls the Misesian picture of the boom an “overinvestment” theory.\footnote{Haberler, \textit{Prosperity and Depression}, chap. 3.} Mises has brilliantly shown the error of this label. As Mises points out:

\begin{quote}
[A]dditional investment is only possible to the extent that there is an additional supply of capital goods available. \ldots The boom itself does not result in a restriction but rather in an increase in consumption, it does not
\end{quote}
procure more capital goods for new investment. The essence of the credit-expansion boom is not overinvestment, but investment in wrong lines, i.e., malinvestment . . . on a scale for which the capital goods available do not suffice. Their projects are unrealizable on account of the insufficient supply of capital goods. . . . The unavoidable end of the credit expansion makes the faults committed visible. There are plants which cannot be utilized because the plants needed for the production of the complementary factors of production are lacking; plants the products of which cannot be sold because the consumers are more intent upon purchasing other goods which, however, are not produced in sufficient quantities.

The observer notices only the malinvestments which are visible and fails to recognize that these establishments are malinvestments only because of the fact that other plants—those required for the production of the complementary factors of productions and those required for the production of consumers’ goods more urgently demanded by the public—are lacking. . . . The whole entrepreneurial class is, as it were, in the position of a master-builder [who] . . . overestimates the quantity of the available supply [of materials] . . . oversizes the groundwork . . . and only discovers later . . . that he lacks the material needed for the completion of the structure. It is obvious that our master-builder’s fault was not overinvestment, but an inappropriate [investment].

Some critics have insisted that if the boom goes on long enough, these processes might finally be “completed.” But this takes the metaphor too literally. The point is that credit expansion distorts investment by directing too much of the available capital into the higher orders of production, leaving too little for lower

33Mises, Human Action, pp. 556–57. Mises also refutes the old notion that the boom is characterized by an undue conversion of “circulating capital” into “fixed capital.” If that were true, then the crisis would reveal a shortage of circulating capital, and would greatly drive up the prices of, e.g., industrial raw materials. Yet, these materials are precisely among the ones revealed by the crisis to be overabundant, i.e., resources were malinvested in “circulating” as well as in “fixed” capital in the higher stages of production.
orders. The unhampered market assures that a complementary structure of capital is harmoniously developed; bank credit expansion hobbles the market and destroys the processes that bring about a balanced structure. 34 The longer the boom goes on, the greater the extent of the distortions and malinvestments.

Banks: Active or Passive?

During the early 1930s, there was a great deal of interest, in the United States and Great Britain, in Mises’s theory of the trade cycle, an interest unfortunately nipped in the bud by the excitement surrounding the “Keynesian Revolution.” The adherents had split on an important question: Mises asserting that the cycle is always generated by the interventionary banking system and his followers claiming that often banks might only err in being passive and not raising their interest charges quickly enough. 35 The followers held that for one reason or another the “natural rate” of interest might rise, and that the banks, which after all are not omniscient, may inadvertently cause the cycle by merely maintaining their old interest rate, now below the free-market rate.

In defense of the Mises “anti-bank” position, we must first point out that the natural interest rate or “profit rate” does not suddenly increase because of vague improvements in “investment opportunities.” The natural rate increases because time preferences increase. 36 But how can banks force market interest rates

34 For a stimulating discussion of some of these processes, see Ludwig M. Lachmann, Capital and Its Structure (London: London School of Economics, 1956).


36 The error of the followers stems from their failure to adopt the pure time-preference theory of interest of Fetter and Mises, and their clinging to eclectic “productivity” elements in their explanation of interest. See the references mentioned in footnote 5 above.
below the free-market rates? Only by expanding their credit! To avoid the business cycle, then, it is not necessary for the banks to be omniscient; they need only refrain from credit expansion. If they do so, their loans made out of their own capital will not expand the money supply but will simply take their place with other savings as one of the determinants of the free-market interest rate.\(^\text{37}\)

Hayek believes that Mises’s theory is somehow deficient because it is exogenous—because it holds that the generation of business cycles stems from interventionary acts rather than from acts of the market itself. This argument is difficult to fathom. Processes are either analyzed correctly or incorrectly; the only test of any analysis is its truth, not whether it is exogenous or endogenous. If the process is really exogenous, then the analysis should reveal this fact; the same holds true for endogenous processes. No particular virtue attaches to a theory because it is one or the other.

**Recurrence of Cycles**

Another common criticism asserts that Mises’s theory may explain any one prosperity–depression cycle, but it fails to explain another familiar phenomenon of business cycles—their perpetual recurrence. Why does one cycle begin as the previous one ends? Yet Mises’s theory does explain recurrence, and without requiring us to adopt the familiar but unproven hypothesis that cycles are “self-generating,”—that some mysterious processes within a cycle lead to another cycle without tending toward an equilibrium condition. The self-generating assumption violates the general law of the tendency of the economy toward an equilibrium, while, on the other hand, the Mises theory for the first time succeeds in integrating the theory of the business cycle into the whole structural design of economic theory. Recurrence stems from the fact that

\(^{37}\text{Mises points out (Human Action, p. 789n.) that if the banks simply lowered the interest charges on their loans without expanding their credit, they would be granting gifts to debtors, and would not be generating a business cycle.}\)
banks will always try to inflate credit if they can, and government will almost always back them up and spur them on. Bank profits derive mainly from credit expansion, so they will tend to inflate credit as much as they can until they are checked.\textsuperscript{38} Government, too, is inherently inflationary. Banks are forced to halt their credit expansion because of the combined force of external and internal drains, and, during a deflation, the drains, and their fears of bankruptcy, force them to contract credit. When the storm has run its course and recovery has arrived, the banks and the government are free to inflate again, and they proceed to do so. Hence the continual recurrence of business cycles.

\textit{Gold Changes and the Cycle}

On one important point of business cycle theory this writer is reluctantly forced to part company with Mises. In his \textit{Human Action}, Mises first investigated the laws of a free-market economy and then analyzed various forms of coercive intervention in the free market. He admits that he had considered relegating trade-cycle theory to the section on intervention, but then retained the discussion in the free market part of the volume. He did so because he believed that a boom-bust cycle could also be generated by an increase in gold money, provided that the gold entered the loan market before all its price-raising effects had been completed. The potential range of such cyclical effects in practice, of course, is severely limited: the gold supply is limited by the fortunes of gold mining, and only a fraction of new gold enters the loan market before influencing prices and wage rates. Still, an important theoretical

\textsuperscript{38}Walker, \textit{The Science of Wealth}, pp. 145ff.; also see p. 159.

[B]anks must be constantly desirous of increasing their loans, by issuing their own credit in the shape of circulation and deposits. The more they can get out, the larger the income. This is the \textit{motive power} that ensures the constant expansion of a mixed [fractional reserve] currency to its highest possible limit. The banks will always increase their indebtedness when they can, and only contract it when they must.
problem remains: can a boom-depression cycle of any degree be generated in a 100 percent gold economy? Can a purely free market suffer from business cycles, however limited in extent? One crucial distinction between a credit expansion and entry of new gold onto the loan market is that bank credit expansion *distorts* the market’s reflection of the pattern of voluntary time preferences; the gold inflow *embodies* changes in the structure of voluntary time preferences. Setting aside any permanent shifts in income distribution caused by gold changes, time preferences may temporarily fall during the transition period before the effect of increased gold on the price system is completed. (On the other hand, time preferences may temporarily rise.) The fall will cause a temporary increase in saved funds, an increase that will disappear once the effects of the new money on prices are completed. This is the case noted by Mises.

Here is an instance in which savings may be expected to increase first and then decline. There may certainly be other cases in which time preferences will change suddenly on the free market, first falling, then increasing. The latter change will undoubtedly cause a “crisis” and temporary readjustment to malinvestments, but these would be better termed irregular fluctuations than regular processes of the business cycle. Furthermore, entrepreneurs are trained to estimate changes and avoid error. They can handle irregular fluctuations, and certainly they should be able to cope with the results of an inflow of gold, results which are roughly predictable. They could not forecast the results of a credit expansion, because the credit expansion tampered with all their moorings, distorted interest rates and calculations of capital. No such tampering takes place when gold flows into the economy, and the normal forecasting ability of entrepreneurs is allowed full sway. We must, therefore, conclude that we cannot apply the “business cycle” label to any processes of the free market. Irregular fluctuations, in response to changing consumer tastes, resources, etc. will certainly occur, and sometimes there will be aggregate losses as a result. But the regular, systematic distortion that invariably ends in a cluster of business errors and depression—characteristic phenomena of
the “business cycle”—can only flow from intervention of the banking system in the market.39

Session 8

**A Critique of Endogenous Business Cycle Theories**

- *Man, Economy, and State*
  Chapter 11: Money and Its Purchasing Power,
  5. The Demand for Money: Hoarding and the Keynesian System

- *Man, Economy, and State*
  Chapter 11: Money and Its Purchasing Power,
  16. Schumpeter’s Theory of Business Cycles,
  17. Further Fallacies of the Keynesian System

- *America’s Great Depression*
  Chapter 2: Keynesian Criticisms of the Theory

- *America’s Great Depression*
  Chapter 3: Some Alternative Explanations of Depression: A Critique
income. Total cash remains the same, but its proportion to incomes, as well as its real value, declines. 10

F. HOARDING AND THE KEYNESIAN SYSTEM

(1) Social Income, Expenditures, and Unemployment

To the great bulk of writers “hoarding”—an increase in the demand for money—has appeared an unmitigated catastrophe. The very word “hoarding” is a most inappropriate one to use in economics, since it is laden with connotations of vicious anti-social action. But there is nothing at all antisocial about either “hoarding” or “dishoarding.” “Hoarding” is simply an increase in the demand for money, and the result of this change in valuations is that people get what they desire, i.e., an increase in the real value of their cash balances and of the monetary unit. 11 Conversely, if the people desire a lowering of their real cash balances or in the value of the monetary unit, they may accomplish this through “dishoarding.” No other significant economic relation—real income, capital structure, etc.—need be changed at all. The process of hoarding and dishoarding, then, simply means that people want something, either an increase or a decrease in their real cash balances or in the real value of the monetary unit.

10 Strictly, the ceteris paribus condition will tend to be violated. An increased demand for money tends to lower money prices and will therefore lower money costs of gold mining. This will stimulate gold mining production until the interest return on mining is again the same as in other industries. Thus, the increased demand for money will also call forth new money to meet the demand. A decreased demand for money will raise money costs of gold mining and at least lower the rate of new production. It will not actually decrease the total money stock unless the new production rate falls below the wear-and-tear rate. Cf. Jacques Rueff, “The Fallacies of Lord Keynes’ General Theory” in Henry Hazlitt, ed., The Critics of Keynesian Economics (Princeton, N.J.: D. Van Nostrand, 1960), pp. 238–63.

monetary unit, and that they are able to obtain this result. What is wrong with that? We see here simply another manifestation of consumers’ or individuals’ “sovereignty” on the free market.

Furthermore, there is no theoretical way of defining “hoarding” beyond a simple addition to one’s cash balance in a certain period of time. Yet most writers use the term in a normative fashion, implying that there is some vague standard below which a cash balance is legitimate and above which it is antisocial and vicious. But any quantitative limit set on the demand-for-money schedule would be completely arbitrary and unwarranted.

One of the two major pillars of the Keynesian system (now happily beginning to wane after sweeping the economic world in the 1930’s and 1940’s) is the proclamation that savings become equal to investment only through the terrible route of a decline in social income. The (implicit) foundation of Keynesianism is the assertion that at a certain level of total social income, total social expenditures out of this income will be lower than income, the remainder going into hoards. This will lower total social income in the next period of time, since, as we have seen, total income in one “day” equals, and is determined by, total expenditures in the previous “day.”

The Keynesian “consumption function” plays its part in establishing an alleged law that there exists a certain level of total income, say $A$, above which expenditures will be less than income (net hoarding), and below which expenditures will be greater than income (net dishoarding). But the basic Keynesian worry is hoarding, when total income must decline. This situation may be diagramed as in Figure 78.

In this graph, money income is plotted on both the horizontal and the vertical axes. Hence, a 45-degree straight line between the axes is equal to social income.12 To illustrate: A

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12The term generally used is “national” income. However, in a free-market economy the nation will no more be an important economic boundary than the village or region. It is more convenient, then, to set aside regional problems for other analysis and to concentrate on aggregate social
social income of 100 on the horizontal axis will correspond to, and equal, a social income of 100 on the vertical axis. The coordinates of these figures will meet at a point equidistant between the two axes. The Keynesian law asserts social expenditures to be lower than social income above point $A$, and higher than social income below point $A$, so that $A$ will be the equilibrium point for social income to equal expenditure. For if social income is higher than $A$, social expenditures will be lower than income, and income will therefore tend to decline from one day to the next until the equilibrium point $A$ is reached. If social income is lower than $A$, dishoarding will occur, expenditures will be higher than income, until finally $A$ is reached again.

Below, we shall investigate the validity of this alleged law and the “consumption function” on which it rests. But suppose that we now grant the validity of such a law; the only comment can
be an impertinent: So what? What if there is a fall in the national income? Since the fall need only be in money terms, and real income, real capital, etc., may remain the same, why any alarm? The only change is that the hoarders have accomplished their objective of increasing their real cash balances and increasing the real value of the monetary unit. It is true that the picture is rather more complex for the transition process until equilibrium is reached, and this will be treated further below (although our final conclusion will be the same). But the Keynesian system attempts to establish the perniciousness of the equilibrium position, and this it cannot do.

Therefore, the elaborate attempts of the Keynesians to demonstrate that free-market expenditures will be limited—that consumption is limited by the “function,” and investment by stagnation of opportunities and “liquidity preference”—are futile. For even if they were correct (which they are not), the result would be pointless. There is nothing wrong with hoarding or dishoarding, or with “low” or “high” levels (whatever that may mean) of social money income.

The Keynesian attempt to salvage meaning for their doctrine rests on one point and one point alone—the second major pillar of their system. This is the thesis that money social income and level of employment are correlated, and that the latter is a function of the former. This assumes that a certain “full employment” level of social income exists below which there is correspondingly greater unemployment. This can be diagramed as in Figure 79.

On the previous diagram is superimposed a vertical FF line, which represents the point of alleged “full-employment” social income. If the intersection A is below (to the left of) the FF line, then there is permanent unemployment corresponding to the distance by which A falls short of that line.

Keynesians have also attempted, with little success, to give meaning to an equilibrium position where A falls to the right of the FF line, identifying this with inflation. Inflation, as we shall see below, is a dynamic process, the essence of which is change. The Keynesian system centers around the equilibrium position
The nub of the Keynesian critique of the free market economy, then, rests on the involuntary unemployment allegedly caused by too low a level of social expenditures and income. But how can this be, since we have previously explained that there can be no involuntary unemployment in a free market? The answer has become evident (and is admitted in the most intelligent of the Keynesian writings): The Keynesian “underemployment equilibrium” occurs only if money wage rates are rigid downward, i.e., if the supply curve of labor below “full employment” is infinitely elastic.\(^{13}\) Thus, suppose there is a


![Figure 79. Relation Between Full Employment and Social Income and Social Expenditures According to Keynes](image-url)
“hoarding” (an increased demand for money), and social income falls. The result is a fall in the monetary demand curves for labor factors, as well as in all other monetary demand curves. We would expect the general supply curve of labor factors to be vertical. Since only money wage rates are being changed while real wage rates (in terms of purchasing power) remain the same, there will be no shift in labor/leisure preferences, and the total stock of labor offered on the market will remain constant. At any rate, certainly no involuntary unemployment will arise.

How then can the Keynesian case arise? How can the supply of labor remain horizontal at the old money wage rate? In only two ways: (1) if people voluntarily agree with the unions, which insist that no one be employed at lower than the old money wage rate. Since selling prices are falling, maintaining the old money wage rate is equivalent to demanding a higher real wage rate. We have seen above that the unions’ raising of real wage rates causes unemployment. But this unemployment is voluntary, since the workers acquiesce in the imposition of a higher minimum real wage rate, below which they will not undercut the union and accept employment. Or (2) unions or government coercively impose the minimum wage rate. But this is an example of a hampered market, not the free market to which we are confining our analysis here.

Situation (1) or (2) may be diagramed as in Figure 80.

The original demand curve for labor is DD (for simplicity of exposition we assume as meaningful the concept of “demand for labor” in general). Total stock of labor in the society is 0F, or at least that is the stock put forward upon the market. Now an increase in the demand for money shifts all demand curves downward as all money prices fall. If wage rates are free to fall, the intersection point will move from H to C and nominal wage

rates reduced accordingly, from $FH$ to $FC$. There is still “full employment” at level $0F$. Now suppose however, that a union sets a minimum money wage rate of $0B$ (or $FH$). Then the supply-of-labor curve becomes $BHG$; horizontal up to $FG$ and vertical from there on. The new demand curve $D'D'$ will now intersect the supply of labor at point $E$ instead of point $C$. Total amount of labor now employed is reduced to $BE$, and $EH$ are now unemployed as a result of the union action.

Keynes’ own exposition tended to run in terms of real rather than money magnitudes—real social income, real expenditures, etc.\(^{14}\) Such an analysis obscures dynamic considerations, since transactions take place at least superficially in monetary terms on the market. However, the essential conclusion of our analysis remains unchanged if we pursue it directly in real terms. Instead of falling, demand curves in real terms will now remain the same. This is true for the labor market as well. Instead of being

depicted on a diagram as a horizontal line at existing wage rates, the effect of union action would have to be shown as a horizontally imposed increase in real wage rates (the result of keeping money wage rates constant while selling prices fall). The relevant diagram is shown in Figure 81. The facts depicted in this diagram are the same as in the previous diagram: unions causing unemployment (EH) by insisting on an excessively high money (and therefore real) wage (0B).

**Figure 81. Unemployment Resulting from Fixing Real Wages at Higher Than Free-Market Rates**

The sum and substance of the “Keynesian Revolution” was the thesis that there can be an unemployment equilibrium on the free market. As we have seen, the only sense in which this is true was known years before Keynes: that widespread union maintenance of excessively high wage rates will cause unemployment.

Keynes believed that while other elements of the economic system, including prices, were set basically in real terms, workers bargained even ultimately only in terms of money wages—that unions insisted on minimum money wage rates downward, but
would passively accept falling real wages in the form of rising prices, money wage rates remaining the same. The Keynesian prescription for eliminating unemployment therefore rests specifically on the “money illusion”—that unions will impose minimum money wage rates, but are too stupid to impose minimum real wage rates per se. Unions, however, have learned about purchasing-power problems and the distinction between money and real rates; indeed, it hardly requires much reasoning ability to grasp this distinction.Ironically, Keynes’ advocacy of inflation based on the “money illusion” rested on the historical experience (which we shall treat more fully below) that, during an inflation, selling prices rise faster than wage rates. Yet an economy in which unions impose minimum wage rates is precisely an economy in which unions will be alive to any losses in their real, as well as their money, wages. Inflation, therefore, cannot be used as a means of duping unions into relieving unemployment. Keynesianism has been touted as at least a “practical” system. Whatever its theoretical defects, it is alleged to be fit for the modern world of unionism. Yet it is precisely in the modern world that Keynes’ doctrine is least appropriate or practical.

The Keynesians object that to allow rigid money wage rates to become flexible downward would further lower monetary

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16 Furthermore, inflation is, at best, an inefficient and distortive substitute for flexible wage rates. For inflation affects the entire economy and its prices, while particular wage rates will fall only to the extent necessary to “clear” the market for the particular labor factor. Thus, freely flexible wage rates will fall only in those fields necessary to eliminate unemployment in those particular areas. Cf. Henry Hazlitt, The Failure of the “New Economics” (Princeton, N.J.: D. Van Nostrand, 1959), pp. 278 ff.

demand for goods, and therefore monetary income. But this completely confuses wage rates with aggregate payroll, or total income going to wages.\(^\text{18}\) That the former falls does not mean that the latter falls. On the contrary, total income is, as we have seen, determined by total expenditures in the previous period of time. Lower wage rates will cause the hiring of those made unemployed by the old excessively high wage rates. The fact that labor is now cheaper relatively to land factors will cause investors to expend a greater proportion on labor vis-à-vis land than before. And the employment of unemployed labor increases production and therefore aggregate real income. Furthermore, even if payrolls also decline, prices and wage rates can adjust—but this will be taken up in the next section on liquidity preference.

(2) “Liquidity Preference”

Those Keynesians who recognize the grave difficulties of their system fall back on one last string in their bow—“liquidity preference.” Intelligent Keynesians will concede that involuntary unemployment is a “special” or rare case, and Lindahl goes even further to say that it could be only a short-run and not a long-run equilibrium phenomenon.\(^\text{19}\) Neither Modigliani nor Lindahl, however, is thoroughgoing enough in his critique of the Keynesian system, particularly of the “liquidity preference” doctrine.

The Keynesian system, as is quite clear from the mathematical portrayals of it given by its followers, suffers grievously from the mathematical-economic sin of “mutual determination.” The use of mathematical functions, which are reversible at will, is appropriate in physics, where we do not know the causes of the observed movements. Since we do not know the causes, any

\(^\text{18}\)Cf. Hutt, “Significance of Price Flexibility.”

mathematical law explaining or describing movements will be reversible, and, as far as we are concerned, any of the variables in the function is just as much “cause” as another. In praxeology, the science of human action, however, we know the original cause—motivated action by individuals. This knowledge provides us with true axioms. From these axioms, true laws are deduced. They are deduced step by step in a logical, cause-and-effect relationship. Since first causes are known, their consequent effects are also known. Economics therefore traces unilinear cause-and-effect relations, not vague “mutually determining” relations.

This methodological reminder is singularly applicable to the Keynesian theory of interest. For the Keynesians consider the rate of interest \((a)\) as determining investment and \((b)\) as being determined by the demand for money to hold “for speculative purposes” (liquidity preference). In practice, however, they treat the latter \(not\) as determining the rate of interest, but as \(being determined\) by it. The methodology of “mutual determination” has completely obscured this sleight of hand. Keynesians might object that all demand and supply curves are “mutually determining” in their relation to price. But this facile assertion is not correct. Demand curves are determined by utility scales, and supply curves by speculation and the stock produced by given labor and land factors, which is ultimately governed by time preferences.

The Keynesians therefore treat the rate of interest, \(not\) as they believe they do—as determined by liquidity preference—but rather as some sort of mysterious and unexplained force imposing itself on the other elements of the economic system. Thus, Keynesian discussion of liquidity preference centers around “inducement to hold cash” as the rate of interest rises or falls. According to the theory of liquidity preference, a fall in the rate of interest increases the quantity of cash demanded for “speculative purposes” (liquidity preferences), and a rise in the rate of interest lowers liquidity preference.
The first error in this concept is the arbitrary separation of the demand for money into two separate parts: a “transactions demand,” supposedly determined by the size of social income, and a “speculative demand,” determined by the rate of interest. We have seen that all sorts of influences impinge themselves on the demand for money. But they are only influences working through the value scales of individuals. And there is only one final demand for money, because each individual has only one value scale. There is no way by which we can split the demand up into two parts and speak of them as independent entities. Furthermore, there are far more than two influences on demand. In the final analysis, the demand for money, like all utilities, cannot be reduced to simple determinants; it is the outcome of free, independent decisions on individual value scales. There is, therefore, no “transaction demand” uniquely determined by the size of income.

The “speculative demand” is mysterious indeed. Modigliani explains this “liquidity preference” as follows:

we should expect that any fall in the rate of interest . . . would induce a growing number of potential investors to keep their assets in the form of money, rather than securities; that is to say, we should expect a fall in the rate of interest to increase the demand for money as an asset.20

This is subject to the criticism, as we have seen, that the rate of interest is here determining, and is not itself explained by any cause. Furthermore, what does this statement mean? A fall in the rate of interest, according to the Keynesians, means that less interest is being earned from bonds, and therefore there is a greater inducement to hold cash. This is correct (as long as we allow ourselves to think in terms of the interest rate as determining instead of being determined), but highly inadequate. For

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if a lower interest rate “induces” greater cash holdings, it also induces greater consumption, since consumption also becomes more attractive. In fact, one of the grave defects of the liquidity-preference approach is that the Keynesians never think in terms of three “margins” being decided at once. They think only in terms of two at a time. Hence, Modigliani: “Having made his consumption-saving plan, the individual has to make decisions concerning the assets he owns”; i.e., he then allocates them between money and securities. In other words, people first decide between consumption and saving (in the sense of not consuming); and then they decide between investing and hoarding these savings. But this is an absurdly artificial construction. People decide on all three of their alternatives, weighing one against each of the others. To say that people first decide between consuming and not consuming and then choose between hoarding and investing is just as misleading as to say that people first choose how much to hoard and then decide between consumption and investment.

People, therefore, allocate their money among consumption, investment, and hoarding. The proportion between consumption and investment reflects individual time preferences. Consumption reflects desires for present goods, and investment reflects desires for future goods. An increase in the demand-for-money schedule does not affect the rate of interest if the proportion between consumption and investment (i.e., time preference) remains the same.

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The rate of interest, we must reiterate, is \textit{determined} by time preferences, which also determine the proportions of consumption and investment. To think of the rate of interest as “inducing” more or less saving or hoarding is to misunderstand the problem completely.\textsuperscript{23}

Admitting, then, that time preference determines the proportions of consumption and investment and that the demand for money determines the proportion of income hoarded, does the demand for money play a role in determining the interest rate? The Keynesians assert that there is a relation between the rate of interest and a “speculative” demand for cash. Should the schedule of the latter rise, the former rises also. But this is not necessarily true. A greater proportion of funds hoarded can be drawn from three alternative sources: \(a\) from funds that formerly went into consumption, \(b\) from funds that went into investment, and \(c\) from a mixture of both that leaves the old consumption-investment proportion unchanged. Condition \(a\) will bring about a \textit{fall} in the rate of interest; condition \(b\) a \textit{rise} in the rate of interest, and condition \(c\) will leave the rate of interest unchanged. Thus hoarding may reflect either a rise, a fall, or no change in the rate of interest, depending on whether \textit{time preferences} have concomitantly risen, fallen, or remained the same.

The Keynesians contend that the speculative demand for cash depends upon and determines the rate of interest in this way: if people expect that the rate of interest will rise in the near future, then their liquidity preference increases to await this rise. This, however, can hardly be a part of a long-run \textit{equilibrium} theory, such as Keynes is trying to establish. Speculation, by its very nature, disappears in the ERE, and hence no fundamental causal theory can be based upon it. Furthermore, what \textit{is} an interest rate? One grave and fundamental Keynesian error is to persist in regarding the interest rate as a contract rate on loans, instead of the price spreads between stages of production. The former, as we have seen, is only the reflection of the latter.

A strong expectation of a rapid rise in interest rate means a strong expectation of an increase in the price spreads, or rate of net return. A fall in prices means that entrepreneurs generally expect that factor prices will fall further in the near future than their selling prices. But it requires no Keynesian labyrinth to explain this phenomenon; all we are confronted with is a situation in which entrepreneurs, expecting that factor prices will soon fall, cease investing and wait for this happy event so that their return will be greater. This is not "liquidity preference," but speculation on price changes. It involves a modification of our previous discussion of the relation between prices and the demand for money, caused by a fact that we shall explore soon in detail, namely, that prices do not change equally and proportionately.

The expectation of falling factor prices speeds up the movement toward equilibrium and hence toward the pure interest relation as determined by time preference.24

If, for example, unions keep wage rates artificially high, "hoarding" will increase as unions keep wage rates ever higher than the equilibrium rate at which "full employment" can be maintained. This induced hoarding lowers the money demand for factors and increases unemployment still further, but only because of wage-rate rigidity.25

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24Hutt concludes that equilibrium is secured when all services and products are so priced that they are (i) brought within the reach of people’s pockets (i.e., so that they are purchasable by existing money incomes) or (ii) brought into such a relation to predicted prices that no postponement of expenditure on them is induced. For instance, the products and services used in the manufacture of investment goods must be so priced that anticipated future money incomes will be able to buy the services and depreciation of new equipment or replacement. (Hutt, “Significance of Price Flexibility,” p. 394)

25“Postponements (in purchases) arise because it is judged that a cut in costs (or other prices) is less than will eventually have to take place, or because the rate of fall of costs is insufficiently rapid.” Ibid., p. 395.
The final Keynesian bogey is that people may acquire an unlimited demand for money, so that hoards will indefinitely increase. This is termed an “infinite” liquidity preference. And this is the only case in which neo-Keynesians such as Modigliani believe that involuntary unemployment can be compatible with price and wage freedom. The Keynesian worry is that people will hoard instead of buying bonds for fear of a fall in the price of securities. Translating this into more important “natural” terms, this would mean, as we have stated, not investing because of expectation of imminent increases in the natural interest rate. Rather than act as a blockade, however, this expectation speeds the ensuing adjustment. Furthermore, the demand for money could not be infinite since people must always continue consuming, whatever their expectations. Of necessity, therefore, the demand for money could never be infinite. The existing level of consumption, in turn, will require a certain level of investment. As long as productive activities are continuing, there is no need or possibility of lasting unemployment, regardless of the degree of hoarding.26

A demand for money to hold stems from the general uncertainty of the market. Keynesians, however, attribute liquidity preference, not to general uncertainty, but to the specific uncertainty of future bond prices. Surely this is a highly superficial and limiting view.

In the first place, this cause of liquidity preference could occur only on a highly imperfect securities market. As Lachmann pointed out years ago in a neglected article, Keynes’ causal pattern—“bearishness” causing “liquidity preference” (demand for cash) and high interest rates—could take place only in the absence of an organized forward or futures market for securities.

26 As Hutt points out, if we can conceive of a situation of infinitely elastic liquidity preference (and no such situation has ever existed), then “we can conceive of prices falling rapidly, keeping pace with expectations of price changes, but never reaching zero, with full utilization of resources persisting all the way.” Ibid., p. 398.
If such a market existed, both bears and bulls on the bond market could express their expectations by forward transactions which do not require any cash. Where the market for securities is fully organized over time, the owner of 4% bonds who fears a rise in the rate of interest has no incentive to exchange them for cash, for he can always “hedge” by selling them forward.27

Bearishness would cause a fall in forward bond prices, followed immediately by a fall in spot prices. Thus, speculative bearishness would, of course, cause at least a temporary rise in the rate of interest, but accompanied by no increase in the demand for cash. Hence, any attempted connection between liquidity preference, or demand for cash, and the rate of interest, falls to the ground.

The fact that such a securities market has not been organized indicates that traders are not nearly as worried about rising interest rates as Keynes believes. If they were and this fear loomed as an important phenomenon, then surely a futures market would have developed in securities.

Furthermore, as we have seen, interest rates on loans are merely a reflection of price spreads, so that a prediction of higher interest rates really means the expectation of lower prices and, especially, lower costs, resulting in a greater demand for money. And all speculation, on the free market, is self-correcting and speeds adjustment, rather than a cause of economic trouble.

G. THE PURCHASING-POWER AND TERMS-OF-TRADE COMPONENTS IN THE RATE OF INTEREST

Many economists, beginning with Irving Fisher, have asserted that the market rate of interest, in addition to containing specific entrepreneurial components superimposed on the

point: the cluster of errors after a boom. In fact, such an explanation can never be found, since no such cluster could appear on the free market.

The nearest attempt at an explanation stressed general swings of “overoptimism” and “overpessimism” in the business community. But put in such fashion, the theory looks very much like a _deus ex machina._ Why should hardheaded businessmen, schooled in trying to maximize their profits, suddenly fall victim to such psychological swings? In fact, the crisis brings bankruptcies regardless of the emotional state of particular entrepreneurs. We shall see in chapter 12 that feelings of optimism _do_ play a role, but they are _induced_ by certain objective economic conditions. We must search for the objective reasons that cause businessmen to become “overoptimistic.” And they cannot be found on the free market.64 The positive explanation of the business cycle, therefore, will have to be postponed to the next chapter.

16. Schumpeter’s Theory of Business Cycles

Joseph Schumpeter’s business cycle theory is one of the very few that attempts to integrate an explanation of the business cycle with an analysis of the entire economic system. The theory was presented in essence in his _Theory of Economic Development,_

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64 See V. Lewis Bassie:

The whole psychological theory of the business cycle appears to be hardly more than an inversion of the real causal sequence. Expectations more nearly derive from objective conditions than produce them. . . . It is not the wave of optimism that makes times good. Good times are almost bound to bring a wave of optimism with them. On the other hand, when the decline comes, it comes not because anyone loses confidence, but because the basic economic forces are changing. (V. Lewis Bassie, “Recent Development in Short-Term Forecasting,” _Studies in Income and Wealth,_ XVII [Princeton, N.J.: National Bureau of Economic Research, 1955], 10–12)
published in 1912. This analysis formed the basis for the “first approximation” of his more elaborate doctrine, presented in the two-volume *Business Cycles*, published in 1939. The latter volume, however, was a distinct retrogression from the former, for it attempted to explain the business cycle by postulating three superimposed cycles (each of which was explainable according to his “first approximation”). Each of these cycles is supposed to be roughly periodic in length. They are alleged by Schumpeter to be the three-year “Kitchin” cycle; the nine-year “Juglar”; and the very long (50-year) “Kondratieff.” These cycles are conceived as independent entities, combining in various ways to yield the aggregate cyclical pattern. Any such “multicyclic” approach must be set down as a mystical adoption of the fallacy of conceptual realism. There is no reality or meaning to the allegedly independent sets of “cycles.” The market is one interdependent unit, and the more developed it is, the greater the interrelations among market elements. It is therefore impossible for several or numerous independent cycles to coexist as self-contained units. It is precisely the characteristic of a business cycle that it permeates all market activities.

Many theorists have assumed the existence of periodic cycles, where the length of each successive cycle is uniform, even down to the precise number of months. The quest for periodicity is a chimera after the laws of physics; in human action there are no quantitative constants. Praxeological laws can be only qualitative in nature. Therefore, there will be no periodicity in the length of business cycles.

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It is best, then, to discard Schumpeter's multicyclical schema entirely and to consider his more interesting one-cycle “approximation” (as presented in his earlier book), which he attempts to derive from his general economic analysis. Schumpeter begins his study with the economy in a state of “circular flow” equilibrium, i.e., what amounts to a picture of an evenly rotating economy. This is proper, since it is only by hypothetically investigating the disturbances of an imaginary state of equilibrium that we can mentally isolate the causal factors of the business cycle. First, Schumpeter describes the ERE, where all anticipations are fulfilled, every individual and economic element is in equilibrium, profits and losses are zero—all based on given values and resources. Then, asks Schumpeter, what can impel changes in this setup? First, there are possible changes in consumer tastes and demands. This is cavalierly dismissed by Schumpeter as unimportant.\(^{67}\) There are possible changes in population and therefore in the labor supply; but these are gradual, and entrepreneurs can readily adapt to them. Third, there can be new saving and investment. Wisely, Schumpeter sees that changes in saving-investment rates imply no business cycle; new saving will cause continuous growth. Sudden changes in the rate of saving, when unanticipated by the market, can cause dislocations, of course, as may any sudden, unanticipated change. But there is nothing cyclic or mysterious about these effects. Instead of concluding from this survey, as he should have done, that there can be no business cycle on the free market, Schumpeter turned to a fourth element, which for him was the generator of all growth as well as of business cycles—innovation in productive techniques.

We have seen above that innovations cannot be considered the prime mover of the economy, since innovations can work their effects only through saving and investment and since there

are always a great many investments that could improve techniques within the corpus of existing knowledge, but which are not made for lack of adequate savings. This consideration alone is enough to invalidate Schumpeter’s business-cycle theory.

A further consideration is that Schumpeter’s own theory relies specifically for the financing of innovations on newly expanded bank credit, on new money issued by the banks. Without delving into Schumpeter’s theory of bank credit and its consequences, it is clear that Schumpeter assumes a hampered market, for we have seen that there could not be any monetary credit expansion on a free market. Schumpeter therefore cannot establish a business-cycle theory for a purely unhampered market.

Finally, Schumpeter’s explanation of innovations as the trigger for the business cycle necessarily assumes that there is a recurrent cluster of innovations that takes place in each boom period. Why should there be such a cluster of innovations? Why are innovations not more or less continuous, as we would expect? Schumpeter cannot answer this question satisfactorily. The fact that a bold few begin innovating and that they are followed by imitators does not yield a cluster, for this process could be continuous, with new innovators arriving on the scene. Schumpeter offers two explanations for the slackening of innovative activity toward the end of the boom (a slackening essential to his theory). On the one hand, the release of new products yielded by the new investments creates difficulties for old producers and leads to a period of uncertainty and need for “rest.” In contrast, in equilibrium periods, the risk of failure and uncertainty is less than in other periods. But here Schumpeter mistakes the auxiliary construction of the ERE for the real world. There is never in existence any actual period of certainty; all periods are uncertain, and there is no reason why increased production should cause more uncertainty to develop or any vague needs for rest. Entrepreneurs are always seeking profit-making opportunities, and there is no reason for any periods of “waiting” or of “gathering the harvest” to develop suddenly in the economic system.
Schumpeter’s second explanation is that innovations cluster in only one or a few industries and that these innovation opportunities are therefore limited. After a while they become exhausted, and the cluster of innovations ceases. This is obviously related to the Hansen stagnation thesis, in the sense that there are alleged to be a certain limited number of “investment opportunities”—here innovation opportunities—at any time, and that once these are exhausted there is temporarily no further room for investments or innovations. The whole concept of “opportunity” in this connection, however, is meaningless. There is no limit on “opportunity” as long as wants remain unfulfilled. The only other limit on investment or innovation is saved capital available to embark on the projects. But this has nothing to do with vaguely available opportunities which become “exhausted”; the existence of saved capital is a continuing factor. As for innovations, there is no reason why innovations cannot be continuous or take place in many industries, or why the innovatory pace has to slacken.

As Kuznets has shown, a cluster of innovation must assume a cluster of entrepreneurial ability as well, and this is clearly unwarranted. Clemence and Doody, Schumpeterian disciples, countered that entrepreneurial ability is exhausted in the act of founding a new firm. But to view entrepreneurship as simply the founding of new firms is completely invalid. Entrepreneurship is not just the founding of new firms, it is not merely innovation; it is \textit{adjustment}: adjustment to the uncertain, changing conditions of the future. This adjustment takes

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69In so far as innovation is a regularized business procedure of research and development, rents from innovations will accrue to the research and development workers in firms, rather than to entrepreneurial profits. Cf. Carolyn Shaw Solo, “Innovation in the Capitalist Process:
place, perforce, all the time and is not exhausted in any single act of investment.

We must conclude that Schumpeter’s praiseworthy attempt to derive a business cycle theory from general economic analysis is a failure. Schumpeter almost hit on the right explanation when he stated that the only other explanation that could be found for the business cycle would be a cluster of errors by entrepreneurs, and he saw no reason, no objective cause, why there should be such a cluster of errors. That is perfectly true—for the free, unhampered market!

17. Further Fallacies of the Keynesian System

In the text above, we saw that even if the Keynesian functions were correct and social expenditures fell below income above a certain point and vice versa, this would have no unfortunate consequences for the economy. The level of national money income, and consequently of hoarding, is an imaginary bogey. In this section, we shall pursue our analysis of the Keynesian system and demonstrate further grave fallacies within the system itself. In other words, we shall see that the consumption function and investment are not ultimate determinants of social income (whereas above we demonstrated that it makes no particular difference if they are or not).

A. INTEREST AND INVESTMENT

Investment, though the dynamic and volatile factor in the Keynesian system, is also the Keynesian stepchild. Keynesians have differed on the causal determinants of investment. Originally, Keynes determined it by the interest rate as compared with the marginal efficiency of capital, or prospect for net return. The interest rate is supposed to be determined by the money relation; we have seen that this idea is fallacious. Actually, the equilibrium

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net rate of return is the interest rate, the natural rate to which the bond rate conforms. Rather than changes in the interest rate causing changes in investment, as we have seen before, changes in time preference are reflected in changes in consumption-investment decisions. Changes in the interest rate and in investment are two sides of a coin, both determined by individual valuations and time preferences.

The error of calling the interest rate the cause of investment changes, and itself determined by the money relation, is also adopted by such “critics” of the Keynesian system as Pigou, who asserts that falling prices will release enough cash to lower the interest rate, stimulate investment, and thus finally restore full employment.

Modern Keynesians have tended to abandon the intricacies of the relation between interest and investment and simply declare themselves agnostic on the factors determining investment. They rest their case on an alleged determination of consumption.70

B. THE “CONSUMPTION FUNCTION”

If Keynesians are unsure about investment, they have, until very recently, been very emphatic about consumption. Investment is a volatile, uncertain expenditure. Aggregate consumption, on the other hand, is a passive, stable “function” of immediately previous social income. Total net expenditures determining and equaling total net income in a period (gross expenditures between stages of production are unfortunately removed from discussion) consist of investment and consumption. Furthermore, consumption always behaves so that below a certain income level consumption will be higher than income, and above that level consumption will be lower. Figure 82 depicts

70Some Keynesians account for investment by the “acceleration principle” (see below). The Hansen “stagnation” thesis—that investment is determined by population growth, the rate of technological improvement, etc.—seems happily to be a thing of the past.
the relations among consumption, investment, expenditure, and social income.

The relation between income and expenditure is the same as shown in Figure 78. Now we see why the Keynesians assume the expenditure curve to have a smaller slope than income. Consumption is supposed to have the identical slope as expenditures; for investment is unrelated to income, as the determinants are unknown. Hence, investment is depicted as having no functional relation to income and is represented as a constant gap between the expenditure and consumption lines.

The stability of the passive consumption function, as contrasted with the volatility of active investment, is a keystone of the Keynesian system. This assumption is replete with so many grave errors that it is necessary to take them up one at a time.

(a) How do the Keynesians justify the assumption of a stable consumption function with the shape as shown above? One route was through “budget studies”—cross-sectional studies of the relation between family income and expenditure by income
groups in a given year. Budget studies such as that of the National Resources Committee in the mid-1930’s yielded similar “consumption functions” with dishoardings increasing below a certain point, and hoardings above it (i.e., income below expenditures below a certain point, and expenditures below income above it).

This is supposed to intimate that those doing the “dissaving,” i.e., the dishoarding, are poor people below the subsistence level who incur deficits by borrowing. But how long is this supposed to go on? How can there be a continuous deficit? Who would continue to lend these people the money? It is more reasonable to suppose that the dishoarders are decumulating their previously accumulated capital, i.e., that they are wealthy people whose businesses suffered losses during that year.

(b) Aside from the fact that budget studies are misinterpreted, there are graver fallacies involved. For the curve given by the budget study has no relation whatever to the Keynesian consumption function! The former, at best, gives a cross section of the relation between classes of family expenditure and income for one year; the Keynesian consumption function attempts to establish a relation between total social income and total social consumption for any given year, holding true over a hypothetical range of social incomes. At best, one entire budget curve can be summed up to yield only one point on the Keynesian consumption function. Budget studies, therefore, can in no way confirm the Keynesian assumptions.

(c) Another very popular device to confirm the consumption function reached the peak of its popularity during World War II. This was historical-statistical correlation of national income and consumption for a definite period of time, usually the 1930’s. This correlation equation was then assumed to be the “stable” consumption function. Errors in this procedure were numerous. In the first place, even assuming such a stable relation, it would only be an historical conclusion, not a theoretical law. In physics, an experimentally determined law may be assumed to be constant for other identical situations; in human action, historical
situations are never the same, and therefore there are no quantitative constants! Conditions and valuations could change at any time, and the “stable” relationship altered. There is here no proof of a stable consumption function. The dismal record of forecasts (such as those of postwar unemployment) made on this assumption should not have been surprising.

Moreover, a stable relation was not even established. Income was correlated with consumption and with investment. Since consumption is a much larger magnitude than (net) investment, no wonder that its percentage deviations around the regression equation were smaller! Furthermore, income is here being correlated with 80–90 percent of itself; naturally, the “stability” is tremendous. If income were correlated with saving, of similar magnitude as investment, there would be no greater stability in the income-saving function than in the “income-investment function.”

Thirdly, the consumption function is necessarily an *ex ante* relation; it is supposed to tell how much consumers will decide to spend given a certain total income. Historical statistics, on the other hand, record only *ex post* data, which give a completely different story. For any given period of time, for example, hoarding and dishoarding cannot be recorded *ex post*. In fact, *ex post*, on double-entry accounting records, total social income is always equal to total social expenditures. Yet, in the dynamic, *ex ante*, sense, it is precisely the divergence between total social income and total social expenditures (hoarding or dishoarding) that plays the crucial role in the Keynesian theory. But these divergences can never be revealed, as Keynesians believe, by study of *ex post* data. *Ex post*, in fact, saving always equals investment, and social expenditure always equals social income, so that the *ex post* expenditure line coincides with the income line.71

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71 See Lindahl, “On Keynes’ Economic System—Part I,” p. 169 n. Lindahl shows the difficulties of mixing an *ex post* income line with *ex ante* consumption and spending, as the Keynesians do. Lindahl also shows
(d) Actually, the whole idea of stable consumption functions has now been discredited, although many Keynesians do not fully realize this fact. In fact, Keynesians themselves have admitted that, in the long run, the consumption function is not stable, since total consumption rises as income rises; and that in the short run it is not stable, since it is affected by all sorts of changing factors. But if it is not stable in the short run and not stable in the long run, what kind of stability does it have? Of what use is it? We have seen that the only really important runs are the immediate and the long-run, which shows the direction in which the immediate is tending. There is no use for some sort of separate “intermediate” situation.

(e) It is instructive to turn now to the reasons that Keynes himself, in contrast to his followers, gave for assuming his stable consumption function. It is a confused exposition indeed. The “propensity to consume” out of given income, according to Keynes, is determined by two sets of factors, “objective” and “subjective.” It seems clear, however, that these are purely subjective decisions, so that there can be no separate objective determinants. In classifying subjective factors, Keynes makes the mistake of subsuming hoarding and investing motivations that the expenditure and income lines coincide if the divergence between expected and realized income affects income and not stocks. Yet it cannot affect stocks, for, contrary to Keynesian assertion, there is no such thing as hoarding or any other unexpected event leading to “unintended increase in inventories.” An increase in inventories is never unintended, since the seller has the alternative of selling the good at the market price. The fact that his inventory increases means that he has voluntarily invested in larger inventory, hoping for a future price rise.


under categories of separate “causes”: precaution, foresight, improvement, etc. Actually, as we have seen, the demand for money is ultimately determined by each individual for all sorts of reasons, but all tied up with uncertainty; motives for investment are to maintain and increase future standards of living. By a sleight of hand completely unsupported by facts or argument Keynes simply assumes all these subjective factors to be given in the short run, although he admits that they will change in the long run. (If they change in the long run, how can his system yield an equilibrium position?) He simply reduces the subjective motives to current economic organization, customs, standards of living, etc., and assumes them to be given. The “objective factors” (which in reality are subjective, such as time-preference changes, expectations, etc.) can admittedly cause short-run changes in the consumption function (such as windfall changes in capital values). Expectations of future changes in income can affect an individual’s consumption, but Keynes simply asserts without discussion that this factor “is likely to average out for the community as a whole.” Time preferences are discussed in a very confused way, with interest rate and time preference assumed to be apart from and influencing the propensity to consume. Here again, short-run fluctuations are assumed to have little effect, and Keynes simply leaps to the conclusion that the propensity to consume is, in the short run, a “fairly” stable function.

(f) The failure of the consumption-function theory is not only the failure of a specific theory. It is a profound epistemological failure as well. For the concept of a consumption function has no place in economics at all. Economics is praxeological,
i.e., its propositions are absolutely true given the existence of the axioms—the basic axiom being the existence of human action itself. Economics, therefore, is not and cannot be “empirical” in the positivist sense, i.e., it cannot establish some sort of empirical hypothesis which could or could not be true, and at best is only true approximately. Quantitative, empirico-historical “laws” are worthless in economics, since they may only be coincidences of complex facts, and not isolable, repeatable laws which will hold true in the future. The idea of the consumption function is not only wrong on many counts; it is irrelevant to economics.

Furthermore, the very term “function” is inappropriate in a study of human action. Function implies a quantitative, determined relationship, whereas no such quantitative determinism exists. People act and can change their actions at any time; no causal, constant, external determinants of action can exist. The term “function” is appropriate only to the unmotivated, repeatable motion of inorganic matter.

In conclusion, there is no reason whatever to assume that at some point, expenditures will be below income, while at lower points it will be above income. Economics does not and cannot know what ex ante expenditure will ever be in relation to income; at any point, it could be equal, or there could be net hoarding or dishoarding. The ultimate decisions are made by the individuals and are not determinable by science. There is, therefore, no stable expenditure function whatever.

C. THE MULTIPLIER

The once highly esteemed “multiplier” has now happily faded in popularity, as economists have begun to realize that it is simply the obverse of the stable consumption function. However, the complete absurdity of the multiplier has not yet been fully appreciated. The theory of the “investment multiplier” runs somewhat as follows:

\[
\text{Social Income} = \text{Consumption} + \text{Investment}
\]
Consumption is a stable function of income, as revealed by statistical correlation, etc. Let us say, for the sake of simplicity, that Consumption will always be .80 (Income). In that case,

\[ \text{Income} = .80 \text{ (Income)} + \text{Investment}. \]
\[ .20 \text{ (Income)} = \text{Investment}; \text{ or} \]
\[ \text{Income} = 5 \text{ (Investment)}. \]

The “5” is the “investment multiplier.” It is then obvious that all we need to increase social money income by a desired amount is to increase investment by \( \frac{1}{5} \) of that amount; and the multiplier magic will do the rest. The early “pump primers” believed in approaching this goal through stimulating private investment; later Keynesians realized that if investment is an “active” volatile factor, government spending is no less active and more certain, so that government spending must be relied upon to provide the needed multiplier effect. Creating new money would be most effective, since the government would then be sure not to reduce private funds. Hence the basis for calling all government spending “investment”: it is “investment” because it is not tied passively to income.

The following is offered as a far more potent “multiplier,” on Keynesian grounds even more potent and effective than the investment multiplier, and on Keynesian grounds there can be no objection to it. It is a reductio ad absurdum, but it is not simply a parody, for it is in keeping with the Keynesian method.

Social Income = Income of (insert name of any person, say the reader) + Income of everyone else.

Let us use symbols:

Social Income = \( Y \)
Income of the Reader = \( R \)
Income of everyone else = \( V \)

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\(^{76}\)Actually, the form of the Keynesian function is generally “linear,” e.g., Consumption = .80 (Income) + 20. The form given in the text simplifies the exposition without, however, changing its essence.
We find that $V$ is a completely stable function of $Y$. Plot the two on coordinates, and we find historical one-to-one correspondence between them. It is a tremendously stable function, far more stable than the “consumption function.” On the other hand, plot $R$ against $Y$. Here we find, instead of perfect correlation, only the remotest of connections between the fluctuating income of the reader of these lines and the social income. Therefore, this reader’s income is the active, volatile, uncertain element in the social income, while everyone else’s income is passive, stable, determined by the social income.

Let us say the equation arrived at is:

$$V = .99999 Y$$

Then, $Y = .99999 Y + R$

$$\begin{align*}
0.00001 Y & = R \\
Y & = 100,000 R
\end{align*}$$

This is the reader’s own personal multiplier, a far more powerful one than the investment multiplier. To increase social income and thereby cure depression and unemployment, it is only necessary for the government to print a certain number of dollars and give them to the reader of these lines. The reader’s spending will prime the pump of a 100,000-fold increase in the national income.77

18. The Fallacy of the Acceleration Principle

The “acceleration principle” has been adopted by some Keynesians as their explanation of investment, then to be combined with the “multiplier” to yield various mathematical “models” of the business cycle. The acceleration principle antedates Keynesianism, however, and may be considered on its own merits. It is almost always used to explain the behavior of investment in the business cycle.

77 Also see Hazlitt, Failure of the “New Economics,” pp. 135–55.
The essence of the acceleration principle may be summed up in the following illustration:

Let us take a certain firm or industry, preferably a first-rank producer of consumers’ goods. Assume that the firm is producing an output of 100 units of a good during a certain period of time and that 10 machines of a certain type are needed in this production. If the period is a year, consumers demand and purchase 100 units of output per year. The firm has a stock of 10 machines. Suppose that the average life of a machine is 10 years. In equilibrium, the firm buys one machine as replacement every year (assuming it had bought a new machine every year to build up to 10). Now suppose that there is a 20-percent increase in the consumer demand for the firm’s output. Consumers now wish to purchase 120 units of output. Assuming a fixed ratio of capital investment to output, it is now necessary for the firm to have 12 machines (maintaining the ratio of one machine: 10 units of annual output). In order to have the 12 machines, it must buy two additional machines this year. Add this demand to its usual demand of one machine, and we see that there has been a 200-percent increase in demand for the machine. A 20-percent increase in demand for the product has caused a 200-percent increase in demand for the capital good. Hence, say the proponents of the acceleration principle, an increase in consumption demand in general causes an enormously magnified increase in demand for capital goods. Or rather, it causes a magnified increase in demand for “fixed” capital goods, of high durability. Obviously, capital goods lasting only one year would receive no magnification effect. The essence of the acceleration principle is the relationship between the increased demand and the low level of replacement demand for a durable good. The more durable the good, the greater the magnification and the greater, therefore, the acceleration effect.

78It is usually overlooked that this replacement pattern, necessary to the acceleration principle, could apply only to those firms or industries that had been growing in size rapidly and continuously.
Now suppose that, in the next year, consumer demand for output remains at 120 units. There has been no change in consumer demand from the second year (when it changed from 100 to 120) to the third year. And yet, the accelerationists point out, dire things are happening in the demand for fixed capital. For now there is no longer any need for firms to purchase any new machines beyond what is necessary for replacement. Needed for replacement is still only one machine per year. As a result, while there is zero change in demand for consumers’ goods, there is a 200-percent decline in demand for fixed capital. And the former is the cause of the latter. In the long run, of course, the situation stabilizes into an equilibrium with 120 units of output and one unit of replacement. But in the short run there has been consequent upon a simple increase of 20 percent in consumer demand, first a 200-percent increase in the demand for fixed capital, and next a 200-percent decrease.

To the upholders of the acceleration principle, this illustration provides the key to some of the main features of the business cycle: the greater fluctuations of fixed capital-goods industries as compared with consumers’ goods, and the mass of errors revealed by the crisis in the investment goods industries. The acceleration principle leaps boldly from the example of a single firm to a discussion of aggregate consumption and aggregate investment. Everyone knows, the advocates say, that consumption increases in a boom. This increase in consumption accelerates and magnifies increases in investment. Then, the rate of increase of consumption slows down, and a decline is brought about in investment in fixed capital. Furthermore, if consumption demand declines, then there is “excess capacity” in fixed capital—another feature of the depression.

The acceleration principle is rife with error. An important fallacy at the heart of the principle has been uncovered by Professor Hutt.\textsuperscript{79} We have seen that consumer demand

\textsuperscript{79}See his brilliant critique of the acceleration principle in W.H. Hutt, \textit{Co-ordination and the Price System} (unpublished, but available from
increases by 20 percent; but why must two extra machines be purchased in a year? What does the year have to do with it? If we analyze the matter closely, we find that the year is a purely arbitrary and irrelevant unit even within the terms of the example itself. We might just as readily take a week as the period of time. Then we would have to say that consumer demand (which, after all, goes on continuously) increases 20 percent over the first week, thereby necessitating a 200-percent increase in demand for machines in the first week (or even an infinite increase if the replacement does not precisely occur in the first week), followed by a 200-percent (or infinite) decline in the next week, and stability thereafter. A week is never used by the accelerationists because the example would then be glaringly inapplicable to real life, which does not see such enormous fluctuations in the course of a couple of weeks. But a week is no more arbitrary than a year. In fact, the only nonarbitrary period to choose would be the life of the machine (e.g., 10 years). Over a ten-year period, demand for machines had previously been ten (in the previous decade), and in the current and succeeding decades it will be 10 plus the extra two, i.e., 12. In short, over the 10-year period the demand for machines will increase precisely in the same proportion as the demand for consumers’ goods—and there is no magnification effect whatever.

Since businesses buy and produce over planned periods covering the life of their equipment, there is no reason to assume that the market will not plan production suitably and smoothly, without the erratic fluctuations manufactured by the model of the acceleration principle. There is, in fact, no validity in saying that increased consumption requires increased production of machines immediately; on the contrary, it is only increased saving and investment in machines, at points of time chosen by entrepreneurs strictly on the basis of expected profit,
that permits increased production of consumers’ goods in the future.

Secondly, the acceleration principle makes a completely unjustified leap from the single firm or industry to the whole economy. A 20-percent increase in consumption demand at one point must signify a 20-percent drop in consumption somewhere else. For how can consumption demand in general increase? Consumption demand in general can increase only through a shift from saving. But if saving decreases, then there are less funds available for investment. If there are less funds available for investment, how can investment increase even more than consumption? In fact, there are less funds available for investment when consumption increases. Consumption and investment compete for the use of funds.

Another important consideration is that the proof of the acceleration principle is couched in physical rather than monetary terms. Actually, consumption demand, particularly aggregate consumption demand, as well as demand for capital goods, cannot be expressed in physical terms; it must be expressed in monetary terms, since the demand for goods is the reverse of the supply of money on the market for exchange. If consumer demand increases either for one good or for all, it increases in monetary terms, thereby raising prices of consumers’ goods. Yet we notice that there has been no discussion whatever of prices or price relationships in the acceleration principle. This neglect of price relationships is sufficient by itself to invalidate the entire principle. The acceleration principle simply glides from a demonstration in physical terms to a conclusion in monetary terms.

Furthermore, the acceleration principle assumes a constant relationship between “fixed” capital and output, ignoring substitutability, the possibility of a range of output, the more or

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80 Neglect of prices and price relations is at the core of a great many economic fallacies.
less intensive working of factors. It also assumes that the new machines are produced practically instantaneously, thus ignoring the requisite period of production.

In fact, the entire acceleration principle is a fallaciously mechanistic one, assuming automatic reactions by entrepreneurs to present data, thereby ignoring the most important fact about entrepreneurship: that it is speculative, that its essence is estimating the data of the uncertain future. It therefore involves judgment of future conditions by businessmen, and not simply blind reactions to past data. Successful entrepreneurs are those who best forecast the future. Why can’t the entrepreneurs foresee the supposed slackening of demand and arrange their investments accordingly? In fact, that is what they will do. If the economist, armed with knowledge of the acceleration principle, thinks that he will be able to operate more profitably than the generally successful entrepreneur, why does he not become an entrepreneur and reap the rewards of success himself? All theories of the business cycle attempting to demonstrate general entrepreneurial error on the free market founder on this problem. They do not answer the crucial question: Why does a whole set of men most able in judging the future suddenly lapse into forecasting error?

A clue to the correct business cycle theory is contained in the fact that buried somewhere in a footnote or minor clause of all business cycle theories is the assumption that the money supply expands during the boom, in particular through credit expansion by the banks. The fact that this is a necessary condition in all the theories should lead us to explore this factor further: perhaps it is a sufficient condition as well. But, as we have seen above, there can be no bank credit expansion on the free market, since this is equivalent to the issue of fraudulent warehouse receipts. The positive discussion of business cycle theory will have to be postponed to the next chapter, since there can be no business cycle in the purely free market.

Business-cycle theorists have always claimed to be more “realistic” than general economic theorists. With the exceptions of
Mises and Hayek (correctly) and Schumpeter (fallaciously), none has tried to deduce his business cycle theory from general economic analysis. It should be clear that this is required for a satisfactory explanation of the business cycle. Some, in fact, have explicitly discarded economic analysis altogether in their study of business cycles, while most writers use aggregative “models” with no relation to a general economic analysis of individual action. All of these commit the fallacy of “conceptual realism”—i.e., of using aggregative concepts and shuffling them at will, without relating them to actual individual action, while believing that something is being said about the real world. The business-cycle theorist pores over sine curves, mathematical models, and curves of all types; he shuffles equations and interactions and thinks that he is saying something about the economic system or about human action. In fact, he is not. The overwhelming bulk of current business cycle theory is not economics at all, but meaningless manipulation of mathematical equations and geometric diagrams.

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Keynesian Criticisms of the Theory

There are two standard Keynesian criticisms of the Mises cycle theory. One charge takes the followers of Mises to task for identifying saving and investment. Saving and investment, the Keynesians charge, are two entirely separate processes, performed by two sets of people with little or no link between them; the “classical” identification of saving and investment is therefore illegitimate. Savings “leak” out of the consumption-spending stream; investments pour in from some other phase.

F.A. Hayek subjected J.M. Keynes’s early Treatise on Money (now relatively forgotten amid the glow of his later General Theory) to a sound and searching critique, much of which applies to the later volume. Thus, Hayek pointed out that Keynes simply assumed that zero aggregate profit was just sufficient to maintain capital, whereas profits in the lower stages combined with equal losses in the higher stages would reduce the capital structure; Keynes ignored the various stages of production; ignored changes in capital value and neglected the identity between entrepreneurs and capitalists; took replacement of the capital structure for granted; neglected price differentials in the stages of production as the source of interest; and did not realize that, ultimately, the question faced by businessmen is not whether to invest in consumer goods or capital goods, but whether to invest in capital goods that will yield consumer goods at a nearer or later date. In general, Hayek found Keynes ignorant of capital theory and real-interest theory, particularly that of Böhm-Bawerk, a criticism borne out in Keynes’s remarks on Mises’s theory of interest. See John Maynard Keynes, The General Theory of Employment, Interest, and Money (New York: Harcourt, Brace, 1936), pp. 192–93; F.A. Hayek, “Reflections on the Pure Theory of Money of Mr. J.M. Keynes,” Economica (August, 1931): 270–95; and idem, “A Rejoinder to Mr. Keynes,” Economica (November, 1931): 400–02.
of spending. The task of government in a depression, according to the Keynesians, is accordingly to stimulate investments and discourage savings, so that total spendings increase.

Savings and investment are indissolubly linked. It is impossible to encourage one and discourage the other. Aside from bank credit, investments can come from no other source than savings (and we have seen what happens when investments are financed by bank credit). Not only consumers save directly, but also consumers in their capacity as independent businessmen or as owners of corporations. But can’t savings be “hoarded”? This, however, is an artificial and misleading way of putting the matter. Consider a man’s possible allocation of his monetary assets:

He can (1) spend money on consumption; (2) spend on investment; (3) add to cash balance or subtract from previous cash balance. This is the sum of his alternatives. The Keynesians assume, most contrarily, that he first decides how much to consume or not, calling this “not-consumption” saving, and then decides how much to invest and how much to “leak” into hoards. (This, of course, is neo-Keynesianism rather than pure Keynesian orthodoxy, which banishes hoarding from the living room, while readmitting it by the back door.) This is a highly artificial approach and confirms Sir Dennis Robertson’s charge that the Keynesians are incapable of “visualizing more than two margins at once.”\(^2\) Clearly, our individual decides at one and the same stroke about allocating his income in the three different channels. Furthermore, he allocates between the various categories on the basis of two embracing utilities: his time preferences decide his allocation between consumption and investment (between spending on present vs. future consumption); his utility of money decides how much he will keep in his cash balance. In order to invest resources in the future, he must restrict his consumption and save funds. This restricting is

his savings, and so saving and investment are always equivalent. The two terms may be used almost interchangeably.

These various individual valuations sum up to social time-preference ratios and social demand for money. If people’s demand for cash balances increases, we do not call this “savings leaking into hoards”; we simply say that demand for money has increased. In the aggregate, total cash balances can only rise to the extent that the total supply of money rises, since the two are identical. But real cash balances can increase through a rise in the value of the dollar. If the value of the dollar is permitted to rise (prices are permitted to fall) without hindrance, no dislocations will be caused by this increased demand, and depressions will not be aggravated. The Keynesian doctrine artificially assumes that any increase (or decrease) in hoards will be matched by a corresponding fall (or rise) in invested funds. But this is not correct. The demand for money is completely unrelated to the time-preference proportions people might adopt; increased hoarding, therefore, could just as easily come out of reduced consumption as out of reduced investment. In short, the savings-investment-consumption proportions are determined by time preferences of individuals; the spending-cash balance proportion is determined by their demands for money.

**The Liquidity “Trap”**

The ultimate weapon in the Keynesian arsenal of explanations of depressions is the “liquidity trap.” This is not precisely a critique of the Mises theory, but it is the last line of Keynesian defense of their own inflationary “cures” for depression. Keynesians claim that “liquidity preference” (demand for money) may be so persistently high that the rate of interest could not fall low enough to stimulate investment sufficiently to raise the economy out of the depression. This statement assumes that the rate of interest is determined by “liquidity preference” instead of by time preference; and it also assumes again that the link between savings and investment is very tenuous indeed, only tentatively exerting itself *through* the rate of interest. But, on the contrary, it is not a question of saving and investment each being acted upon by the
rate of interest; in fact, saving, investment, and the rate of interest are each and all simultaneously determined by individual time preferences on the market. Liquidity preference has nothing to do with this matter. Keynesians maintain that if the “speculative” demand for cash rises in a depression, this will raise the rate of interest. But this is not at all necessary. Increased hoarding can either come from funds formerly consumed, from funds formerly invested, or from a mixture of both that leaves the old consumption–investment proportion unchanged. Unless time preferences change, the last alternative will be the one adopted. Thus, the rate of interest depends solely on time preference, and not at all on “liquidity preference.” In fact, if the increased hoards come mainly out of consumption, an increased demand for money will cause interest rates to fall—because time preferences have fallen.

In their stress on the liquidity trap as a potent factor in aggravating depression and perpetuating unemployment, the Keynesians make much fuss over the alleged fact that people, in a financial crisis, expect a rise in the rate of interest, and will therefore hoard money instead of purchasing bonds and contributing toward lower rates. It is this “speculative hoard” that constitutes the “liquidity trap,” and is supposed to indicate the relation between liquidity preference and the interest rate. But the Keynesians are here misled by their superficial treatment of the interest rate as simply the price of loan contracts. The crucial interest rate, as we have indicated, is the natural rate—the “profit spread” on the market. Since loans are simply a form of investment, the rate on loans is but a pale reflection of the natural rate. What, then, does an expectation of rising interest rates really mean? It means that people expect increases in the rate of net return on the market, via wages and other producers’ goods prices falling faster than do consumer goods’ prices. But this needs no labyrinthine explanation; investors expect falling wages and other factor prices, and they are therefore holding off investing in factors until the fall occurs. But this is old-fashioned “classical” speculation on price changes. This expectation, far from being an upsetting element, actually speeds up the adjustment. Just as all speculation speeds up adjustment to the proper levels, so this expectation hastens the fall in wages and other factor prices, hastening the recovery, and permitting normal
Keynesian Criticisms of the Theory

...prosperity to return that much faster. Far from “speculative” hoarding being a bogey of depression, therefore, it is actually a welcome stimulus to more rapid recovery.\(^3\)

Such intelligent neo-Keynesians as Modigliani concede that only an “infinite” liquidity preference (an unlimited demand for money) will block return to full-employment equilibrium in a free market.\(^4\) But, as we have seen, heavy speculative demand for money speeds the adjustment process. Moreover, the demand for money could never be infinite because people must always continue consuming, on some level, regardless of their expectations. Since people must continue consuming, they must also continue producing, so that there can be adjustment and full employment regardless of the degree of hoarding. The failure to juxtapose hoarding and consuming again stems from the Keynesian neglect of more than two margins at once and their erroneous belief that hoarding only reduces investment, not consumption.

In a brilliant article on Keynesianism and price-wage flexibility, Professor Hutt points out that:

> No condition which even distinctly resembles infinite elasticity of demand for money assets has even been recognized, I believe, because general expectations have always envisaged either (a) the attainment in the not too

\(^3\)For more on the equilibrating effects of wage reductions in a depression see the following section.


> [T]he apparent revolution wrought by Keynes after 1936 has been reversed by a bloodless counter-revolution conducted unwittingly by higher critics who tried very hard to be faithful. Whether some permanent benefit to our science will have made up for the destruction which the revolution left in its train, is a question which economic historians of the future will have to answer.

distant future of some definite scale of prices, or (b) so
   gradual a decline of prices that no cumulative postpone-
   ment of expenditure has seemed profitable.

But even if such an unlikely demand arose:
   If one can seriously imagine [this situation] . . . with the
   aggregate real value of money assets being inflated, and
   prices being driven down catastrophically, then one may
   equally legitimately (and equally extravagantly) imagine
   continuous price coordination accompanying the emer-
   gence of such a position. We can conceive, that is, of
   prices falling rapidly, keeping pace with expectations of
   price changes, but never reaching zero, with full utiliza-
   tion of resources persisting all the way.5

WAGE RATES AND UNEMPLOYMENT

Sophisticated Keynesians now admit that the Keynesian theory
of “underemployment equilibrium” does not really apply (as was
first believed) to the free and unhampered market: that it assumes,
in fact, that wage rates are rigid downward. “Classical” economists
have always maintained that unemployment is caused precisely by
wage rates not being allowed to fall freely; but in the Keynesian
system this assumption has been buried in a mass of irrelevant
equations. The assumption is there, nevertheless, and it is crucial.6
The Keynesian prescription for unemployment rests on the per-
sistence of a “money illusion” among workers, i.e., on the belief
that while, through unions and government, they will keep money
wage rates from falling, they will also accept a fall in real wage rates
via higher prices. Governmental inflation, then, is supposed to
eliminate unemployment by bringing about such a fall in real wage
rates. In these times of ardent concentration on the cost-of-living


6See Modigliani, “Liquidity Preference and the Theory of Interest and
index, such duplicity is impossible and we need not repeat here the various undesirable consequences of inflation.\footnote{See L. Albert Hahn, *The Economics of Illusion* (New York: Squier, 1949), pp. 50ff., 166ff.}

It is curious that even economists who subscribe to a general theory of prices balk whenever the theory is logically applied to wages, the prices of labor services. Marginal productivity theory, for example, may be applied strictly to other factors; but, when wages are discussed, we suddenly read about "zones of indeterminacy" and "bargaining."\footnote{Actually, zones of indeterminacy are apt to be wide where only two or three people live on a desert island and narrow progressively the greater the population and the more advanced the economic system. No special zone adheres to the labor contract.} Similarly, most economists would readily admit that keeping the price of any good above the amount that would clear the market will cause unsold surpluses to pile up. Yet, they are reluctant to admit this in the case of labor. If they claim that "labor" is a general good, and therefore that wage cuts will injure general purchasing power, it must first be replied that "general labor" is not sold on the market; that it is certain specific labor that is usually kept artificially high and that this labor will be unemployed. It is true, however, that the wider the extent of the artificially high wage rates, the more likely will mass unemployment be. If, for example, only a few crafts manage, by union or government coercion to boost the wage rate in their fields above the free-market rate, displaced workers will move into a poorer line of work, and find employment there. In that case, the remaining union workers have gained their wage increase at the expense of lower wage rates elsewhere and of a general misallocation of productive factors. The wider the extent of the rigid wages, however, the less opportunity there will be to move and the greater will be the extent and duration of the unemployment.

In a free market, wage rates will tend to adjust themselves so that there is no involuntary unemployment, i.e., so that all those desiring to work can find jobs. Generally, wage rates can only be kept above full-employment rates through coercion by government,
unions, or both. Occasionally, however, the high wage rates are maintained by voluntary choice (although the choice is usually ignorant of the consequences) or by coercion supplemented by voluntary choice. It may happen, for example, that either business firms or the workers themselves may become persuaded that maintaining wage rates artificially high is their bounden duty. Such persuasion has actually been at the root of much of the unemployment of our time, and this was particularly true in the 1929 depression. Workers, for example, become persuaded of the great importance of preserving the mystique of the union: of union solidarity in “not crossing a picket line,” or not undercutting union wage rates. Unions almost always reinforce this mystique with violence, but there is no gainsaying the breadth of its influence. To the extent that workers, both in and out of the union, feel bound by this mystique, to that extent will they refuse to bid wages downward even when they are unemployed. If they do that, then we must conclude that they are unemployed voluntarily, and that the way to end their unemployment is to convince them that the mystique of the union is morally absurd. However, while these workers are unemployed voluntarily, as a consequence of their devotion to the union, it is highly likely that the workers do not fully realize the consequences of their ideas and actions. The mass of men are generally ignorant of economic truths. It is highly possible that once they discovered that their unemployment was the direct result of their devotion to union solidarity, much of this devotion would quickly wither away.

Both workers and businessmen may become persuaded by the mistaken idea that artificial propping of wage rates is beneficial. This factor played a great role in the 1929 depression. As early as the 1920s, “big” businessmen were swayed by “enlightened” and “progressive” ideas, one of which mistakenly held that American prosperity was caused by the payment of high wages (rates?) instead of the other way round. As if other countries had a lower standard of living because their businessmen stupidly refused to quadruple or quintuple their wage rates! By the time of the depression, then,

\( ^9 \) It is immaterial to the argument whether or not the present writer believes the mystique to be morally absurd.
businessmen were ripe for believing that lowering wage rates would cut “purchasing power” (consumption) and worsen the depression (a doctrine that the Keynesians later appropriated and embellished). To the extent that businessmen become convinced of this economic error, they are responsible for unemployment, but responsible, be it noted, not because they are acting “selfishly” and “greedily” but precisely because they are trying to act “responsibly.” Insofar as government reinforces this conviction with cajolery and threat, the government bears the primary guilt for unemployment.

What of the Keynesian argument, however, that a fall in wage rates would \textit{not} help cure unemployment because it would slash purchasing power and therefore deprive industry of needed demand for its products? This argument can be answered on many levels. In the first place, as prices fall in a depression, \textit{real} wage rates are not only maintained but \textit{increased}. If this helps employment by raising purchasing power, why not advocate drastic \textit{increases} in money wage rates? Suppose the government decreed, for example, a minimum wage law where the minimum was triple the going wage rates? What would happen? Why don’t the Keynesians advocate such a measure?

It is clear that the effect of such a decree would be total mass unemployment and a complete stoppage of the wheels of production. Unless . . . unless the money supply were increased to permit employers to pay such sums, but in that case \textit{real} wage rates have not increased at all! Neither would it be an adequate reply to say that this measure would “go too far” because wage rates are \textit{both} costs to entrepreneurs and incomes to workers. The point is that the free-market rate is precisely the one that adjusts wages—costs \textit{and} incomes—to the full-employment position. Any other wage rate distorts the economic situation.\textsuperscript{10}

The Keynesian argument confuses wage \textit{rates} with wage \textit{incomes}—a common failing of the economic literature, which often

\textsuperscript{10}Maximum wage controls, such as prevailed in earlier centuries and in the Second World War, created artificial shortages of labor throughout the economy—the reverse of the effect of minimum wages.
talks vaguely of “wages” without specifying rate or income. Actually, wage income equals wage rate multiplied by the amount of time over which the income is earned. If the wage rate is per hour, for example, wage rate will equal total wage income divided by the total number of hours worked. But then the total wage income depends on the number of hours worked as well as on the wage rate. We are contending here that a drop in the wage rate will lead to an increase in the total number employed; if the total man-hours worked increases enough, it can also lead to an increase in the total wage bill, or payrolls. A fall in wage rate, then, does not necessarily lead to a fall in total wage incomes; in fact, it may do the opposite. At the very least, however, it will lead to an absorption of the unemployed, and this is the issue under discussion. As an illustration, suppose that we simplify matters (but not too drastically) and assume a fixed “wages fund” which employers can dispense to workers. Clearly, then, a reduced wage rate will permit the same payroll fund to be spread over a greater number of people. There is no reason to assume that total payroll will fall.

In actuality, there is no fixed fund for wages, but there is rather a fixed “capital fund” which business pays out to all factors of production. Ultimately, there is no return to capital goods, since their prices are all absorbed by wages and land rents (and interest, which, as the price of time, permeates the economy). Therefore, what business as a whole has at any time is a fixed fund for wages, rents, and interest. Labor and land are perennial competitors. Since production functions are not fixed throughout the economy, a widespread reduction in wage rates would cause business to substitute labor for land, labor now being relatively more attractive vis-à-vis land than it was before. Consequently, aggregate payrolls would not be the same; they would increase, because of the substitution effect in favor of labor as against land. The aggregate demand for labor would therefore be “elastic.”


12Various empirical studies have maintained that the aggregate demand for labor is highly elastic in a depression, but the argument here does not rest upon them. See Benjamin M. Anderson, “The Road Back to Full Employment,” in
Keynesian Criticisms of the Theory

Suppose, however, that the highly improbable “worst” occurs, and the demand for labor turns out to be inelastic, i.e., total payrolls decline as a result of a cut in wage rates. What then? First, such inelasticity could only be due to businesses holding off from investing in labor in expectation that wage rates will fall further. But the way to meet such speculation is to permit wage rates to fall as quickly and rapidly as possible. A quick fall to the free-market rate will demonstrate to businessmen that wage rates have fallen their maximum viable amount. Not only will this not lead businesses to wait further before investing in labor, it will stimulate businesses to hurry and invest before wage rates rise again. The popular tendency to regard speculation as a commanding force in its own right must be avoided; the more astute as forecasters and diviners of the economy the businessmen are, the more they will “speculate,” and the more will their speculation spur rather than delay the natural equilibrating forces of the market. For any mistakes in speculation—selling or buying goods or services too fast or too soon—will directly injure the businessmen themselves. Speculation is not self-perpetuating; it depends wholly and ultimately on the underlying forces of natural supply and consumer demand, and it promotes adjustment to those forces. If businessmen overspeculate in inventory of a certain good, for example, the piling up of unsold stock will lead to losses and speedy correction. Similarly, if businessmen wait too long to purchase labor, labor “shortages” will develop and businessmen will quickly bid up wage rates to their “true” free-market rates. Entrepreneurs, we remember, are trained to forecast the market correctly; they only make mass errors when governmental or bank intervention distorts the “signals” of the market and misleads them on the true state of underlying supply and demand. There is no interventionary deception here; on the contrary, we are discussing a return to the free market after a previous intervention has been eliminated.

If a quick fall in wage rates ends and even reverses withholding of the purchase of labor, a slow, sluggish, downward drift of wage

rates will aggravate matters, because (a) it will perpetuate wages above free market levels and therefore perpetuate unemployment; and (b) it will stimulate withholding of labor purchases, thereby tending to aggravate the unemployment problem even further.

Second, whether or not such speculation takes place, there is still no reason why unemployment cannot be speedily eliminated. If workers do not hold out for a reserve price because of union pressure or persuasion, unemployment will disappear even if total payroll has declined.

The following diagram will illustrate this process: (see Figure 1). Quantity of Labor is on the horizontal axis; wage rate on the vertical. \(D_L\) \(D_L\) is the aggregate demand for Labor; \(I\) is the total stock of labor in the society; that is, the total supply of labor seeking work. The supply of labor is represented by vertical line \(S_L\) \(S_L\), rather than by the usual forward-sloping supply curve, because we
may abstain from any cutting of hours due to falling wage rates, and more important, because we are investigating the problem of *involuntary* unemployment rather than voluntary. Those who wish to cut back their hours, or quit working altogether when wage rates fall, can hardly be considered as posing an “unemployment problem” to society, and we can therefore omit them here.

In a free market, the wage rate will be set by the intersection of the labor supply curve $S_1, S_1$ and the demand curve $D_1, D_1$, or at point $E$ or wage rate $0I$. The labor stock $IE$ will be fully employed. Suppose, however, that because of coercion or persuasion, the wage rate is kept rigid so that it does not fall below $0A$. The supply of labor curve is now changed: it is now horizontal over $AC$, then rises vertically upward, $CS_L$. Instead of intersecting the demand for labor at point $E$ the new supply of labor curve intersects it at point $B$. This equilibrium point now sets the minimum wage rate of $0A$, but only employs $AB$ workers, leaving $BC$ unemployed. Clearly, the remedy for the unemployment is to remove the artificial prop keeping the supply of labor curve at $AC$, and to permit wage rates to fall until full-employment equilibrium is reached.\(^{13}\)

Now, the critic might ask: suppose there is not only speculation that will speed adjustment, but speculation that *overshoots* its mark. The “speculative demand for labor” can then be considered to be $D_3 D_3$, purchasing less labor at every wage rate than the “true” demand curve requires. What happens? Not unemployment, but full employment at a lower wage rate, $0J$. Now, as the wage rate falls below underlying market levels, the true demand for labor becomes ever greater than the supply of labor; at the new “equilibrium” wage the gap is equal to $GH$. The enormous pressure of this true demand leads entrepreneurs to see the gap, and they begin to bid up wage rates to overcome the resulting “shortage of labor.” Speculation is self *correcting* rather than self aggravating, and wages are bid up to the underlying free-market wage $0I$.

If speculation presents no problems whatever and even helps matters when wage rates are permitted to fall freely, it accentuates

\(^{13}\)See Hutt, “The Significance of Price Flexibility.” p. 400.
the evils of unemployment as long as wages are maintained above free-market levels. Keeping wage rates up or only permitting them to fall sluggishly and reluctantly in a depression sets up among businessmen the expectation that wage rates must eventually be allowed to fall. Such speculation lowers the aggregate demand curve for labor, say to D₅D₅. But with the supply curve of labor still maintained horizontally at AC, the equilibrium wage rate is pushed farther to the left at F. and the amount employed reduced to AF, the amount unemployed increased to FC.¹⁴

Thus, even if total payrolls decline, freely falling wage rates will always bring about a speedy end to involuntary unemployment. The Keynesian linkage of total employment with total monetary demand for products implicitly assumes rigid wage rates downward; it therefore cannot be used to criticize the policy of freely-falling wage rates. But even if full employment is maintained, will not the declining demand further depress business? There are two answers to this. In the first place, what has happened to the existing money supply? We are assuming throughout a given quantity of money existing in the society. This money has not disappeared. Neither, for that matter, has total monetary spending necessarily declined. If total payrolls have declined, something else has gone up: the total retained by entrepreneurs, or by investors, for example. In fact, given the total money supply, the total flow of monetary spending will only decline if the social demand for money has increased. In other words, if “hoarding” has increased. But an increase in hoarding, in total demand for money, is, as we have seen, no social

¹⁴Note that, in Figure 1, the S₅S₅ line stops before reaching the horizontal axis. Actually, the line must stop at the wage yielding the minimum subsistence income. Below that wage rate, no one will work, and therefore, the supply curve of labor will really be horizontal, on the free market, at the minimum subsistence point. Certainly it will not be possible for speculative withholding to reduce wage rates to the subsistence level, for three reasons: (a) this speculative withholding almost always results in hoarding, which reduces prices all-round and which will therefore reduce the equilibrium money wage rate without reducing the equilibrium real wage rate—the relevant rate for the subsistence level, (b) entrepreneurs will realize that their speculation has overshot the mark long before the subsistence level is reached; and (c) this is especially true in an advanced capitalist economy, where the rates are far above subsistence.
calamity. In response to the needs and uncertainties of depression, people desire to increase their real cash balances, and they can only do so, with a given amount of total cash, by lowering prices. Hoarding, therefore, lowers prices all around, but need exert no depressing effect whatever upon business. Business, as we have pointed out, depends for its profitability on price differentials between factor and selling prices, not upon general price levels. Decrease or increase in total monetary spending is, therefore, irrelevant to the general profitability of business.

Finally, there is the Keynesian argument that wage earners consume a greater proportion of their income than landlords or entrepreneurs, and therefore that a decreased total wage bill is a calamity because consumption will decline and savings increase. In the first place, this is not always accurate. It assumes (1) that the laborers are the relatively “poor” and the nonlaborers the relative “rich,” and (2) that the poor consume a greater proportion of their income than the rich. The first assumption is not necessarily correct. The President of General Motors is, after all, a “laborer,” and so also is Mickey Mantle; on the other hand, there are a great many poor landlords, farmers, and retailers. Manipulating relations between wage earners and others is a very clumsy and ineffective

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15 On the other hand, wage rates maintained above the free-market level will discourage investment and thereby tend to increase hoarding at the expense of saving–investment. This decline in the investment–consumption ratio aggravates the depression further. Freely declining wage rates would permit investments to return to previous proportions, thus adding another important impetus to recovery. See Frederic Benham, British Monetary Policy (London: P.S. King and Son, 1932), p. 77.

16 It has often been maintained that a failing price level injures business firms because it aggravates the burden of fixed monetary debt. However, the creditors of a firm are just as much its owners as are the equity shareholders. The equity shareholders have less equity in the business to the extent of its debts. Bondholders (long-term creditors) are just different types of owners, very much as preferred and common stock holders exercise their ownership rights differently. Creditors save money and invest it in an enterprise, just as do stockholders. Therefore, no change in price level by itself helps or hampers a business; creditor–owners and debtor–owners may simply divide their gains (or losses) in different proportions. These are mere intra-owner controversies.
way of manipulating relations between poor and rich (provided we desire any manipulation at all). The second assumption is often, but not necessarily, true, as we have seen above. As we have also seen, however, the empirical study of Lubell indicates that a redistribution of income between rich and poor may not appreciably affect the social consumption-saving proportions. But suppose that all these objections are waved aside for the moment, and we concede for the sake of argument that a fall in total payroll will shift the social proportion against consumption and in favor of saving. What then? But this is precisely an effect that we should highly prize. For, as we have seen, any shift in social time preferences in favor of saving and against consumption will speed the advent of recovery, and decrease the need for a lengthy period of depression readjustment. Any such shift from consumption to savings will foster recovery. To the extent that this dreaded fall in consumption does result from a cut in wage rates, then, the depression will be cured that much more rapidly.

A final note: The surplus “quantity of labor” caused by artificially high wage rates is a surplus quantity of hours worked. This can mean (1) actual unemployment of workers, and/or (2) reduction in working time for employed workers. If a certain number of labor hours are surplus, workers can be discharged outright, or many more can find their weekly working time reduced and their payroll reduced accordingly. The latter scheme is often advanced during a depression, and is called “spreading the work.” Actually, it simply spreads the unemployment. Instead of most workers being fully employed and others unemployed, all become under-employed. Universal adoption of this proposal would render artificial wage maintenance absurd, because no one would be really benefitting from the high wage rates. Of what use are continuing high hourly wage rates if weekly wage rates are lower? The hour-reduction scheme, moreover, perpetuates underemployment. A mass of totally unemployed is liable to press severely on artificial wage rates, and out-compete the employed workers. Securing a greater mass of under-employed prevents such pressure—and this, indeed, is one of the main reasons that unions favor the scheme. In many cases, of course, the plea for shorter hours is accompanied by
a call for higher hourly wage rates to 'keep weekly take-home pay the same'; this of course is a blatant demand for higher real wage rates, accompanied by reduced production and further unemployment as well.

Reduction of hours to 'share the work' will also reduce everyone's real wage rate and the general standard of living, for production will not only be lower but undoubtedly far less efficient, and workers all less productive. This will further widen the gap between the artificially maintained wage rate and the free-market wage rate, and hence further aggravate the unemployment problem.
3

Some Alternative Explanations of Depression: A Critique

Some economists are prepared to admit that the Austrian theory could “sometimes” account for cyclical booms and depressions, but add that other instances might be explained by different theories. Yet, as we have stated above, we believe this to be an error: we hold that the Austrian analysis is the only one that accounts for business cycles and their familiar phenomena. Specific crises can, indeed, be precipitated by other government action or intervention in the market. Thus, England suffered a crisis in its cotton textile industry when the American Civil War cut off its supply of raw cotton. A sharp increase in taxation may depress industry and the urge to invest and thereby precipitate a crisis. Or people may suddenly distrust banks and trigger a deflationary run on the banking system. Generally, however, bank runs only occur after a depression has already weakened confidence, and this was certainly true in 1929. These instances, of course, are not cyclical events but simple crises without preceding booms. They are always identifiable and create no mysteries about the underlying causes of the crises. When W.R. Scott investigated the business annals of the early modern centuries, he found such contemporary explanations of business crises as the following: famine, plague, seizure of bullion by Charles I, losses in war, bank runs, etc. It is the fact that no such obvious disaster can explain modern depressions that accounts for the search for a deeper causal theory of
1929 and all other depressions. Among such theories, only Mises’s can pass muster.¹

**GENERAL OVERPRODUCTION**

“Overproduction” is one of the favorite explanations of depressions. It is based on the common-sense observation that the crisis is marked by unsold stocks of goods, excess capacity of plant, and unemployment of labor. Doesn’t this mean that the “capitalist system” produces “too much” in the boom, until finally the giant productive plant outruns itself? Isn’t the depression the period of rest, which permits the swollen industrial apparatus to wait until reduced business activity clears away the excess production and works off its excess inventory?

This explanation, popular or no, is arrant nonsense. Short of the Garden of Eden, there is no such thing as general “overproduction.” As long as any “economic” desires remain unsatisfied, so long will production be needed and demanded. Certainly, this impossible point of universal satiation had not been reached in 1929. But, these theorists may object, “we do not claim that all desires have ceased. They still exist, but the people lack the money to exercise their demands.” But some money still exists, even in the steepest deflation. Why can’t this money be used to buy these “overproduced” goods? There is no reason why prices cannot fall low enough, in a free market, to clear the market and sell all the goods available.² If businessmen choose to keep prices up, they are simply speculating on an imminent rise in market prices; they are, in short, voluntarily investing in inventory. If they wish to sell their “surplus” stock, they need only cut their prices low enough to sell all of their product.³ But won’t they then suffer losses? Of course,

³In the Keynesian theory, “aggregate equilibrium” is reached by two routes: profits and losses, and “unintended” investment or disinvestment in inventory.
but now the discussion has shifted to a different plane. We find no overproduction, we find now that the selling prices of products are below their cost of production. But since costs are determined by expected future selling prices, this means that costs were previously bid too high by entrepreneurs. The problem, then, is not one of “aggregate demand” or “overproduction,” but one of cost–price differentials. Why did entrepreneurs make the mistake of bidding costs higher than the selling prices turned out to warrant? The Austrian theory explains this cluster of error and the excessive bidding up of costs; the “overproduction” theory does not. In fact, there was overproduction of specific, not general, goods. The mal-investment caused by credit expansion diverted production into lines that turned out to be unprofitable (i.e., where selling prices were lower than costs) and away from lines where it would have been profitable. So there was overproduction of specific goods relative to consumer desires, and underproduction of other specific goods.

**UNDERCONSUMPTION**

The “underconsumption” theory is extremely popular, but it occupied the “underworld” of economics until rescued, in a sense, by Lord Keynes. It alleges that something happens during the boom—in some versions too much investment and too much production, in others too high a proportion of income going to upper-income groups—which causes consumer demand to be insufficient to buy up the goods produced. Hence, the crisis and depression. There are many fallacies involved in this theory. In the first place, as long as people exist, some level of consumption will persist. Even if people suddenly consume less and hoard instead, they must consume certain minimum amounts. Since hoarding cannot proceed so far as to eliminate consumption altogether, some level of consumption will be maintained, and therefore some monetary flow of consumer demand will persist. There is no reason why, in a free market, the prices of all the various factors of production, as well as

But there is no unintended investment, since prices could always be cut low enough to sell inventory if so desired.
the final prices of consumer goods, cannot adapt themselves to this desired level. Any losses, then, will be only temporary in shifting to the new consumption level. If they are anticipated, there need be no losses at all.

Second, it is the entrepreneurs’ business to anticipate consumer demand, and there is no reason why they cannot predict the consumer demand just as they make other predictions, and adjust the production structure to that prediction. The underconsumption theory cannot explain the cluster of errors in the crisis. Those who espouse this theory often maintain that production in the boom outruns consumer demand; but (1) since we are not in Nirvana, there will always be demand for further production, and (2) the unanswered question remains: why were costs bid so high that the product has become unprofitable at current selling prices? The productive machine expands because people want it so, because they desire higher standards of living in the future. It is therefore absurd to maintain that production could outrun consumer demand in general.

One common variant of the underconsumption theory traces the fatal flaw to an alleged shift of relative income to profits and to the higher-income brackets during a boom. Since the rich presumably consume less than the poor, the mass does not then have enough “purchasing-power” to buy back the expanded product. We have already seen that: (1) marginally, empirical research suggests a doubt about whether the rich consume less, and (2) there is not necessarily a shift from the poor to the rich during a boom. But even granting these assumptions, it must be remembered that: (a) entrepreneurs and the rich also consume, and (b) that savings constitute the demand for producers’ goods. Savings, which go into investment, are therefore just as necessary to sustain the structure of production as consumption. Here we tend to be misled because national income accounting deals solely in net terms. Even “gross national product” is not really gross by any means; only gross durable investment is included, while gross inventory purchases are excluded. It is not true, as the underconsumptionists tend to assume, that capital is invested and then pours forth onto the market in the form of production, its work over and done. On the
contrary, to sustain a higher standard of living, the production structure—the capital structure—must be permanently “lengthened.” As more and more capital is added and maintained in civilized economies, more and more funds must be used just to maintain and replace the larger structure. This means higher gross savings, savings that must be sustained and invested in each higher stage of production. Thus, the retailers must continue buying from the wholesalers, the wholesalers from the jobbers, etc. Increased savings, then, are not wasted, they are, on the contrary, vital to the maintenance of civilized living standards.

Underconsumptionists assert that expanding production exerts a depressing secular effect on the economy because prices will tend to fall. But falling prices are not depressant; on the contrary, since falling prices due to increased investment and productivity are reflected in lower unit costs, profitability is not at all injured. Falling prices simply distribute the fruits of higher productivity to all the people. The natural course of economic development, then, barring inflation, is for prices to fall in response to increased capital and higher productivity. Money wage rates will also tend to fall, because of the increased work the given money supply is called upon to perform over a greater number of stages of production. But money wage rates will fall less than consumer goods prices, and as a result economic development brings about higher real wage rates and higher real incomes throughout the economy. Contrary to the underconsumption theory, a stable price level is not the norm, and inflating money and credit in order to keep the “price level” from falling can only lead to the disasters of the business cycle.4

If underconsumption were a valid explanation of any crisis, there would be depression in the consumer goods industries, where surpluses pile up, and at least relative prosperity in the producers’ goods industries. Yet, it is generally admitted that it is the

4We often come across the argument that the money supply must be increased “in order to keep up with the increased supply of goods.” But goods and money are not at all commensurate, and the entire injunction is therefore meaningless. There is no way that money can be matched with goods.
producers’, not the consumers’ goods industries that suffer most during a depression. Underconsumptionism cannot explain this phenomenon, while Mises’s theory explains it precisely. \(^5\) \(^6\) Every crisis is marked by malinvestment and undersaving, not underconsumption.

**The Acceleration Principle**

There is only one way that the underconsumptionists can try to explain the problem of greater fluctuation in the producers' than the consumer goods' industries: the acceleration principle. The acceleration principle begins with the undeniable truth that all production is carried on for eventual consumption. It goes on to state that, not only does demand for producers' goods depend on consumption demand, but that this consumers' demand exerts a multiple leverage effect on investment, which it magnifies and accelerates. The demonstration of the principle begins inevitably with a hypothetical single firm or industry: assume, for example, that a firm is producing 100 units of a good per year, and that 10 machines of a certain type are needed in its production. And assume further that consumers demand and purchase these 100 units. Suppose further that the average life of the machine is 10 years. Then, in equilibrium, the firm buys one new machine each year to replace the one worn out. Now suppose that there is a 20 percent increase in consumer demand for the firm's product. Consumers now wish to purchase 120 units. If we assume a fixed ratio of capital to output, it is now necessary for the firm to have 12 machines. It therefore buys two new machines this year, purchasing a total of three machines instead of one. Thus, a 20 percent increase in consumer demand has led to a 200 percent increase in


\(^6\) The Keynesian approach stresses underspending rather than underconsumption alone; on “hoarding,” the Keynesian dichotomization of saving and investment, and the Keynesian view of wages and unemployment, see above.
demand for the machine. Hence, say the accelerationists, a general increase in consumer demand in the economy will cause a greatly magnified increase in the demand for capital goods, a demand intensified in proportion to the durability of the capital. Clearly, the magnification effect is greater the more durable the capital good and the lower the level of its annual replacement demand.

Now, suppose that consumer demand remains at 120 units in the succeeding year. What happens now to the firm’s demand for machines? There is no longer any need for firms to purchase any new machines beyond those necessary for replacement. Only one machine is still needed for replacement this year; therefore, the firm’s total demand for machines will revert, from three the previous year, to one this year. Thus, an unchanged consumer demand will generate a 200 percent decline in the demand for capital goods. Extending the principle again to the economy as a whole, a simple increase in consumer demand has generated far more intense fluctuations in the demand for fixed capital, first increasing it far more than proportionately, and then precipitating a serious decline. In this way, say the accelerationists, the increase of consumer demand in a boom leads to intense demand for capital goods. Then, as the increase in consumption tapers off, the lower rate of increase itself triggers a depression in the capital goods industries. In the depression, when consumer demand declines, the economy is left with the inevitable “excess capacity” created in the boom. The acceleration principle is rarely used to provide a full theory of the cycle; but it is very often used as one of the main elements in cycle theory, particularly accounting for the severe fluctuations in the capital-goods industries.

The seemingly plausible acceleration principle is actually a tissue of fallacies. We might first point out that the seemingly obvious pattern of one replacement per year assumes that one new machine has been added in each of the ten previous years; in short, it makes the highly dubious assumption that the firm has been expanding rapidly and continuously over the previous decade.⁷

⁷Either that, or such an expansion must have occurred in some previous decade, after which the firm—or whole economy—lapsed into a sluggish stationary state.
This is indeed a curious way of describing an *equilibrium* situation; it is also highly dubious to explain a *boom and depression* as only occurring after a decade of previous expansion. Certainly, it is just as likely that the firm bought all of its ten machines at once—an assumption far more consonant with a current equilibrium situation for that firm. If that happened, then replacement demand by the firm would occur only once every decade. At first, this seems only to strengthen the acceleration principle. After all, the replacement-denominator is now that much less, and the intensified demand so much greater. But it is only strengthened on the surface. For everyone knows that, in real life, in the "normal" course of affairs, the economy in general does not experience zero demand for capital, punctuated by decennial bursts of investment. Overall, on the market, investment demand is more or less constant during near-stationary states. But if, overall, the market can iron out such rapid fluctuations, why can’t it iron out the milder ones postulated in the standard version of the acceleration principle?

There is, moreover, an important fallacy at the very heart of the accelerationists’ own example, a fallacy that has been uncovered by W.H. Hutt. We have seen that consumer demand increases by 20 percent—but why must the two extra machines be purchased in a year? What does the year have to do with it? If we analyze the matter closely, we find that the year is a purely arbitrary and irrelevant unit even within the terms of the example itself. We might just as well take a *week* as the time period. Then we would aver that consumer demand (which, after all, goes on continuously) increases 20 percent over the first week, thus necessitating a 200 percent increase in demand for machines in the first week (or even an *infinite* increase if replacement does not occur in the first week) followed by a 200 percent (or infinite) decline in the next week, and stability thereafter. A week is never used by the accelerationists because the example would then clearly not apply to real life, which

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does not see such enormous fluctuations in the course of a couple of weeks, and the theory could certainly not then be used to explain the general business cycle. But a week is no more arbitrary than a year. In fact, the only non-arbitrary time-period to choose would be the life of the machine (e.g., ten years).\footnote{This is not merely the problem of a time lag necessary to produce the new machines; it is the far broader question of the great range of choice of the time period in which to make the investment. But this reminds us of another fallacy made by the accelerationists: that production of the new machines is virtually instantaneous.\footnote{The accelerationists habitually confuse consumption with production of consumer goods, and talk about one when the other is relevant.}} Over a ten-year period, demand for machines had previously been ten and in the current and succeeding decades will be ten plus the extra two, e.g., 12: in short, over the ten-year period, the demand for machines will increase in \textit{precisely the same proportion} as the demand for consumer goods—and there is no ramification effect whatever. Since businesses buy and produce over planned periods covering the lives of their equipment, there is no reason to assume that the market will not plan production accordingly and smoothly, without the erratic fluctuations manufactured by the accelerationists' model. There is, in fact, no validity in saying that increased consumption \textit{requires} increased production of machines immediately; on the contrary, it is increased saving and investment in machines, at points of time chosen by entrepreneurs strictly on the basis of expected profitability, that \textit{permits} future increased production of consumer goods.\footnote{This is not merely the problem of a time lag necessary to produce the new machines; it is the far broader question of the great range of choice of the time period in which to make the investment. But this reminds us of another fallacy made by the accelerationists: that production of the new machines is virtually instantaneous.\footnote{The accelerationists habitually confuse consumption with production of consumer goods, and talk about one when the other is relevant.}}

There are other erroneous assumptions made by the acceleration principle. Its postulate of a fixed capital–output ratio, for example, ignores the ever-present possibility of substitution, more or less intensive working of different factors, etc. It also assumes that capital is finely divisible, ignoring the fact that investments are "lumpy," and made discontinuously, especially those in a fixed plant.

There is yet a far graver flaw—and a fatal one—in the acceleration principle, and it is reflected in the rigidity of the mechanical model. No mention whatever is made of the price system or of
entrepreneurship. Considering the fact that all production on the market is run by entrepreneurs operating under the price system, this omission is amazing indeed. It is difficult to see how any economic theory can be taken seriously that completely omits the price system from its reckoning. A change in consumer demand will change the prices of consumer goods, yet such reactions are forgotten, and monetary and physical terms are hopelessly entwined by the theory without mentioning price changes. The extent to which any entrepreneur will invest in added production of a good depends on its price relations—on the differentials between its selling price and the prices of its factors of production. These price differentials are interrelated at each stage of production. If, for example, monetary consumer demand increases, it will reveal itself to producers of consumer goods through an increase in the price of the product. If the price differential between selling and buying prices is raised, production of this good will be stimulated. If factor prices rise faster than selling prices, production is curtailed, however, and there is no effect on production if the prices change pari passu. Ignoring prices in a discussion of production, then, renders a theory wholly invalid.

Apart from neglecting the price system, the principle’s view of the entrepreneur is hopelessly mechanistic. The prime function of the entrepreneur is to speculate, to estimate the uncertain future by using his judgment. But the acceleration principle looks upon the entrepreneur as blindly and automatically responding to present data (i.e., data of the immediate past) rather than estimating future data. Once this point is stressed, it will be clear that entrepreneurs, in an unhampered economy, should be able to forecast the supposed slackening of demand and arrange their investments accordingly. If entrepreneurs can approximately forecast the alleged “acceleration principle,” then the supposed slackening of investment demand, while leading to lower activity in those industries, need not be depressive, because it need not and would not engender losses among businessmen. Even if the remainder of the principle were conceded, therefore, it could only explain fluctuations, not depression—not the cluster of errors made by the entrepreneurs. If the accelerationists claim that the errors are precisely caused by entrepreneurial failure
to forecast the change, we must ask, why the failure? In Mises’s theory, entrepreneurs are prevented from forecasting correctly because of the tampering with market “signals” by government intervention. But here there is no government interference, the principle allegedly referring to the unhampered market. Furthermore, the principle is far easier to grasp than the Mises theory. There is nothing complex about it, and if it were true, then it would be obvious to all entrepreneurs that investment demand would fall off greatly in the following year. Theirs, and other people’s, affairs would be arranged accordingly, and no general depression or heavy losses would ensue. Thus, the hypothetical investment in seven-year locust equipment may be very heavy for one or two years, and then fall off drastically in the next years. Yet this need engender no depression, since these changes would all be discounted and arranged in advance. This cannot be done as efficiently in other instances, but certainly entrepreneurs should be able to foresee the alleged effect. In fact, everyone should foresee it; and the entrepreneurs have achieved their present place precisely because of their predictive ability. The acceleration principle cannot account for entrepreneurial error.\textsuperscript{11}

One of the most important fallacies of the acceleration principle is its wholly illegitimate leap from the single firm or industry to the overall economy. Its error is akin to those committed by the great bulk of Anglo-American economic theories: the concentration on only two areas—the single firm or industry, and the economy as a whole. Both these concentrations are fatally wrong, because they leave out the most important areas: the interrelations between the various parts of the economy. Only a general economic theory is valid—never a theoretical system based on either a partial or isolated case, or on holistic aggregates, or on a mixture of the two.\textsuperscript{12} In the case of the acceleration principle, how did the 20

\textsuperscript{11}The “Cobweb Theorem” is another doctrine built on the assumption that all entrepreneurs are dolts, who blindly react rather than speculate and succeed in predicting the future.

\textsuperscript{12}Anglo-American economics suffers badly from this deficiency. The Marshallian system rested on a partial theory of the “industry,” while modern
percent increase in consumption of the firm’s product come about? Generally, a 20 percent increase in consumption in one field must signify a 20 percent reduction of consumption somewhere else. In that case, of course, the leap from the individual to the aggregate is peculiarly wrong, since there is then no overall boom in consumption or investment. If the 20 percent increase is to obtain over the whole economy, how is the increase to be financed? We cannot simply postulate an increase in consumption; the important question is: how can it be financed? What general changes are needed elsewhere to permit such an increase? These are questions that the accelerationists never face. Setting aside changes in the supply or demand for money for a moment, increased consumption can only come about through a decrease in saving and investment. But if aggregate saving and investment must decrease in order to permit an aggregate increase in consumption, then investment cannot increase in response to rising consumption; on the contrary, it must decline. The acceleration principle never faces this problem because it is profoundly ignorant of economics—the study of the working of the means–ends principle in human affairs. Short of Nirvana, all resources are scarce, and these resources must be allocated to the uses most urgently demanded by all individuals in the society. This is the unique economic problem, and it means that to gain a good of greater value, some other good of lesser value to individuals must be given up. Greater aggregate present consumption can only be acquired through lowered aggregate savings and investment. In short, people choose between present and future consumption, and can only increase present consumption at the expense of future, or vice versa. But the acceleration principle neglects the economic problem completely and disastrously.

economics fragments itself further to discuss the isolated firm. To remedy this defect, Keynesians and later econometric systems discuss the economy in terms of a few holistic aggregates. Only the Misesian and Walrasian systems are truly general, being based themselves on interrelated individual exchanges. The Walrasian scheme is unrealistic, consisting solely of a mathematical analysis of an unrealizable (though important) equilibrium system.
The only way that investment can rise together with consumption is through inflationary credit expansion—and the accelerationists will often briefly allude to this prerequisite. But this admission destroys the entire theory. It means, first, that the acceleration principle could not possibly operate on the free market. That, if it exists at all, it must be attributed to government rather than to the working of laissez-faire capitalism. But even granting the necessity of credit expansion cannot save the principle. For the example offered by the acceleration principle deals in physical, real terms. It postulates an increased production of units in response to increased demand. But if the increased demand is purely monetary, then prices, both of consumer and capital goods, can simply rise without any change in physical production—and there is no acceleration effect at all. In short, there might be a 20 percent rise in money supply, leading to a 20 percent rise in consumption and in investment—indeed in all quantities—but real quantities and price relations need not change, and there is no magnification of investment, in real or monetary terms. The same applies, incidentally, if the monetary increase in investment or consumption comes from dishoarding rather than monetary expansion.

It might be objected that inflation does not and cannot increase all quantities proportionately, and that this is its chief characteristic. Precisely so. But proceed along these lines, and we are back squarely and firmly in the Austrian theory of the trade cycle—and the acceleration principle has been irretrievably lost. The Austrian theory deals precisely with the distortions of market adjustment to consumption-investment proportions, brought about by inflationary credit expansion.\textsuperscript{13} Thus, the accelerationists maintain, in effect, that the entrepreneurs are lured by increased consumption to overexpand durable investments. But the Austrian theory

\textsuperscript{13}Another defect of the accelerationist explanation of the cycle is its stress on durable capital equipment as the preeminently fluctuating activity. Actually, as we have shown above, the boom is not characterized by an undue stress on durable capital; in fact, such non-durable items as industrial raw materials fluctuate as strongly as fixed capital goods. The fluctuation takes place in producers’ goods industries (the Austrian emphasis) and not just durable producers’ goods (the accelerationist emphasis).
demonstrates that, due to the effect of inflation on prices, even credit expansion can only cause malinvestment, not “overinvestment.” Entrepreneurs will overinvest in the higher stages, and underinvest in the lower stages, of production. Total investment is limited by the total supply of savings available, and a general increase in consumption signifies a decrease in saving and therefore a decline in total investment (and not an increase or even magnified increase, as the acceleration principle claims). Furthermore, the Austrian theory shows that the cluster of entrepreneurial error is caused by the inflationary distortion of market interest rates.

DEARTH OF “INVESTMENT OPPORTUNITIES”

A very common tendency among economists is to attribute depression to a dearth, or “saturation,” of “investment opportunities.” Investment opportunities open themselves up during the boom and are exploited accordingly. After a while, however, these opportunities disappear, and hence depression succeeds the boom. The depression continues until opportunities for investment reappear. What gives rise to these alleged “opportunities”? Typical are the causal factors listed in a famous article by Professor Hansen, who attributed the depression of the 1930s to a dearth of investment opportunities caused by an insufficient rate of population growth, the lack of new resources, and inadequate technical


\[15\] The acceleration principle also claims to explain the alleged tendency of the downturn in capital goods to lead downturns in consumer goods activity. However, it could only do so, even on its own terms, under the very special—and almost never realized—assumption that the sale of consumer goods describes a sine-shaped curve over the business cycle. Other possible curves give rise to no leads at all.

innovation. The importance of this doctrine goes far beyond Hansen’s “stagnation” theory—that these factors would behave in the future so as to cause a permanent tendency toward depression. For the “refuters” of the stagnation theory tacitly accepted Hansen’s causal theory and simply argued empirically that these factors would be stronger than Hansen had believed. Rarely have the causal connections themselves been challenged. The doctrine has been widely assumed without being carefully supported.

Whence come these causal categories? A close look will show their derivation from the equilibrium conditions of the Walrasian system which assumes a constant and evenly rotating economy, with tastes, technological knowledge, and resources considered given. Changes can only occur if one or more of these given variables change. If new net investment is considered the key to depression or prosperity, then, knowing that new investment is zero in equilibrium (i.e., there is only enough investment to replace and maintain capital), it is easy to conclude that only changes in the ultimate given variables can lead to new investment. Population and natural resources both fall under the Walrasian “resource” category. Hansen’s important omission, of course, is tastes. The omission of tastes is enough to shatter the entire scheme. For it is time preferences (the “tastes” of the society for present vis-à-vis future consumption) that determines the amount that individuals will save and invest. Omitting time preferences leaves out the essential determinant of saving and investment.

New natural resources, a relatively unimportant item, is rarely stressed. We used to hear about the baleful effects on the “closing of the frontier” of open land, but this frontier closed long before the 1930s with no ill effects. Actually, physical space by itself provides

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17 For an example, see George Terborgh, *The Bogey of Economic Maturity* (Chicago: Machinery and Allied Products Institute, 1945).

18 Curiously, these same worrywarts did not call upon the federal government to abandon its conservation policies, which led it to close millions of acres of public
no assurance of profitable investment opportunities. Population
growth is often considered an important factor making for prosp-
erity or depression, but it is difficult to see why. If population is
below the optimum (maximum real income per capita), its further
growth permits investment to increase productivity by extending
the division of labor. But this can only be done through greater
investment. There is no way, however, that population growth can
stimulate investment, and this is the issue at hand. One thesis holds
that increased population growth stimulates demand for residen-
tial construction. But demand stems from purchasing power,
which in turn stems ultimately from production, and an increase in
babies may run up against inability to produce enough goods to
demand the new houses effectively. But even if more construction
is demanded, this will simply reduce consumption demand in other
areas of the economy. If total consumption increases due to popula-
tion growth (and there is no particular reason why it should), it will
cause a decline in saved and invested funds rather than the reverse.

Technology is perhaps the most emphatically stressed of these
alleged causal factors. Schumpeter’s cycle theory has led many
economists to stress the importance of technological innovation,
particularly in great new industries; and thus we hear about the
Railroad Boom or the Automobile Boom. Some great technologi-
cal innovation is made, a field for investment opens up, and a boom
is at hand. Full exploitation of this field finally exhausts the boom,
and depression sets in. The fallacy involved here is neglect of the
fact that technology, while vitally important, is only indirectly, and
not directly, involved in an investment. At this point, we see again
why the conditions of Misesian rather than Walrasian equilibrium
should have been employed. Austrian theory teaches us that invest-
ment is always less than the maximum amount that could possibly
exploit existing technology. Therefore, the “state of technical
knowledge” is not really a limiting condition to investment. We
can see the truth of this by simply looking about us; in every field,
in every possible line of investment, there are always some firms

domain permanently. Nowadays, outer space will presumably provide “frontier”

enough.
which are not using the latest possible equipment, which are still using older methods. This fact indicates that there is a narrower limit on investment than technological knowledge. The backward countries may send engineers aplenty to absorb “American know-how,” but this will not bring to these countries the great amount of investment needed to raise their standard of living appreciably. What they need, in short, is saving: this is the factor limiting investment.¹⁹ And saving, in turn, is limited by time preference: the preference for present over future consumption. Investment always takes place by a lengthening of the processes of production, since the shorter productive processes are the first to be developed. The longer processes remaining untapped are more productive, but they are not exploited because of the limitations of time-preference. There is, for example, no investment in better and new machines because not enough saving is available.

Even if all existing technology were exploited, there would still be unlimited opportunities for investment, since there would still not be satiation of wants. Even if better steel mills and factories could not be built, more of them could always be built, to produce more of the presently produced consumer goods. New technology improves productivity, but is not essential for creating investment opportunities; these always exist, and are only limited by time preferences and available saving. The more saving, the more investment there will be to satisfy those desires not now fulfilled.

Just as in the case of the acceleration principle, the fallacy of the “investment opportunity” approach is revealed by its complete neglect of the price system. Once again, price and cost have disappeared. Actually, the trouble in a depression comes from costs being greater than the prices obtained from sale of capital goods; with costs greater than selling prices, businessmen are naturally reluctant to invest in losing concerns. The problem, then, is the rigidity of costs. In a free market, prices determine costs and not vice versa, so that reduced final prices will also lower the prices of productive

¹⁹Saving, not monetary expansion. A backward country, for example, could not industrialize itself by issuing unlimited quantities of paper money or bank deposits. That could only bring on runaway inflation.
factors—thereby lowering the costs of production. The failure of “investment opportunity” in the crisis stems from the overbidding of costs in the boom, now revealed in the crisis to be too high relative to selling prices. This erroneous overbidding was generated by the inflationary credit expansion of the boom period. The way to retrieve investment opportunities in a depression, then, is to permit costs—factor prices—to fall rapidly, thus reestablishing profitable price-differentials, particularly in the capital goods industries. In short, wage rates, which constitute the great bulk of factor costs, should fall freely and rapidly to restore investment opportunities. This is equivalent to the reestablishment of higher price-differentials—higher natural interest rates—on the market. Thus, the Austrian approach explains the problem of investment opportunities, and other theories are fallacious or irrelevant.

Equally irrelevant is all discussion in terms of specific industries—an approach very similar to the technological opportunity doctrine. Often it is maintained that a certain industry—say construction or autos—was particularly prosperous in the boom, and that the depression occurred because of depressed conditions in that particular industry. This, however, confuses simple specific business fluctuations with general business cycles. Declines in one or several industries are offset by expansion in others, as demand shifts from one field to another. Therefore, attention to particular industries can never explain booms or depressions in general business—especially in a multi-industry country like the United States. It is, for example, irrelevant whether or not the construction industry experiences a “long cycle” of twenty-odd years.

**Schumpeter’s Business Cycle Theory**

Joseph Schumpeter’s cycle theory is notable for being the only doctrine, apart from the Austrian, to be grounded on, and integrated

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20 The economic fortunes of a small country producing one product for the market will of course be dominated by the course of events in that industry.
with, general economic theory. Unfortunately, it was grounded on Walrasian, rather than Austrian, general economics, and was thus doomed from the start. The unique Schumpeterian element in discussing equilibrium is his postulate of a zero rate of interest. Schumpeter, like Hansen, discards consumer tastes as an active element and also dispenses with new resources. With time preference ignored, interest rate becomes zero in equilibrium, and its positive value in the real world becomes solely a reflection of positive profits, which in turn are due to the only possible element of change remaining: technological innovations. These innovations are financed, Schumpeter maintains, by bank credit expansion, and thus Schumpeter at least concedes the vital link of bank credit expansion in generating the boom and depression, although he pays it little actual attention. Innovations cluster in some specific industry, and this generates the boom. The boom ends as the innovatory investments exhaust themselves, and their resulting increased output pours forth on the market to disrupt the older firms and industries. The ending of the cluster, accompanied by the sudden difficulties faced by the old firms, and a generally increased risk of failure, bring about the depression, which ends as the old and new firms finally adapt themselves to the new situation.

There are several fallacies in this approach:

1. There is no explanation offered on the lack of accurate forecasting by both the old and new firms. Why were not the difficulties expected and discounted?22


22To be sure, the Schumpeterian “Pure Model” explicitly postulates perfect knowledge and therefore absence of error by entrepreneurs. But this is a flagrantly self-contradictory assumption within Schumpeter’s own model, since the very reason for depression in the Pure Model is the fact that risks increase, old firms are suddenly driven to the wall, etc., and no one innovates again until the situation clears.
2. In reality, it may take a long time for a cluster of innovations in a new industry to develop, and yet it may take a relatively short time for the output of that industry to increase as a result of the innovations. Yet the theory must assume that output increases after the cluster has done its work; otherwise, there is no boom nor bust.

3. As we have seen above, time preferences and interest are ignored, and also ignored is the fact that saving and not technology is the factor limiting investment. Hence, investment financed by bank credit need not be directed into innovations, but can also finance greater investment in already known processes.

4. The theory postulates a periodic cluster of innovations in the boom periods. But there is no reasoning advanced to account for such an odd cluster. On the contrary, innovations, technological advance, take place continually, and in most, not just a few, firms. A cluster of innovations implies, furthermore, a periodic cluster of entrepreneurial ability, and this assumption is clearly unwarranted. And insofar as innovation is a regular business procedure of research and development, rents from innovations will accrue to the research and development departments of firms, rather than as entrepreneurial profits.

5. Schumpeter's view of entrepreneurship—usually acclaimed as his greatest contribution—is extremely narrow and one-sided. He sees entrepreneurship as solely the making of innovations, setting up new firms to innovate, etc. Actually, entrepreneurs are continually at work, always adjusting to uncertain future demand and supply conditions, including the effects of innovations.

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23 Schumpeter wisely saw that voluntary savings could only cause simple economic growth and could not give rise to business cycles.


25 This refutes Clemons and Doody's defense of Schumpeter against Kuznets's criticism that the cluster of innovations assumes a cluster of entrepreneurial ability. Clemons and Doody identified such ability solely with the making of innovations and the setting up of new firms. See Richard V. Clemons and Francis S. Doody, The Schumpeterian System (Cambridge, Mass.: Addison Wesley
In his later version, Schumpeter recognized that different specific innovations generating cycles would have different “periods of gestation” for exploiting their opportunities until new output had increased to its fullest extent. Hence, he modified his theory by postulating an economy of three separate, and interacting, cycles: roughly one of about three years, one of nine years, and one of 55 years. But the postulate of multi-cycles breaks down any theory of a general business cycle. All economic processes interact on the market, and all processes mesh together. A cycle takes place over the entire economy, the boom and depression each being general. The price system integrates and interrelates all activities, and there is neither warrant nor relevance for assuming hermetically-sealed “cycles,” each running concurrently and adding to each other to form some resultant of business activity. The multi-cycle scheme, then, is a complete retreat from the original Schumpeterian model, and itself adds grievous fallacies to the original.  

**QUALITATIVE CREDIT DOCTRINES**

Of the theories discussed so far, only the Austrian or Misesian sees anything wrong in the boom. The other theories hail the boom, and see the depression as an unpleasant reversal of previous prosperity. The Austrian and Schumpeterian doctrines see the depression as the inevitable result of processes launched in the boom. But while Schumpeter considers “secondary wave” deflation unfortunate and unsettling, he sees the boom–bust of his pure model as the necessary price to be paid for capitalist economic development. Only the Austrian theory, therefore, holds the inflationary boom to be wholly unfortunate and sees the full depression

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Schumpeter also discusses a “secondary wave” superimposed on his pure model. This wave takes into account general inflation, price speculation, etc., but there is nothing particularly Schumpeterian about this discussion, and if we discard both the pure model and the multicyle approach, the Schumpeterian theory is finished.
as necessary to eliminate distortions introduced by the boom. Various “qualitative credit” schools, however, also see the depression as inevitably generated by an inflationary boom. They agree with the Austrians, therefore, that booms should be prevented before they begin, and that the liquidation process of depression should be allowed to proceed unhampered. They differ considerably, however, on the causal analysis, and the specific ways that the boom and depression can be prevented.

The most venerable wing of qualitative credit theory is the old Banking School doctrine, prominent in the nineteenth century and indeed until the 1930s. This is the old-fashioned “sound banking” tradition, prominent in older money-and-banking textbooks, and spearheaded during the 1920s by two eminent economists: Dr. Benjamin M. Anderson of the Chase National Bank, and Dr. H. Parker Willis of the Columbia University Department of Banking, and editor of the *Journal of Commerce*. This school of thought, now very much in decline, holds that bank credit expansion only generates inflation when directed into the wrong lines, i.e., in assets other than self-liquidating short-term credit matched by “real goods,” loaned to borrowers of impeccable credit standing. Bank credit expansion in such assets is held not to be inflationary, since it is then allegedly responsive solely to the legitimate “needs of business,” the money supply rising with increased production, and falling again as goods are sold. All other types of loans—whether in long-term credit, real estate, stock market, or to shaky borrowers—are considered inflationary, and create a boom–bust situation, the depression being necessary to liquidate the wasteful inflation of the boom. Since the bank loans of the 1920s were extended largely in assets considered unsound by the Banking School, these theorists joined the “Austrians” in opposing the bank credit inflation of the 1920s, and in warning of impending depression.

The emphasis of the Banking School, however, is invalid. The important aspect of bank credit expansion is the *quantity* of new money thrown into business lending, and not at all the *type* of business loans that are made. Short-term, “self-liquidating” loans are just as inflationary as long-term loans. Credit needs of business, on the other hand, can be financed by borrowing from voluntary savings:
there is no good reason why short-term loans in particular should be financed by bank inflation. Banks do not simply passively await business firms demanding loans; these very demands vary inversely to the rate of interest that the banks charge. The crucial point is the injection of new money into business firms; regardless of the type of business loan made, this money will then seep into the economy, with the effects described in the Austrian analysis. The irrelevance of the type of loan may be seen from the fact that business firms, if they wish to finance long-term investment, can finance it indirectly from the banks just as effectively as from direct loans. A firm may simply cease using its own funds for financing short-term inventory, and instead borrow the funds from the banks. The funds released by this borrowing can then be used to make long-term investments. It is impossible for banks to prevent their funds being used indirectly in this manner. All credit is inter-related on the market, and there is no way that the various types of credit can be hermetically sealed from each other.\footnote{Thus, during the late 1920s, when banks, influenced by qualitative credit doctrines, tried to shut off the flow of credit to the stock market specifically, the market was able to borrow from the swollen funds of non-bankers, funds swollen by years of bank credit inflation.} And even if there were, it would make no economic sense to do so.

In short, the “self-liquidating” loan is just as inflationary as any other type of loan, and the only merit of this theory is the indirect one of quantitatively limiting the lending of banks that cannot find as many such loans as they would like. This loan does not even have the merit of speedier retirement, since short-term loans can and are renewed or reloaned elsewhere, thus perpetuating the loan for as long a time as any “long-term” loan. This emphasis of the Banking School weakened its salutary effect in the 1920s, for it served to aggravate the general over-emphasis on types of loans—in

\footnotetext{Thus, during the late 1920s, when banks, influenced by qualitative credit doctrines, tried to shut off the flow of credit to the stock market specifically, the market was able to borrow from the swollen funds of non-bankers, funds swollen by years of bank credit inflation.}

On the fallacies of the qualitative credit theorists, and of their views on the stock market, see the excellent study by Fritz Machlup, who at that time was a leading Austrian School theorist, *The Stock Market, Credit and Capital Formation* (New York: Macmillan, 1940).
particular the stock market—as against the quantity of money outstanding.

More dangerous than the Banking School in this qualitative emphasis are those observers who pick out some type of credit as being particularly grievous. Whereas the Banking School opposed a quantitative inflation that went into any but stringently self-liquidating assets, other observers care not at all about quantity, but only about some particular type of asset—e.g., real estate or the stock market. The stock market was a particular whipping boy in the 1920s and many theorists called for restriction on stock loans in contrast to “legitimate” business loans. A popular theory accused the stock market of “absorbing” capital credit that would otherwise have gone to “legitimate” industrial or farm needs. “Wall Street” had been a popular scapegoat since the days of the Populists, and since Thorstein Veblen had legitimated a fallacious distinction between “finance” and “industry.”

The “absorption of capital” argument is now in decline, but there are still many economists who single out the stock market for attack. Clearly, the stock market is a channel for investing in industry. If A buys a new security issue, then the funds are directly invested; if he buys an old share, then (1) the increased price of stock will encourage the firm to float further stock issues, and (2) the funds will then be transferred to the seller B, who in turn will consume or directly invest the funds. If the money is directly invested by B, then once again the stock market has channelled savings into investment. If B consumes the money, then his consumption or dissaving just offsets A’s saving, and no aggregate net saving has occurred.

Much concern was expressed in the 1920s over brokers’ loans, and the increased quantity of loans to brokers was taken as proof of credit absorption in the stock market. But a broker only needs a loan when his client calls on him for cash after selling his stock; otherwise, the broker will keep an open book account with no need for cash. But when the client needs cash he sells his stock and gets out of the market. Hence, the higher the volume of brokers’ loans from banks, the greater the degree that funds are leaving the stock market rather than entering it. In the 1920s, the high volume of
brokers’ loans indicated the great degree to which industry was using the stock market as a channel to acquire saved funds for investment.  

The often marked fluctuations of the stock market in a boom and depression should not be surprising. We have seen the Austrian analysis demonstrate that greater fluctuations will occur in the capital goods industries. Stocks, however, are units of title to masses of capital goods. Just as capital goods’ prices tend to rise in a boom, so will the prices of titles of ownership to masses of capital. The fall in the interest rate due to credit expansion raises the capital value of stocks, and this increase is reinforced both by the actual and the prospective rise in business earnings. The discounting of higher prospective earnings in the boom will naturally tend to raise stock prices further than most other prices. The stock market, therefore, is not really an independent element, separate from or actually disturbing, the industrial system. On the contrary, the stock market tends to reflect the “real” developments in the business world. Those stock market traders who protested during the late 1920s that their boom simply reflected their “investment in America” did not deserve the bitter comments of later critics; their error was the universal one of believing that the boom of the 1920s was natural and perpetual, and not an artificially-induced prelude to disaster. This mistake was hardly unique to the stock market.

Another favorite whipping-boy during recent booms has been installment credit to consumers. It has been charged that installment loans to consumers are somehow uniquely inflationary and unsound. Yet, the reverse is true. Installment credit is no more inflationary than any other loan, and it does far less harm than business loans (including the supposedly “sound” ones) because it

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28 On all this, see Machlup, *The Stock Market, Credit, and Capital Formation*. An individual broker might borrow in order to pay another broker, but in the aggregate, inter-broker transactions cancel out and total brokers’ loans reflect only broker-customer relations.

29 Real estate values will often behave similarly, real estate conveying units of title of capital in land.
does not lead to the boom–bust cycle. The Mises analysis of the business cycle traces causation back to inflationary expansion of credit to business on the loan market. It is the expansion of credit to business that overstimulates investment in the higher orders, misleads business about the amount of savings available, etc. But loans to consumers qua consumers have no ill effects. Since they stimulate consumption rather than business spending, they do not set a boom–bust cycle into motion. There is less to worry about in such loans, strangely enough, than in any other.

**Overoptimism and Overpessimism**

Another popular theory attributes business cycles to alternating psychological waves of “overoptimism” and “overpessimism.” This view neglects the fact that the market is geared to reward correct forecasting and penalize poor forecasting. Entrepreneurs do not have to rely on their own psychology; they can always refer their actions to the objective tests of profit and loss. Profits indicate that their decisions have borne out well; losses indicate that they have made grave mistakes. These objective market tests check any psychological errors that may be made. Furthermore, the successful entrepreneurs on the market will be precisely those, over the years, who are best equipped to make correct forecasts and use good judgment in analyzing market conditions. Under these conditions, it is absurd to suppose that the entire mass of entrepreneurs will make such errors, *unless* objective facts of the market are distorted over a considerable period of time. Such distortion will hobble the objective “signals” of the market and mislead the great bulk of entrepreneurs. This is the distortion explained by Mises’s theory of the cycle. The prevailing optimism is not the cause of the boom; it is the reflection of events that seem to offer boundless prosperity. There is, furthermore, no reason for general overoptimism to shift suddenly to overpessimism; in fact, as Schumpeter has pointed out (and this was certainly true after 1929) businessmen usually persist in dogged and unwarranted optimism for quite a while after a depression breaks out.  

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from, rather than causal to, the objective business situation. Economic expectations are therefore self-correcting, not self-aggravating. As Professor Bassic has pointed out:

The businessman may expect a decline, and he may cut his inventories, but he will produce enough to fill the orders he receives; and as soon as the expectations of a decline prove to be mistaken, he will again rebuild his inventories . . . the whole psychological theory of the business cycle appears to be hardly more than an inversion of the real causal sequence. Expectations more nearly derive from objective conditions than produce them. The businessman both expands and expects that his expansion will be profitable because the conditions he sees justifies the expansion . . . It is not the wave of optimism that makes times good. Good times are almost bound to bring a wave of optimism with them. On the other hand, when the decline comes, it comes not because anyone loses confidence, but because the basic economic forces are changing. Once let the real support for the boom collapse, and all the optimism bred through years of prosperity will not hold the line. Typically, confidence tends to hold up after a downturn has set in.31

Session 9
A Critique of Arguments for Intervention

- Power and Market
  Chapter 6: Antimarket Ethics:
  A Praxeological Critique

- Egalitarianism as a Revolt Against Nature and Other Essays
  Egalitarianism as a Revolt Against Nature
EGALITARIANISM AS A REVOLT AGAINST NATURE

For well over a century, the Left has generally been conceded to have morality, justice, and “idealism” on its side; the Conservative opposition to the Left has largely been confined to the “impracticality” of its ideals. A common view, for example, is that socialism is splendid “in theory,” but that it cannot “work” in practical life. What the Conservatives failed to see is that while short-run gains can indeed be made by appealing to the impracticality of radical departures from the status quo, that by conceding the ethical and the “ideal” to the Left they were doomed to long-run defeat. For if one side is granted ethics and the “ideal” from the start, then that side will be able to effect gradual but sure changes in its own direction; and as these changes accumulate, the stigma of “impracticality” becomes less and less directly relevant. The Conservative opposition, having staked its all on the seemingly firm ground of the “practical” (that is, the status quo) is doomed to lose as the status quo moves further in the left direction. The fact that the unreconstructed Stalinists are universally considered to be the “Conservatives” in the Soviet Union is a happy logical joke upon conservatism; for in Russia the unrepentant statists are indeed the repositories of at least a superficial “practicality” and of a clinging to the existing status quo.
Never has the virus of “practicality” been more widespread than in the United States, for Americans consider themselves a “practical” people, and hence, the opposition to the Left, while originally stronger than elsewhere, has been perhaps the least firm at its foundation. It is now the advocates of the free market and the free society who have to meet the common charge of “impracticality.”

In no area has the Left been granted justice and morality as extensively and almost universally as in its espousal of massive equality. It is rare indeed in the United States to find anyone, especially any intellectual, challenging the beauty and goodness of the egalitarian ideal. So committed is everyone to this ideal that “impracticality”—that is, the weakening of economic incentives—has been virtually the only criticism against even the most bizarre egalitarian programs. The inexorable march of egalitarianism is indication enough of the impossibility of avoiding ethical commitments; the fiercely “practical” Americans, in attempting to avoid ethical doctrines, cannot help setting forth such doctrines, but they can now only do so in unconscious, *ad hoc*, and unsystematic fashion. Keynes’s famous insight that “practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist”—is true all the more of ethical judgments and ethical theory.1

The unquestioned ethical status of “equality” may be seen in the common practice of economists. Economists are often caught in a value-judgment bind—eager to make political pronouncements. How can they do so while remaining “scientific” and value-free? In the area of egalitarianism, they

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have been able to make a flat value judgment on behalf of equality with remarkable impunity. Sometimes this judgment has been frankly personal; at other times, the economist has pretended to be the surrogate of “society” in the course of making its value judgment. The result, however, is the same. Consider, for example, the late Henry C. Simons. After properly criticizing various “scientific” arguments for progressive taxation, he came out flatly for progression as follows:

> The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely.²

Another typical tactic may be culled from a standard text on public finance. According to Professor John F. Due,

> [t]he strongest argument for progression is the fact that the consensus of opinion in society today regards progression as necessary for equity. This is, in turn, based on the principle that the pattern of income distribution, before taxes, involves excessive inequality.

The latter “can be condemned on the basis of inherent unfairness in terms of the standards accepted by society.”³

Whether the economist boldly advances his own value judgments or whether he presumes to reflect the values of “society,” his immunity from criticism has been remarkable nonetheless. While candor in proclaiming one’s values may be admirable, it is surely not enough; in the quest for truth it

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is scarcely sufficient to proclaim one’s value judgments as if they must be accepted as tablets from above that are not themselves subject to intellectual criticism and evaluation. Is there no requirement that these value judgments be in some sense valid, meaningful, cogent, true? To raise such considerations, of course, is to flout the modern canons of pure \textit{wert-freiheit} in social science from Max Weber onward, as well as the still older philosophic tradition of the stern separation of “fact and value,” but perhaps it is high time to raise such fundamental questions. Suppose, for example, that Professor Simons’s ethical or aesthetic judgment was not on behalf of equality but of a very different social ideal. Suppose, for example, he had been in favor of the murder of all short people, of all adults under five feet, six inches in height. And suppose he had then written: “The case for the liquidation of all short people must be rested on the case against the existence of short people—on the ethical or aesthetic judgment that the prevailing number of short adults is distinctly evil or unlovely.” One wonders if the reception accorded to Professor Simons’s remarks by his fellow economists or social scientists would have been quite the same. Or, we can ponder Professor Due writing similarly on behalf of the “opinion of society today” in the Germany of the 1930s with regard to the social treatment of Jews. The point is that in all these cases the logical status of Simons’s or Due’s remarks would have been precisely the same, even though their reception by the American intellectual community would have been strikingly different.

My point so far has been twofold: (1) that it is not enough for an intellectual or social scientist to proclaim his value judgments—that these judgments must be rationally defensible and must be demonstrable to be valid, cogent, and correct: in short, that they must no longer be treated as above
intellectual criticism; and (2) that the goal of equality has for too long been treated uncritically and axiomatically as the ethical ideal. Thus, economists in favor of egalitarian programs have typically counterbalanced their uncriticized “ideal” against possible disincentive effects on economic productivity; but rarely has the ideal itself been questioned.\(^4\)

Let us proceed, then, to a critique of the egalitarian ideal itself—should equality be granted its current status as an unquestioned ethical ideal? In the first place, we must challenge the very idea of a radical separation between something that is “true in theory” but “not valid in practice.” If a theory is correct, then it does work in practice; if it does not work in practice, then it is a bad theory. The common separation between theory and practice is an artificial and fallacious one. But this is true in ethics as well as anything else. If an ethical ideal is inherently “impractical,” that is, if it cannot work in practice, then it is a poor ideal and should be discarded forthwith. To put it more precisely, if an ethical goal violates the nature of man and/or the universe and, therefore, cannot work in practice, then it is a bad ideal and should be dismissed as a goal. If the goal itself violates the nature of man, then it is also a poor idea to work in the direction of that goal.

Suppose, for example, that it has come to be adopted as a universal ethical goal that all men be able to fly by flapping

\(^4\)Thus:

A third line of objection to progression, and undoubtedly the one which has received the most attention, is that it lessens the economic productivity of the society. Virtually everyone who has advocated progression in an income tax has recognized this as a counterbalancing consideration. (Blum and Kalven, *The Uneasy Case for Progressive Taxation*, p. 21)

The “ideal” vs. the “practical” once again!
their arms. Let us assume that “pro-flappers” have been generally conceded the beauty and goodness of their goal, but have been criticized as “impractical.” But the result is unending social misery as society tries continually to move in the direction of arm-flying, and the preachers of arm-flapping make everyone’s lives miserable for being either lax or sinful enough not to live up to the common ideal. The proper critique here is to challenge the “ideal” goal itself; to point out that the goal itself is impossible in view of the physical nature of man and the universe; and, therefore, to free mankind from its enslavement to an inherently impossible and, hence, evil goal. But this liberation could never occur so long as the anti-armfliers continued to be solely in the realm of the “practical” and to concede ethics and “idealism” to the high priests of arm-flying. The challenge must take place at the core—at the presumed ethical superiority of a nonsensical goal. The same, I hold, is true of the egalitarian ideal, except that its social consequences are far more pernicious than an endless quest for man’s flying unaided. For the condition of equality would wreak far more damage upon mankind.

What, in fact, is “equality”? The term has been much invoked but little analyzed. A and B are “equal” if they are identical to each other with respect to a given attribute. Thus, if Smith and Jones are both exactly six feet in height, then they may be said to be “equal” in height. If two sticks are identical in length, then their lengths are “equal,” etc. There is one and only one way, then, in which any two people can really be “equal” in the fullest sense: they must be identical in all of their attributes. This means, of course, that equality of all men—the egalitarian ideal—can only be achieved if all men are precisely uniform, precisely identical with respect to all of their attributes. The egalitarian world would necessarily be a world of horror fiction—a world of faceless and identical creatures, devoid of all individuality, variety, or special creativity.
Indeed, it is precisely in horror fiction where the logical implications of an egalitarian world have been fully drawn. Professor Schoeck has resurrected for us the depiction of such a world in the British anti-Utopian novel *Facial Justice*, by L.P. Hartley, in which envy is institutionalized by the State’s making sure that all girls’ faces are equally pretty, with medical operations being performed on both beautiful and ugly girls to bring all of their faces up or down to the general common denominator.5 A short story by Kurt Vonnegut provides an even more comprehensive description of a fully egalitarian society. Thus, Vonnegut begins his story, “Harrison Bergeron”:

The year was 2081, and everybody was finally equal. They weren’t only equal before God and the law. They were equal every which way. Nobody was smarter than anybody else. Nobody was better looking than anybody else. Nobody was stronger or quicker than anybody else. All this equality was due to the 211th, 212th, and 213th Amendments to the Constitution, and to the unceasing vigilance of agents of the United States Handicapper General.

The “handicapping” worked partly as follows:

Hazel had a perfectly average intelligence, which meant she couldn’t think about anything except in short bursts. And George, while his intelligence was way above normal, had a little mental handicap radio in his ear. He was required by law to wear it at all times. It was tuned to a government transmitter. Every twenty seconds or so, the transmitter would send out some sharp noise to keep people like George from taking unfair advantage of their brains.

The horror we all instinctively feel at these stories is the intuitive recognition that men are not uniform, that the


species, mankind, is uniquely characterized by a high degree of variety, diversity, differentiation; in short, inequality. An egalitarian society can only hope to achieve its goals by totalitarian methods of coercion; and, even here, we all believe and hope the human spirit of individual man will rise up and thwart any such attempts to achieve an ant-heap world. In short, the portrayal of an egalitarian society is horror fiction because, when the implications of such a world are fully spelled out, we recognize that such a world and such attempts are profoundly antihuman; being antihuman in the deepest sense, the egalitarian goal is, therefore, evil and any attempts in the direction of such a goal must be considered evil as well.

The great fact of individual difference and variability (that is, inequality) is evident from the long record of human experience; hence, the general recognition of the antihuman nature of a world of coerced uniformity. Socially and economically, this variability manifests itself in the universal division of labor, and in the “Iron Law of Oligarchy”—the insight that, in every organization or activity, a few (generally the most able and/or the most interested) will end up as leaders, with the mass of the membership filling the ranks of the followers. In both cases, the same phenomenon is at work—outstanding success or leadership in any given activity is attained by what Jefferson called a “natural aristocracy”—those who are best attuned to that activity.

The age-old record of inequality seems to indicate that this variability and diversity is rooted in the biological nature of man. But it is precisely such a conclusion about biology and human nature that is the most galling of all possible irritants to our egalitarians. Even egalitarians would be hard put to deny the historical record, but their answer is that “culture” has been to blame; and since they obviously hold that culture is a pure act of the will, then the goal of changing the
culture and inculcating society with equality seems to be attainable. In this area, the egalitarians slough off any pretense to scientific caution; they are scarcely content with acknowledging biology and culture as mutually interacting influences. Biology must be read out of court quickly and totally.

Let us ponder an example that is deliberately semi-frivolous. Suppose that we observe our culture and find a common dictum to be: “Redheads are excitable.” Here is a judgment of inequality, a conclusion that redheads as a group tend to differ from the nonredhead population. Suppose, then, that egalitarian sociologists investigate the problem, and they find that redheads do, indeed, tend to be more excitable than nonredheads by a statistically significant amount. Instead of admitting the possibility of some sort of biological difference, the egalitarian will quickly add that the “culture” is responsible for the phenomenon: the generally accepted “stereotype” that redheads are excitable had been instilled into every redheaded child from an early age, and he or she has simply been internalizing these judgments and acting in the way society was expecting him to act. Redheads, in brief, had been “brainwashed” by the predominant nonredhead culture.

While not denying the possibility of such a process occurring, this common complaint seems decidedly unlikely on rational analysis. For the egalitarian culture-bugaboo implicitly assumes that the “culture” arrives and accumulates haphazardly, with no reference to social facts. The idea that “redheads are excitable” did not originate out of the thin air or as a divine commandment; how, then, did the idea come into being and gain general currency? One favorite egalitarian device is to attribute all such group-identifying statements to obscure psychological drives. The public had a psychological need to accuse some social group of excitability,
and redheads were fastened on as scapegoats. But why were redheads singled out? Why not blondes or brunettes? The horrible suspicion begins to loom that perhaps redheads were singled out because they were and are indeed more excitable and that, therefore, society’s “stereotype” is simply a general insight into the facts of reality. Certainly this explanation accounts for more of the data and the processes at work and is a much simpler explanation besides. Regarded objectively, it seems to be a far more sensible explanation than the idea of the culture as an arbitrary and ad hoc bogeyman. If so, then we might conclude that redheads are biologically more excitable and that propaganda beamed at redheads by egalitarians urging them to be less excitable is an attempt to induce redheads to violate their nature; therefore, it is this latter propaganda that may more accurately be called “brainwashing.”

This is not to say, of course, that society can never make a mistake and that its judgments of group-identity are always rooted in fact. But it seems to me that the burden of proof is far more on the egalitarians than on their supposedly “unenlightened” opponents.

Since egalitarians begin with the a priori axiom that all people, and hence all groups of peoples, are uniform and equal, it then follows for them that any and all group differences in status, prestige, or authority in society must be the result of unjust “oppression” and irrational “discrimination.” Statistical proof of the “oppression” of redheads would proceed in a manner all too familiar in American political life; it might be shown, for example, that the median redhead income is lower than nonredheaded income, and further that the proportion of redheaded business executives, university professors, or congressmen is below their quotal representation in the population. The most recent and conspicuous manifestation of this sort of quotal thinking was in the
McGovern movement at the 1972 Democratic Convention. A few groups are singled out as having been “oppressed” by virtue of delegates to previous conventions falling below their quota proportion of the population as a whole. In particular, women, youth, blacks, Chicanos (or the so-called Third World) were designated as having been oppressed; as a result, the Democratic Party, under the guidance of egalitarian-quota thinking, overrode the choices of the voters in order to compel their due quota representation of these particular groups.

In some cases, the badge of “oppression” was an almost ludicrous construction. That youths of 18 to 25 years of age had been “underrepresented” could easily have been placed in proper perspective by a *reductio ad absurdum*, surely some impassioned McGovernite reformer could have risen to point out the grievous “underrepresentation” of five-year-olds at the convention and to urge that the five-year-old bloc receive its immediate due. It is only commonsense biological and social insight to realize that youths win their way into society through a process of apprenticeship; youths know less and have less experience than mature adults, and so it should be clear why they tend to have less status and authority than their elders. But to accept this would be to cast the egalitarian creed into some substantial doubt; further, it would fly into the face of the youth-worship that has long been a grave problem of American culture. And so young people have been duly designated as an “oppressed class,” and the coercing of their population quota is conceived as only just reparation for their previously exploited condition.7

7Egalitarians have, among their other activities, been busily at work “correcting” the English language. The use of the word “girl,” for example, is now held to grievously demean and degrade female youth and to
Women are another recently discovered “oppressed class,” and the fact that political delegates have habitually been far more than 50 percent male is now held to be an evident sign of their oppression. Delegates to political conventions come from the ranks of party activists, and since women have not been nearly as politically active as men, their numbers have understandably been low. But, faced with this argument, the widening forces of “women’s liberation” in America again revert to the talismanic argument about “brainwashing” by our “culture.” For the women’s liberationists can hardly deny the fact that every culture and civilization in history, from the simplest to the most complex, has been dominated by males. (In desperation, the liberationists have lately been countering with fantasies about the mighty Amazonian empire.) Their reply, once again, is that from time immemorial a male-dominated culture has brainwashed oppressed females to confine themselves to nurture, home, and the domestic hearth. The task of the liberationists is to effect a revolution in the female condition by sheer will, by the “raising of consciousness.” If most women continue to cleave to domestic concerns, this only reveals the “false consciousness” that must be extirpated.

Of course, one neglected reply is that if, indeed, men have succeeded in dominating every culture, then this in itself is a demonstration of male “superiority”; for if all genders are equal, how is it that male domination emerged in every case? But apart from this question, biology itself is being angrily denied and cast aside. The cry is that there are no, can be no, must be no biological differences between the sexes; all historical or current differences must be due to cultural brainwashing. In his brilliant refutation of the women’s liberationist imply their natural subservience to adults. As a result, Left egalitarians now refer to girls of virtually any age as “women,” and we may confidently look forward to reading about the activities of “a five-year-old woman.”
Kate Millett, Irving Howe outlines several important biological differences between the sexes, differences important enough to have lasting social effects. They are: (1) “the distinctive female experience of maternity” including what the anthropologist Malinowski calls an “intimate and integral connection with the child . . . associated with physiological effects and strong emotions”; (2) “the hormonic components of our bodies as these vary not only between the sexes but at different ages within the sexes”; (3) “the varying possibilities for work created by varying amounts of musculature and physical controls”; and (4) “the psychological consequences of different sexual postures and possibilities,” in particular the “fundamental distinction between the active and passive sexual roles” as biologically determined in men and women respectively.8

Howe goes on to cite the admission by Dr. Eleanor MacCoby in her study of female intelligence that

it is quite possible that there are genetic factors that differentiate the two sexes and bear upon their intellectual performance. . . . For example, there is good reason to believe that boys are innately more aggressive than girls—and I mean aggressive in the broader sense, not just as it implies fighting, but as it implies dominance and initiative as well—and if this quality is one which underlies the later growth of analytic thinking, then boys have an advantage which girls . . . will find difficult to overcome.

Dr. Maccoby adds that “if you try to divide child training among males and females, we might find out that females need to do it and males don’t.”9

9Ibid., p. 126.
The sociologist Arnold W. Green points to the repeated emergence of what the egalitarians denounce as “stereotyped sex roles” even in communities originally dedicated to absolute equality. Thus, he cites the record of the Israeli kibbutzim:

The phenomenon is worldwide: women are concentrated in fields which require, singly or in combination, housewifely skills, patience and routine, manual dexterity, sex appeal, contact with children. The generalization holds for the Israeli kibbutz, with its established ideal of sexual equality. A “regression” to a separation of “women’s work” from “men’s work” occurred in the division of labor, to a state of affairs which parallels that elsewhere. The kibbutz is dominated by males and traditional male attitudes, on balance to the content of both sexes.  

Irving Howe unerringly perceives that at the root of the women’s liberation movement is resentment against the very existence of women as a distinctive entity:

For what seems to trouble Miss Millett isn’t merely the injustices women have suffered or the discriminations to which they continue to be subject. What troubles her most of all . . . is the sheer existence of women. Miss Millett dislikes the psychobiological distinctiveness of women, and she will go no further than to recognize—what choice is there, alas?—the inescapable differences of anatomy. She hates the perverse refusal of most women to recognize the magnitude of their humiliation, the shameful dependence they show in regard to (not very independent) men, the maddening pleasures they even take in cooking dinners for the “master group” and wiping the noses of their snotty brats. Raging against

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the notion that such roles and attitudes are biologically determined, since the very thought of the biological seems to her a way of forever reducing women to subordinate status, she nevertheless attributes to “culture” so staggering a range of customs, outrages, and evils that this culture comes to seem a force more immovable and ominous than biology itself.\footnote{Howe, “The Middle-Class Mind of Kate Millett,” p. 124.}

In a perceptive critique of the women’s liberation movement, Joan Didion perceives its root to be a rebellion not only against biology but also against the “very organization of nature” itself:

If the necessity for conventional reproduction of the species seemed unfair to women, then let us transcend, via technology, “the very organization of nature,” the oppression, as Shulamith Firestone saw it, “that goes back through recorded history to the animal kingdom itself.” I accept the Universe, Margaret Fuller had finally allowed: Shulamith Firestone did not.\footnote{Joan Didion, “The Women’s Movement,” New York Times Review of Books (July 30, 1972), p. 1.}

To which one is tempted to paraphrase Carlyle’s admonition: “Egad, madam, you’d better.”

Another widening rebellion against biological sex norms, as well as against natural diversity, has been the recently growing call for bisexuality by Left intellectuals. The avoidance of “rigid, stereotyped” heterosexuality and the adoption of indiscriminate bisexuality is supposed to expand consciousness, to eliminate “artificial” distinctions between the sexes and to make all persons simply and unisexually “human.” Once again, brainwashing by a dominant culture (in this case, heterosexual) has supposedly oppressed a homosexual
minority and blocked off the uniformity and equality inherent in bisexuality. For then every individual could reach his or her fullest “humanity” in the “polymorphous perversity” so dear to the hearts of such leading New Left social philosophers as Norman O. Brown and Herbert Marcuse.

That biology stands like a rock in the face of egalitarian fantasies has been made increasingly clear in recent years. The researches of biochemist Roger J. Williams have repeatedly emphasized the great range of individual diversity throughout the entire human organism. Thus:

Individuals differ from each other even in the minutest details of anatomy and body chemistry and physics; finger and toe prints; microscopic texture of hair; hair pattern on the body, ridges and “moons” on the finger and toenails; thickness of skin, its color, its tendency to blister; distribution of nerve endings on the surface of the body; size and shape of ears, of ear canals, or semi-circular canals; length of fingers; character of brain waves (tiny electrical impulses given off by the brain); exact number of muscles in the body; heart action; strength of blood vessels; blood groups; rate of clotting of blood—and so on almost ad infinitum.

We now know a great deal about how inheritance works and how it is not only possible but certain that every human being possesses by inheritance an exceedingly complex mosaic, composed of thousands of items, which is distinctive for him alone.13

The genetic basis for inequality of intelligence has also become increasingly evident, despite the emotional abuse heaped upon such studies by fellow scientists as well as the lay public. Studies of identical twins raised in contrasting environments have been among the ways that this conclusion

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has been reached; and Professor Richard Herrnstein has recently estimated that 80 percent of the variability in human intelligence is genetic in origin. Herrnstein concludes that any political attempts to provide environmental equality for all citizens will only intensify the degree of socioeconomic differences caused by genetic variability.14

The egalitarian revolt against biological reality, as significant as it is, is only a subset of a deeper revolt: against the ontological structure of reality itself, against the “very organization of nature”; against the universe as such. At the heart of the egalitarian left is the pathological belief that there is no structure of reality; that all the world is a tabula rasa that can be changed at any moment in any desired direction by the mere exercise of human will—in short, that reality can be instantly transformed by the mere wish or whim of human beings. Surely this sort of infantile thinking is at the heart of Herbert Marcuse’s passionate call for the comprehensive negation of the existing structure of reality and for its transformation into what he divines to be its true potential.

Nowhere is the Left Wing attack on ontological reality more apparent than in the Utopian dreams of what the future socialist society will look like. In the socialist future of Charles Fourier, according to Ludwig von Mises:

all harmful beasts will have disappeared, and in their places will be animals which will assist man in his labors—or even do his work for him. An antibeaver will see to the fishing; an antihorse will move sailing ships in a calm; an antihippopotamus will tow the river boats. Instead of the lion there will be an antilion, a steed of wonderful swiftness, upon whose back the rider will sit

as comfortably as in a well-sprung carriage. “It will be a
pleasure to live in a world with such servants.”

Furthermore, according to Fourier, the very oceans would
contain lemonade rather than salt water.

Similarly absurd fantasies are at the root of the Marxian
utopia of communism. Freed from the supposed confines of
specialization and the division of labor (the heart of any pro-
duction above the most primitive level and hence of any civi-
lized society), each person in the communist utopia would
fully develop all of his powers in every direction. As Engels
wrote in his Anti-Dühring, communism would give “each
individual the opportunity to develop and exercise all his fac-
ulties, physical and mental, in all directions.” And Lenin
looked forward in 1920 to the “abolition of the division of
labor among people . . . the education, schooling, and train-
ing of people with an all-around development and an all-around
training, people able to do everything. Communism is march-
ing and must march toward this goal, and will reach it.”

In his trenchant critique of the communist vision, Alexan-
der Gray charges:


16Ludwig von Mises, Human Action (New Haven, Conn.: Yale University Press, 1949), p. 71. Mises cites the first and fourth volumes of
Fourier’s Oeuvres Complètes.

17For more on the communist utopia and the division of labor, see
Murray N. Rothbard, Freedom, Inequality, Primitivism, and the Division of Labor (chap. 16, present volume).

18Quoted in Alexander Gray, The Socialist Tradition (London: Long-

19Italics are Lenin’s. V.I. Lenin, Left-Wing Communism: An Infantile Disorder (New York: International Publishers, 1940), p. 34.
That each individual should have the opportunity of developing all his faculties, physical and mental, in all directions, is a dream which will cheer the vision only of the simple-minded, oblivious of the restrictions imposed by the narrow limits of human life. For life is a series of acts of choice, and each choice is at the same time a renunciation.

Even the inhabitant of Engels’s future fairyland will have to decide sooner or later whether he wishes to be Archbishop of Canterbury or First Sea Lord, whether he should seek to excel as a violinist or as a pugilist, whether he should elect to know all about Chinese literature or about the hidden pages in the life of a mackerel.  

Of course one way to try to resolve this dilemma is to fantasize that the New Communist Man of the future will be a superman, superhuman in his abilities to transcend nature. William Godwin thought that, once private property was abolished, man would become immortal. The Marxist theoretician Karl Kautsky asserted that in the future communist society, “a new type of man will arise . . . a superman . . . an exalted man.” And Leon Trotsky prophesied that under communism:

man will become incomparably stronger, wiser, finer. His body more harmonious, his movements more rhythmical, his voice more musical. . . . The human average will rise to the level of an Aristotle, a Goethe, a Marx. Above these other heights new peaks will arise.

We began by considering the common view that the egalitarians, despite a modicum of impracticality, have ethics and moral idealism on their side. We end with the conclusion that egalitarians, however intelligent as individuals, deny the very basis of human intelligence and of human reason: the identification of the ontological structure of reality, of the laws of

\[\text{\cite{Gray, The Socialist Tradition, p. 328.}}\]

\[\text{\cite{Quoted in Mises, Socialism: An Economic and Sociological Analysis, p. 164.}}\]
human nature, and the universe. In so doing, the egalitarians are acting as terribly spoiled children, denying the structure of reality on behalf of the rapid materialization of their own absurd fantasies. Not only spoiled but also highly dangerous; for the power of ideas is such that the egalitarians have a fair chance of destroying the very universe that they wish to deny and transcend, and to bring that universe crashing around all of our ears. Since their methodology and their goals deny the very structure of humanity and of the universe, the egalitarians are profoundly antihuman; and, therefore, their ideology and their activities may be set down as profoundly evil as well. Egalitarians do not have ethics on their side unless one can maintain that the destruction of civilization, and even of the human race itself, may be crowned with the laurel wreath of a high and laudable morality.
Session 10

A Critique of Arguments for Intervention

- *Power and Market*
  Chapter 7: Conclusion: Economics and Public Policy

- *Economic Controversies*
  Praxeology, Value Judgements, and Public Policy

- *Economic Controversies*
  Value Implications of Economic Theory
Praxeology, Value Judgments, and Public Policy

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

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

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

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

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

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

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

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

In economic and political questions, in contrast, ethical and value conflicts abound and permeate society. It is therefore impermissible for the economist or other social scientist to act as if he were a physician, who can generally assume complete agreement on values and goals with his patient and who can therefore prescribe
accordingly and with no compunction. Since, then, praxeology provides no ethics whatsoever but only the data for people to pursue their various values and goals, it follows that it is impermissible for the economist qua economist to make any ethical or value pronouncements or to advocate any social or political policy whatsoever.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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


\(^6\)Adler, “Relation of Ethics,” p. 673.
goals. By advising a steel company on how to increase its profits, the economist is thereby committed to share in the steel entrepreneur’s value judgment that his greater profit is a desirable goal. It is even more important to make this point about the economist who advises the State. In so doing, he commits himself to the value judgments, not simply of the majority of society as in the case of Due, but to the value judgments of the rulers of the State apparatus. To take a deliberately dramatic example, let us suppose that an economist is hired by the Nazis to advise the government on the most efficient method of setting up concentration camps. By agreeing to help make more efficient concentration camps, he is agreeing to make them “better,” in short, he is committing himself willy-nilly to concentration camps as a desirable goal. And he would, again, still be doing so even if this goal were heartily endorsed by the great majority of the German public. To underscore this point, it should be clear that an economist whose value system leads him to oppose concentration camps might well give such advice to the German government as to make the concentration camps as inefficient as possible, that is to sabotage their operations. In short, whatever advice he gives to his clients, a value commitment by the economist, either for or against his clients’ goals, is inescapable.\footnote{Murray N. Rothbard, “Value Implications of Economic Theory,” The American Economist 17 (Spring, 1973): 38–39; included in this volume as chapter 12.}

A more interesting variant of the economist’s attempt to make value-free value judgments is the “unanimity principle,” recently emphasized by James M. Buchanan. Here the idea is that the economist can safely advocate a policy if everyone in the society also advocates it. But, in the first place, the unanimity principle is still subject to the aforementioned strictures: that, even if the economist simply shares in everyone else’s value judgment, he is still making a value judgment. Furthermore, the superficial attractiveness of the unanimity principle fades away under more stringent analysis; for unanimity is scarcely sufficient to establish an ethical principle. For one thing, the requirement of unanimity for any action or change begins with and freezes the status quo. For an action to be adopted, the justice and ethical propriety of the status quo must first be established, and of course economics can scarcely be prepared to do that.
The economist who advocates the unanimity principle as a seemingly value-free pronouncement is thereby making a massive and totally unsupported value judgment on behalf of the status quo. A stark but not untypical example was the debate in the British Parliament during the early nineteenth century on the abolition of slavery, when early adherents of the “compensation principle” variant of the unanimity principle (which has its own additional and grave problems) maintained that the masters must be compensated for the loss of their investment in slaves. At that point, Benjamin Pearson, a member of the Manchester School, declared that “he had thought it was the slaves who should have been compensated.”

Here is a striking example of the need in advocating public policy of some ethical system, of a concept of justice. Those ethicists among us who hold that slavery is unjust would always oppose the idea of compensating the masters and would rather think in terms of reparations to compensate the slaves for their years of oppression. But what is there for the value-free economist to say?

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

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

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

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I have been criticizing rests on the illegitimate psychologizing notion that a scientific economist-observer can know anything about someone else’s value scale except as it is demonstrated through such action as the purchase or sale of a newspaper. And since the compensation principle is necessarily divorced from demonstrated preference, it cannot be employed by scientific economists. Incidentally, I might note here that “demonstrated preference” is very different from Samuelson’s famous concept of “revealed preference,” for Samuelson, in illegitimate psychologizing fashion, assumed the existence of an underlying preference scale that forms the basis of a person’s action and that remains constant in the course of his actions over time. There is, however, no warrant for the scientific economist to make any such assumption. All we can say is that an action, at a specific point of time, reveals some of a person’s preferences at that time. There is no warrant for assuming that such preference orderings remain constant over time.\footnote{Ibid., pp. 228–30; also see Ludwig von Mises, Human Action: A Treatise on Economics (New Haven, Conn.: Yale University Press, 1949), pp. 102–04. Samuelson’s views may be found, among other places, in Paul A. Samuelson, “The Empirical Implications of Utility Analysis,” Econometrica 6 (October 1938): 334–56; and Foundations of Economics (Cambridge, Mass.: Harvard University Press, 1947), pp. 146–63.}

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

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

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

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

12For a posing of this question, see William E. Rappard, “On Reading
17–33.
Essentially, Mises offered two very different solutions to this problem. The first is a variant of the unanimity principle. Essentially this variant affirms that an economist per se cannot say that a given governmental policy is “good” or “bad.” However, if a given policy will lead to consequences, as explained by praxeology, that every one of the supporters of the policy will agree is bad, then the value-free economist is justified in calling the policy a “bad” one. Thus, Mises wrote:

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

And again:

Economics does not say that . . . government interference with the prices of only one commodity . . . is unfair, bad, or unfeasible. It says, that it makes conditions worse, not better, from the point of view of the government and those backing its interference.\(^{14}\)

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

\(^{13}\)Mises, *Human Action*, p. 879.

\(^{14}\)Ibid., p. 758; italics in the original.
newspaper, historians or psychologists may make more or less informed estimates of the newsdealers' or my value scales through the process of interpretive understanding, but all that the economist can know scientifically and with certainty is the preference relative to 15 cents or the newspaper as demonstrated through concrete action. Mises himself emphasized that

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

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

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

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\textsuperscript{15}Ibid., p. 95.
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consequences and still favor it, he could no longer call any of these measures “bad” or “good” or even “appropriate” or “inappropriate” without inserting into his economic policy pronouncements the very value judgments that he himself held to be inadmissible as a scientist of human action. He would no longer be a technical reporter to all advocates of a certain policy but an advocate participating on one side of a value conflict.

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

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

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16Mises himself conceded at one point that a government or a political party may advocate policies for “demagogic,” that is, for hidden and unannounced, reasons (ibid., p. 104n).
learning the praxeological consequences of market activity or of government intervention. He also, and in particular, meant people’s long-run interests. As he stated, “For ‘rightly understood’ interests we may as well say interests ‘in the long run.’”  But what about the high-time-preference folk, who prefer to consult their short-run interests? How can the long run be called “better” than the short run? Why is “right understanding” necessarily the long run?

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

As Mises explained in his second variant:

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

\[17\] Ibid., p. 670 and note.
teachings are valid only for people who are committed to their valuational principles. While praxeology, and therefore economics too, uses the terms happiness and removal of uneasiness in a purely formal sense, liberalism attaches to them a concrete meaning. It presupposes that people prefer life to death, health to sickness . . . abundance to poverty. It teaches men how to act in accordance with these valuations.\textsuperscript{18}

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

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

\textsuperscript{18}Ibid., pp. 153–54.

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

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

Mises attempted to use the cumulative argument to answer the contention that the majority of the public prefer egalitarian measures even knowingly at the expense of a portion of their own wealth. Mises’s comment was that the “reserve fund” was on the point of being exhausted in Europe, and therefore that any further egalitarian measures would have to come directly out of the pockets of the masses through increased taxation. Mises assumed that once this became clear, the masses would no longer support interventionist
measures.20 In the first place, this is no argument against the previous egalitarian measures or in favor of their repeal. But secondly, while the masses might be convinced, there is certainly no apodictic certainty involved; the masses have in the past and presumably will in the future continue knowingly to support egalitarian and other statist measures on behalf of other goals, despite the knowledge that their income and wealth would be reduced. Thus, as William E. Rappard pointed out in his thoughtful critique of Mises's position:

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

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

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

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22 Ibid., p. 33.
example, assume—and this assumption is not very farfetched in view of the record of human history—that the great majority of a society hate and revile redheads, perhaps, to cite Simons again, because they find redheads “evil or unlovely.” Let us further assume that there are very few redheads in the society. This large majority then decide that they would like very much to murder all redheads. Here they are; the murder of redheads is high on the value scales of the great majority of the public; there are few redheads so that there will be little loss in production on the market. How could Mises rebut this proposed policy either as a praxeologist or as a utilitarian liberal? I submit that he could not do so.

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

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

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

The burden of this paper has been to show that, while praxeological economic theory is extremely useful for providing data and knowledge for framing economic policy, it cannot be sufficient by itself to enable the economist to make any value pronouncements or to advocate any public policy whatsoever. More specifically, Ludwig von Mises to the contrary notwithstanding, neither praxeological economics nor Mises’s utilitarian liberalism is sufficient to make the case for *laissez-faire* and the free-market economy. To make such a case, one must go beyond economics and utilitarianism to establish an objective ethics that affirms the overriding value of liberty and morally condemns all forms of statism, from egalitarianism to the murder of redheads, as well as such goals as the lust for power and the satisfaction of envy. To make the full case for liberty, one cannot be a methodological slave to every goal that the majority of the public might happen to cherish.
Economics, as a science, attempts and claims to be purely value-free; that is, separate from the personal, valuational, or political proclivities of the economist. And yet economics and economists are continually making political pronouncements; economics per se is shot through with value-loaded assumptions, usually implicit, which then emerge as political conclusions and recommendations. It is my contention that this procedure is illegitimate and unscientific, and that it is incumbent on economic theory to purge itself of all vestiges of the unsupported value judgment. As a science, economics can and should stand apart from such value judgments. But since all political policy recommendations necessarily involve value judgments, does this mean that the economist must never make any policy recommendations or indeed, never use any terminology that is value-loaded? Not necessarily.

There are only two possible kinds of philosophical status for value judgments. Either they are all necessarily purely subjective and personal whims on the part of the valuer, in which case for the economist to remain a scientist he must indeed refrain from all policy recommendations whatever. Or these judgments may well be part of a general ethical system which is rationally and objectively demonstrable; in that case, it is perfectly legitimate for the economist when he applies his scientific theory to public policy to use this ethical system to arrive at economic policy recommendations. Let us take an example from medicine. A “purely” scientific, value-free medical procedure enables a physician to say that Treatment X will cure disease Y.

As an applied scientist, the physician can then take this knowledge and combine it with the ethical judgment that “cure of the disease is good” and indeed is the goal of his treatment, and then conclude with the “policy” conclusion that he should apply Treatment X. In this case both the patient and the physician are proceeding, implicitly or explicitly, on the basis of a deeply shared ethical system; their value judgments are neither personal nor arbitrary, but stem from a shared ethical system which pronounces health and life as great goods for man and death and disease as corresponding evils.\(^1\)

The point is that in medicine all parties proceed from the basis of a deeply shared ethical system. In the case of economics, this is scarcely true; here there are many competing and clashing values and value-systems held in society. Hence, the applied economist is in a more difficult situation. If an economist does not have an ethical system, but only subjective and arbitrary values, then it is incumbent upon him as a scientist ruthlessly to keep them out of his work. In short, the economist who lacks an ethical system must refrain from any and all value-loaded or political conclusions. (This statement, of course, is itself a value judgment stemming from an ethical system which holds that science must confine itself strictly to the search for, and the exposition of, truth.) But suppose on the other hand that an economist also holds an ethical system. What then?

It must be emphasized that if ethics is a rational and demonstrable discipline, it is self-subsistent, that is, its principles are arrived at apart from economics or any other particular science except itself. As in the case of medicine, the applied economist would then have to take this ethical system and add it to his economic knowledge to arrive at policy conclusions and recommendations. But in that case it is incumbent upon the applied economist to state his ethical system fully and with supporting argument; whatever he does, he must not slip value judgments, \textit{ad hoc}, unanalyzed, and unsupported, into the body of his economic theory or into his policy conclusions. And

\(^1\)In some cases, of course, Treatment X may lead to other effects that both patient and physician may consider “harmful”; again both share a judgment stemming from a shared ethic about the evils of injury to the human organism. Both parties will then have to judge the treatment by weighing these contrasting effects.
yet this is precisely what the bulk of economists have been doing. They, and economic theory along with them, habitually make a host of value judgments which are smuggled into their analyzes, and which then permit them to make policy recommendations, implicit or explicit, without presenting or defending a coherent ethical system. Because they cannot, like physicians, work from a universally shared ethical system, it is incumbent upon economists to present a coherent and supported ethical system or forever hold their valuational and political peace.

There is no room here to cover more than a few of the outstanding examples of the smuggling of unsupported value judgments into economic analysis. In the first place, there is the familiar case of the “Pareto Optimum.” If A and B trade two goods or services, they each do so because they will be, or rather expect to be, better off as a result of the trade. Surely it is legitimate then to say that A and B are both better off, and “therefore” that “society is better off,” since no one demonstrably loses by the exchange. It is implicit, and even explicit from the use of the value-loaded term “optimal,” that this exchange is therefore a “good thing.” I am sympathetic to the view that this exchange is a good thing, but I do not believe that this can be concluded merely from the fact of exchange, as the Pareto Optimum does. In the first place, there might well be one or more people in existence who dislike and envy A or B, and who therefore experience pain and psychic loss because the object of their envy has now improved his lot. We cannot therefore conclude from the mere fact of an exchange that “everyone” is better off, and we can therefore not simply leap to the valuational idea of social utility. In order to pronounce this voluntary exchange as “good,” we need another term to our syllogism: we must make the ethical pronouncement that envy is evil, and should not be allowed to cloud our approval of the exchange. But in that case we are back to the need for a coherent ethical system. I believe, as an “ethicist,” that envy is evil, but I see no willingness among economists to admit the need for, much less set forth, any sort of coherent ethical position.

This brings me to the position of the bulk of free market economists, such as the Chicago School, who favor the free market but claim to do so not on ethical grounds, but purely on the grounds of “efficiency.” I maintain that it is impermissible to advocate the free market without bolstering one’s economic analysis with an ethical
framework. Indeed, in some cases it is even impossible to set forth a coherent free-market approach without taking a frankly ethical position, and a position which goes beyond the almost universally-held utilitarian viewpoint of economists. Let us ponder our above-mentioned voluntary exchange between A and B. The free market economist advocates a world where such exchanges are legitimate and not interfered with. But any exchange implies an exchange of titles to private property. If I buy a newspaper for fifteen cents, what has happened is that I have ceded my ownership of the fifteen cents to the newsdealer, who in turn has granted his ownership of the newspaper to me. But this means that to advocate our right to make this exchange, means also to advocate the propriety, and hence the justice, of the existing property titles in the first place. To pronounce it “good” for myself and the newsdealer to have the right to make the exchange, means also to pronounce it “good” and just for each of us to own the fifteen cents and the newspaper to begin with. Yet economists are not willing to make this extension, for to do so would mean adopting a systematic concept of justice in property titles, which would involve the adoption of a system of political ethics. Economists have generally regarded such ethical systems as beyond their province; but if so, it is illegitimate for them to advocate a free market at all.

Let us illustrate: suppose that in our presumed exchange between A and B, A has sold to B a watch which he has stolen from a third party, C. Here it becomes clear that it is illegitimate to cheer this voluntary exchange from the sidelines. For since A had stolen the watch, it was not his legitimate property, and therefore he had no right to keep it or sell it; the watch was not in his legitimate title to do with as he wished. But if this is true in the case of the watch, then it would also be true in other less directly flagrant cases of unjust property titles.

Furthermore, not only is it illegitimate for the economist to advocate a free market without also adumbrating a theory of justice in property titles; he cannot even define a free market without doing so. For even to define and expound upon the free-market model, the economist is describing a system in which property titles are being exchanged, and therefore he must also define and expound upon how these titles are arrived at in the first place; he must have a theory of original property and of how property comes into being.
This problem of justice in property titles also exposes a fatal flaw in the concept of the “Unanimity Principle” as a supposedly value-free guide for the applied economist. Thus, Professor James Buchanan and others have declared that it is legitimate and presumably value-free for the economist to advocate a public policy, provided that everyone can agree on such a policy. Once again, and even more than in the case of the Pareto Optimum, this position is scarcely self-evident when subjected to analysis. For the implicit assumption of the Unanimity Principle is that all existing property titles are just. The Unanimity Principle would mean, for example, that it would be illegitimate to confiscate A’s watch even though he had stolen it from C. But if we regard A’s property title as illegitimate, then we must say that A’s watch should be confiscated and returned to C. Once again, our ethical systems intrude ineluctably into the discussion.

The well-known Compensation Principle, adopted by most economists as a supposedly value-free route for making political recommendations, is in even worse straits than the pure Unanimity Principle. (\textit{A fortiori}, the “weak” version of the Compensation Principle—that compensation does not \textit{actually} have to be made but only be conceptually possible—seems to me to have no rational foundation whatever.) For the Compensation Principle assumes also that it is conceptually possible to measure losses and thereby to compensate the losers. But “utility” is a purely subjective and unmeasurable concept, and being purely psychic, it cannot be measured, either conceptually or in practice. If I buy the newspaper, all that can be known is that my utility from the newspaper is greater than from the fifteen cents, and \textit{vice versa} for the newsdealer. There is no way of measuring these utility gains, for utility is not a quantity, but a rank order of subjective valuation.

Let us take, for example, the hypothetical proposition that the imposition of a tariff on zinc is “good” or socially useful because the gainers can (and even do) take their gains from the tariff, compensate the losers, and still have monetary gains left over. But suppose that I, as a convinced adherent of free trade and opponent of tariffs, declare that my psychic loss from the imposition of a zinc tariff is so great that no feasible monetary compensation could compensate me for that disutility. No one can say to me nay, and therefore the Compensation Principle falls to the ground. Conversely, the same could
be true for the idea that repeal of the tariff on zinc could be advocated in some sort of value-free manner on compensation grounds. Once again, I might be such a dedicated protectionist that I could not feasibly be compensated for my psychic loss stemming from repeal of the tariff. The Compensation Principle falls in either case.

The relation between the Compensation Principle (as well as the related Unanimity Principle) and theories of justice can be starkly demonstrated from the example of slavery. During the debates in the British Parliament in the early nineteenth century on abolition of slavery, the early adherents of the Compensation Principle were maintaining that the masters must be compensated for the loss of their investment in slaves. At that point, Benjamin Person, a member of the Manchester School, declared that "he had thought it was the slaves who should have been compensated."2 Here is the stark example of the need, in advocating public policy, of an ethical system, of a concept of justice. Those of us who hold that slavery is unjust would always oppose the idea of compensating the masters, and indeed would think rather in terms of reparations: of the masters compensating the slaves for their years of oppression. But what is there here for the wertfrei economist to say?

A similar argument applies to the Coase-Demsetz analysis of property rights and external cost. Coase-Demsetz declare that "it doesn't matter" from the point of view of allocation of resources whether, for example, a railroad is given the property right to pour smoke onto the land of neighboring farmers, or the farmers are given the property right to require compensation for invasion of their land by the railroad. The implication is that the effect is "only" a matter of distribution of wealth. In the first place, of course, the decision "matters" a great deal to the railroad and the farmers. I contend that it is totally invalid to dismiss such "distribution effects" as somehow unworthy of consideration by the economist, even though it is clear that ethical considerations are directly relevant to any treatment of such distribution. But apart from this, the Coase-Demsetz analysis is not even correct for short-run allocational problems (setting aside its validity or invalidity for long-run allocation) if we realize that social costs are psychic to the individual and therefore cannot be measured

in monetary terms. One or more of the farmers, for example, may love his land so deeply that no feasible monetary compensation for the smoke loss could be made by the railroad. As soon as we admit these psychic costs into the picture, the Coase-Demsetz analysis becomes invalid even for the short-run allocation of resources. This is apart from another consideration: that in law, an invasion of property can be stopped completely by court injunction and not merely be compensated after the fact.

This brings us to the entire analysis of neighborhood effects in the economic literature. It is simply assumed without adequate support, for example, that external economies should be internalized. But why? What is the ethical groundwork for this position? Let us take an example of an external economy which no economist has suggested we internalize—not out of logical consistency but simply from empirical convenience. Women, let us say, purchase and use cosmetics; this use has a great deal of external spillover effects in conferring psychic benefits among a large part of the population; and yet these males are “free riders”; they are not paying for the cosmetics. The neighborhood effect theorist, to be consistent, must claim that “too little” cosmetics are being used; that men are free riders on the female use of cosmetics and therefore should be taxed to subsidize females in their use. There are, of course, many problems with this doctrine, apart from those that we have already stated. The “internalizing” theorist must assume illegitimately that he can measure, even conceptually, how much men are being benefited, and gauge the precise amount of tax and subsidy. But apart from the conceptual impossibility of doing this, there are other grave problems involved in all attempts to apply such a principle for governmental action. One is that some men may dislike cosmetics intensely, and that they are therefore being penalized still further by the subsidy program. And furthermore, the very use of government implies a whole host of questionable political value judgments: for example, that government action per se involves neither psychic costs nor ethical injustice.

But there is a flaw even more directly germane to the concept of internalizing external economies. For by what ethical standard is the production and use of cosmetics “too low”? Too low for whom, and by what ethical standards? The very concept of “too low” is a value
judgment which is by no means self-evident and arrives here unsupported by any sort of ethical system.

Professor Demsetz goes on to advocate an allocation of property rights in accordance with whichever allocation involves lower total social transaction costs, such as costs of enforcing the given property right.3 But once again, there are two grave flaws in this position. One, since social costs embody psychic costs or disutilities for each individual, it is impossible to measure and hence to add them up interpersonally. But apart from this, such a gauge for the allocation of property rights brusquely sets aside any consideration of the justice of property titles. But this itself is an ethical position unsupported by the economist. In the case of slavery, for example, it might well be found that the monetary cost of enforcing slave titles is lower than the monetary cost of each freed slave defending himself from re-enslavement. For those of us who claim that slavery is unjust, such considerations would be piddling as compared to the dictates of justice. But for an economist to try to decide such questions as the allocation of property rights by discarding considerations of justice must be totally unscientific and illegitimate.

There is only space here to touch very briefly on a few other examples of the illegitimate use of implicit value assumptions in economics. One example is the long-standing aim of the Chicago School—at least until Milton Friedman’s recent essay on the “Optimum Quantity of Money”—to achieve a constant price level, either in the short or the long run. But little has been written to justify this goal. The value of the goal is scarcely self-evident, particularly when we consider the fact that a growing, unhampered economy will lead to secularly falling prices and costs, with the resulting higher living standards spread throughout the ranks of the consumers. And if falling prices would be a consequence of an increased demand for money, then again it is surely not self-evident that it is the business of government deliberately to thwart the desire of the public for a higher level of real cash balances—any more than it is the business of government to thwart the desires of consumers for any other goods or services.

Another example is the problem of rational pricing for governmental services. Thus, in recent years, much valuable work has been done advocating market-clearing prices for such services as streets, roads, and subways; for example, that pricing be graduated in accordance with peak hours and the degree of congestion on the roads. All this makes a great deal of sense, but one vital assumption is missing: that there is nothing wrong with the fact that an increased amount of revenue will thereby accrue to the coffers of government. The implicit value assumption is that there is nothing wrong economically or ethically with an increased amount of social resources being siphoned off to government. For those of us who do not take such a sanguine ethical view of government, this consideration must be an important factor in our policy conclusions.

In the area of government, indeed, there has been much discussion of the difficulties of national product accounting, but little has been said of the implicit—and scarcely self-evident—value assumption at the heart of the treatment of government. The blithe assumption that government expenditure on its own salaries can in any way measure government’s contribution to the national product encapsulates what some of us would consider a highly naive view of the functions and operations of government—indeed a view that places one’s ethical imprimatur on every one of the government’s activities. In these days of military overkill, and of pyramid-building on a grand scale, there are not very many people who would still automatically accept Lord Keynes’s famous dictum that building pyramids is just as productive an expenditure as anything else. In fact, anyone who believes that government expenditure contains at least 51 percent waste—surely not a very unreasonable assumption by anyone’s reckoning—would construct national product accounts by subtracting government expenditures as a burden upon production and upon society, rather than adding it as a productive contribution.

Finally, there is the generally held view that an economist can provide technical advice to his client while remaining purely value-free. I submit, on the contrary, that servicing a client’s ends thereby commits the economist to the ethical value of the end itself. Often it is held that by simply furnishing advice on the pursuit of goals or values held by the majority of the public, the economist remains uncommitted to values. But surely value-freedom means free of values, period; and the fact that the majority of the public might have such
values does not make commitment to them any less value-laden. To take a deliberately dramatic example, let us suppose that an economist is hired by the Nazis to advise the government on the most efficient way of setting up concentration camps. I submit that by doing so, the economist has, willy-nilly, adopted a pursuit of “better,” that is, more efficient, concentration camps as a goal. And he would be doing so even if this goal were heartily endorsed by the great majority of the German public. To underscore this point, it should be clear that an economist whose value system led him to oppose concentration camps might well then give such advice to his clients as to make the concentration camps as inefficient as possible, that is, to sabotage their operations. In short, whatever advice he gives to his clients, the economist’s value-commitment, for or against the clients’ project, is inescapable. But if this is true for concentration camps, it is true also for the myriad of other and usually less significant projects that his clients have in mind.

I would like to cite a passage on this question from the last essay of the great Italian economist Luigi Einaudi. Einaudi wrote that the economic advisors to government “indispensable, extremely learned, extremely informed, the experts, the only people who know the jargon, have become . . . one of the seven plagues of Egypt, a disgrace to humanity.” A “plague,” Einaudi wrote, because of the typical economist’s view that “I have performed my duty fully when I have decided whether the proposed means or other alternatives are consistent with the end prosecuted by the politician.” Einaudi then commented: “No. The economist has failed in that case to perform the essential part of his task . . . The economist . . . has not the right to be neutral or to hide under an unreal distinction between means and ends. He must declare himself for that end to which he is closest; and must prove what he assumes.”

It is important to stress what this paper is not saying: I am not taking the position, now fashionable in many quarters, that there is no such thing as a value-free economics, that all economic analysis is inextricably shot through with value assumptions. On the contrary, I believe that the main body of economic analysis is scientific and value-free; what I am saying is that any time that economists impinge

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on political or policy conclusions, value-judgments have entered into their discussion. My conclusion, then, is that economists must either make their value judgments explicit and defend them with a coherent ethical system, or strictly refrain from entering, directly, or indirectly into the public policy realm.