Increasing advertising is a function of the increasingly effective range of competition for the consumer's favor.[96]

Not only will businessmen tend to produce for and satisfy what they believe are the given wants of consumers, but the consumers, in contrast to voters, as we have seen above, have a direct market test for every piece of advertising that they confront. If they buy the cleanser and find that much rubbing is still required, the product will soon fade into oblivion. Thus, any advertising claims for *market* products can be and are quickly and readily tested by the consumers. Confronted with these facts, Galbraith could only maintain that the aversion against rubbing was *itself* generated, in some mysterious and sinister fashion, by business advertising.[97]

Advertising is one of the areas in which Galbraith, curiously and in glaring self-contradiction, treats private business differently from governmental activities. Thus, while business is supposed to be "creating" consumer wants through advertising,

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[96]Recent writings by marketing experts on "the marketing revolution" now under way stress precisely this increasing competition for, and courting of, the favor and custom of the consumer. Thus, *see* Robert J. Keith, "The Marketing Revolution," *Journal of Marketing*, January, 1960, pp. 35–38; Goldman, "Product Differentiation and Advertising: Some Lessons From Soviet Experience," and Goldman, "Marketing—a Lesson for Marx," *Harvard Business Review*, January–February, 1960, pp. 79–86.

[97]On the alleged powers of business advertising, it is well to note these pungent comments of Ludwig von Mises:

> It is a widespread fallacy that skillful advertising can talk the consumers into buying everything that the advertiser wants them to buy. . . . However, nobody believes that any kind of advertising would have succeeded in making the candlemakers hold the field against the electric bulb, the horse-drivers against the motorcars, the goose quill against the steel pen and later against the fountain pen. (Mises, *Human Action*, p. 317)

For a critique of the notion of the "hidden persuaders," *see* Raymond A. Bauer, "Limits of Persuasion," *Harvard Business Review*, September–October, 1958, pp. 105–10.

thereby generating an artificial affluence, at the same time the neglected "public sector" is increasingly starved and poverty-stricken. Apparently, Galbraith has never heard of, or refuses to acknowledge the existence of, *governmental* propaganda. He makes no mention whatever of the hordes of press agents, publicists, and propagandists working for government agencies, bombarding the taxpayers with propaganda which the latter have been *forced* to support. Since a considerable part of the propaganda is for ever-greater increases in the particular government bureau's activities, this means that G, the government officials, expropriate T, the bulk of the taxpayers, in order to hire more propagandists for G, to persuade the taxpayers to permit still more funds to be taken from them. And so forth. It is strange that, while waxing indignant over detergent and automobile commercials over television, Professor Galbraith has never had to endure the tedium of "public service commercials" beamed at him from the government. We may pass over the Washington conferences for influential private organizations that serve as "transmission belts" for government propaganda to the grassroots, the "inside briefings" that perform the same function, the vast quantities of printed matter subsidized by the taxpayer and issued by the government, etc.

Indeed, not only does Galbraith *not* consider government propaganda as artificially want-creating (and this is a realm, let us remember, where consumers *have no market test* of the product), but one of his major proposals is for a vast program of what he calls "investment in men," which turns out to be large-scale governmental "education" to uplift the wants and tastes of the citizenry. In short, Galbraith wants society's objective to be the deliberate expansion of the "New Class" (roughly, intellectuals, who are blithely assumed to be the only ones who really enjoy their work), "with its emphasis on education and its ultimate effect on intellectual, literary, cultural and artistic demands. . . ."[98]

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[98]Galbraith, *Affluent Society*, p. 345. In proposing this large-scale creation of an intellectual class, Galbraith virtually ignores the artificiality of

It seems evident that, while the free market and business are accused of artificially creating consumer wants, the shoe is precisely on Galbraith's own foot. It is *Galbraith* who is eager to curtail and suppress the consumers' freely chosen wants, and who is advocating a massive and coercive attempt by the government to create artificial wants, to "invest in men" by "educating" them to redirect their wants into those refined and artistic channels of which Professor Galbraith is so fond. Everyone will have to give up his tailfins so that all may be compelled to . . . read books (like *The Affluent Society*, for example?).

There are other grave and fundamental fallacies in Galbraith's approach to government. In particular, after making much ado over the fact that, with poverty conquered, the marginal utility of further goods is lower, he finds that everything somehow works in reverse for "governmental needs." Governmental needs, in some mystical way, are exempt from this law of diminishing marginal wants; instead, *mirabile dictu*, governmental needs *increase* in urgency as society becomes more affluent. From this flagrant and unresolved contradiction, Galbraith leaps to the conclusion that government must compel the massive shifting of resources from superfluous private, to starved public, needs. But on the basis of diminishing marginal utility alone, there is no case for such a shift, since *all* wants at a higher real income are of lower utility than the wants of the poverty-stricken. And when we realize that if we talk about "created" wants at all, governmental propaganda is vastly more likely to "create" wants than is business, a case, even in Galbraith's own terms, can be made for just the reverse: for a shift from the governmental to the private sector. And, finally, Galbraith, in his lament for the starved and underprivileged public sector, somehow neglects to inform his readers that, whatever statistics are used, it is clear that, in the past half-century, government activity has increased far more than private.

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educating people beyond their interests, capacities, or job opportunities available.

Government is absorbing and confiscating a far greater share of the national product than in earlier days. How much lower its "utility," and how much greater the case, in Galbraith's terms, for a shift *from* government *to* private activity!

Galbraith also airily assumes, in common with many other writers, that many governmental services are "collective goods" and therefore simply *cannot* be supplied by private enterprise. Without going further into the question of the desirability of private enterprise in these fields, one must note that Galbraith is quite wrong. Not only is his thesis simply a bald assertion, unsupported by facts, but, on the contrary, every single service generally assumed to be suppliable by government *alone* has been historically supplied by private enterprise. This includes such services as education, road building and maintenance, coinage, postal delivery, fire protection, police protection, judicial decisions, and military defense—all of which are often held to be self-evidently and necessarily within the exclusive province of government.[99]

There are many other important fallacies in Galbraith's book, but the central thesis of *The Affluent Society* has now been discussed. Thus, one of the reasons why Galbraith sees great danger in the present high consumption is that much is financed by consumer credit, which Galbraith considers, in the conventional manner, to be "inflationary" and to lead to instability and depression. Yet, as we shall see further, consumer credit that does not add to the money supply is *not* inflationary; it simply permits consumers to *redirect* the pattern of their spending so as to buy more of what they want and ascend higher

[99]Since this would take us far afield indeed, we can mention here only one reference: to the successful development of the road and canal networks of eighteenth-century England by private road, canal, and navigation improvement companies. *See* T.S. Ashton, *An Economic History of England: The 18th Century* (New York: Barnes and Noble, n.d.), pp. 72–81. On the fallacy of "collective goods," only suppliable by the government, see Appendix B below.

in their value scales. In short, they may redirect spending from nondurable to durable goods. This is a *transfer* of spending power, not an inflationary rise. The device of consumer credit was a highly productive invention.

Predictably, Galbraith pours much of his scorn on the supply-and-demand explanation of inflation, and especially on the proper monetary explanation, which he terms "mystical." His view of depression is purely Keynesian and assumes that a depression is caused by a deficiency of aggregate demand. "Inflation" is an increase in prices, which he would combat *either* by reducing aggregate demand through high taxes *or* by selective price controls and the fixing, by compulsory arbitration, of important wages and prices. If the former route is chosen, Galbraith, as a Keynesian, believes that unemployment would ensue. But Galbraith is not really worried, for he would take the revolutionary step of separating income from production; production, it seems, is important only because it provides income. (We have seen that government activity has already effected a considerable separation.) He proposes a sliding scale of unemployment insurance provided by the government, to be greater in depression than in boom, the payment in depression rising *almost* to the general prevailing wage (for some reason, Galbraith would not go precisely as high, because of a lingering fear of some disincentive effect on the unemployed's finding jobs). He does not seem to realize that this is merely a way of aggravating and prolonging unemployment during a depression and indirectly subsidizing union wage scales above the market. There is no need to stress the author's other vagaries, such as his adoption of the conventional conservationist concern about using up precious resources—a position, of course, consistent with Galbraith's general attack on the private consumer.[100]

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[100]Amidst the tangle of Galbraith's remaining fallacies and errors, we might mention one: his curious implication that Professor von Mises is a businessman. For first Galbraith talks of the age-old hostility between

As we have indicated above, there *is* a problem of the "public sector"; scarcities and conflicts keep appearing in government services, and in these fields alone, e.g., juvenile delinquency, traffic jams, overcrowded schools, lack of parking space, etc. We have seen above that the single remedy that proponents of government activity can offer is for more funds to be channeled from private to public activity.[101] We have shown, however, that such scarcity and inefficiency are inherent in government operation of any activity. Instead of taking warning from the inefficiencies of government output, writers like Galbraith turn the blame from government onto the taxpayers and consumers, just as government water officials characteristically blame the *consumers* for water shortages. At no time does Galbraith so much as consider the possibility of mending an ailing public sector by *making that sector private*.

How would Galbraith *know* when his desired "social balance" was achieved? What criteria has he set to guide us in knowing *how much* shift there should be from private to public activity? The answer is, *none*; Galbraith cheerfully concedes that there is no way of finding the point of optimum balance: "No test can be applied, for none exists." But, after all, precise

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businessmen and intellectuals, backs this statement by quoting Mises as critical of many intellectuals, and then concedes that "most businessmen" would regard Mises as "rather extreme." But since Mises is certainly not a businessman, it is odd to see his statements used as evidence for businessman-intellectual enmity. Galbraith, *Affluent Society*, pp. 184–85. This peculiar error is shared by Galbraith's Harvard colleagues, whose work he cites favorably, and who persist in quoting such nonbusinessmen as Henry Hazlitt and Dr. F.A. Harper as spokesmen for the "classical business creed." *See* Francis X. Sutton, Seymour E. Harris, Carl Kaysen, and James Tobin, *The American Business Creed* (Cambridge: Harvard University Press, 1956).

The Affluent Society is a work that particularly lends itself to satire, and this has been cleverly supplied in "The Sumptuary Manifesto," *The Journal of Law and Economics*, October, 1959, pp. 120–23.

[101]See pp. 944ff., of this chapter.

definitions, "precise equilibrium," are not important; for to Galbraith it is crystal "clear" that we must move now from private to public activity, and to a "considerable" extent. We shall know when we arrive, for the public sector will then bask in opulence. And to think that Galbraith accuses the perfectly sound and logical monetary theory of inflation of being "mystical" and "unrevealed magic"![102]

Before leaving the question of affluence and the recent attack on consumption—the very goal of the entire economic system, let us note two stimulating contributions in recent years on hidden but important functions of luxury consumption, particularly by the "rich." F.A. Hayek has pointed out the important

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[102]A brief, and therefore bald, version of Galbraith's thesis may be found in John Kenneth Galbraith, "Use of Income That Economic Growth Makes Possible . . ." in *Problems of United States Economic Development* (New York: Committee for Economic Development, January, 1958), pp. 201–06. In the same collection of essays there is in some ways a more extreme statement of the same position by Professor Moses Abramovitz, who presses even further to denounce *leisure* as threatening to deprive us of that "modicum of purposive, disciplined activity which . . . gives savor to our lives." Moses Abramovitz, "Economic Goals and Social Welfare in the Next Generation," *ibid*., p. 195. It is perhaps apropos to note a strong resemblance between coerced deprivation of leisure and slavery, as well as to remark that the only society that can genuinely "invest in men" is a society where slavery abounds. In fact, Galbraith writes almost wistfully of a slave system for this reason. *Affluent Society*, pp. 274–75.

In addition to Galbraith and Abramovitz, other "Galbraithian" papers in the CED Symposium are those of Professor David Riesman and especially Sir Roy Harrod, who is angry at "touts," the British brand of advertiser. Like Galbraith, Harrod would also launch a massive government education program to "teach" people how to use their leisure in the properly refined and esthetic manner. This contrasts to Abramovitz, who would substitute a bracing discipline of work for expanding leisure. But then again, one suspects that the bulk of the people would find a coerced Harrodian esthetic just as disciplinary. Galbraith, *Problems of United States Economic Development*, I, 207–13, 223–34.

function of the luxury consumption of the rich, at any given time, in pioneering new ways of consumption, and thereby paving the way for later diffusion of such "consumption innovations" to the mass of the consumers.[103] And Bertrand de Jouvenel, stressing the fact that refined esthetic and cultural tastes are concentrated precisely in the more affluent members of society, also points out that these citizens are the ones who could freely and voluntarily give many gratuitous services to others, services which, because they are free, are not counted in the national income statistics.[104]

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[103]Hayek, *Constitution of Liberty*, pp. 42 ff. As Hayek puts it:

> A large part of the expenditure of the rich, though not intended for that end, thus serves to defray the cost of the experimentation with the new things that, as a result, can later be made available to the poor.
>
> The important point is not merely that we gradually learn to make cheaply on a large scale what we already know how to make expensively in small quantities but that only from an advanced position does the next range of desires and possibilities become visible, so that the selection of new goals and the effort toward their achievement will begin long before the majority can strive for them. (*Ibid*., pp. 43–44)

Also see the similar point made by Mises 30 years before. Ludwig von Mises, "The Nationalization of Credit" in Sommer, *Essays in European Economic Thought*, pp. 111 f. And *see* Bertrand de Jouvenel, *The Ethics of Redistribution* (Cambridge: Cambridge University Press, 1952), pp. 38 f.

[104]De Jouvenel, *Ethics of Redistribution*, especially pp. 67 ff. If all housewives suddenly stopped doing their own housework and, instead, hired themselves out to their next-door neighbors, the supposed increase in national product, as measured by statistics, would be very great, even though the actual increase would be nil. For more on this point, *see* de Jouvenel, "The Political Economy of Gratuity," *The Virginia Quarterly Review*, Autumn, 1959, pp. 515 ff.

11. Binary Intervention: Inflation and Business Cycles

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.[105]

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[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*.[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. *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,

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the expense of individual holders of legitimate money. The "lines of force" radiate from the interveners to each of those who suffer losses.

[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.

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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[107]Cf. Mises, *Theory of Money and Credit*, pp. 140–42.

the brunt of inflation.[108] 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

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[109]For an interesting discussion of some aspects of the accounting error, *see* W.T. Baxter, "The Accountant's Contribution to the Trade Cycle," *Economica*, May, 1955, pp. 99–112. *Also see* Mises, *Theory of Money and Credit*, pp. 202–04; and *Human Action*, pp. 546 f.

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.[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.

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[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. *Overinvestment* 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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[111]*See* Mises, *Human Action*, p. 557.

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 *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 *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, *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 "consumer 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 distortion 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 depression 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 government keeps wage rates up, it brings about permanent unemployment. 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 business 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 expenditures. 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 reestablished, 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.[112] A further

[112]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

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misleadingly called the "normal profit rate," but is actually the basic rate of interest. See chapter 6 above.

prices and will therefore dishoard. 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.[113] 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.

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[113]If 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

[114]If 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.[115] 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.[116]

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.[117] 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.[118]

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

[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

[119]In 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 desirableness 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

[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).

[123]Mises, *Human Action*, p. 444.

> 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.

[124]Amasa Walker, *Science of Wealth*, pp. 230–31.

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.[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

[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.[126] 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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[126]Foreign 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.[127]

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

[127]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.

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.[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 *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.[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

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[128]Cf. the analysis by John Maynard Keynes in his *A Tract on Monetary Reform* (London: Macmillan & Co., 1923), chap. ii, section 1.

[129]On runaway inflation, *see* Mises, *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.[130] 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

[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.

[132]*See* George Ferdinand, "Review of Albert G. Hart, *Defense without Inflation*," *Christian Economics*, Vol. III, No. 19 (October 23, 1951).

the government and banks *are inflating* or they are not; there is no such thing as "inflationary pressure."[133]

The idea that the government has the duty to tax the public in order to "sop up excess purchasing power" is particularly ludicrous.[134] 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,

[133]*See* Mises in Director, *Defense, Controls, and Inflation*, p. 334.

[134]See 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."

On the other hand, coercion has diametrically opposite features. Directly, coercion benefits one party only at the expense of others. Coerced exchange is a system of exploitation of man by man, in contrast to the free market, which is a system of cooperative exchanges in the exploitation of *nature* alone. And not only does coerced exchange mean that some live at the expense of others, but, indirectly, as we have just observed, coercion leads only to further problems: it is inefficient and chaotic, it cripples production, and it leads to cumulative and unforeseen difficulties. Seemingly orderly, coercion is not only exploitative; it is also profoundly *disorderly*.

The major function of praxeology—of economics—is to bring to the world the knowledge of these indirect, these hidden, consequences of the different forms of human action. The hidden order, harmony, and efficiency of the voluntary free market, the hidden disorder, conflict, and gross inefficiency of coercion and intervention—these are the great truths that economic science, through deductive analysis from self-evident axioms, reveals to us. Praxeology cannot, by itself, pass ethical judgment or make policy decisions. Praxeology, through its *Wertfrei* laws, informs us that the workings of the voluntary principle and of the free market lead inexorably to freedom, prosperity, harmony, efficiency, and order; while coercion and government intervention lead inexorably to hegemony, conflict, exploitation of man by man, inefficiency, poverty, and chaos. At this point, praxeology retires from the scene; and it is up to the citizen—the ethicist—to choose his political course according to the values that he holds dear.

APPENDIX A
GOVERNMENT BORROWING

The major source of government revenue is taxation. Another source is government borrowing. Government borrowing from the banking system is really a form of inflation: it creates new money-substitutes that go first to the government and then diffuse, with each step of spending, into the community. Inflation is discussed in the text above. This is a process entirely different from borrowing from the public, which is not inflationary, for the latter transfers saved funds from private to governmental hands rather than creates new funds. Its economic effect is to divert savings from the channels most desired by the consumers and to shift them to the uses desired by government officials. Hence, from the point of view of the consumers, borrowing from the public wastes savings. The consequences of this waste are a lowering of the capital structure of the society and a lowering of the general standard of living in the present and the future. Diversion and waste of savings from investment causes interest rates to be higher than they otherwise would, since now private uses must compete with government demands. Public borrowing strikes at individual *savings* more effectively even than taxation, for it specifically lures away *savings* rather than taxing income in general.

It might be objected that lending to the government is voluntary and is therefore equivalent to any other voluntary contribution to the government; the "diversion" of funds is something desired by the consumers and hence by society.[135] Yet the process is "voluntary" only in a one-sided way. For we must not forget that the government enters the time market as a bearer of coercion and as a guarantor that it will use this coercion to obtain funds for repayment. The government is armed by coercion with a crucial power denied to all other people on the market; it is always assured of funds, whether by taxation or by inflation. The government will therefore be able to divert considerable funds from savers, and at an interest rate lower than any paid elsewhere. For the risk component in the interest rate

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[135]A recent objection of this sort appears in James M. Buchanan, *Public Principles of Public Debt* (Homewood, Ill.: Richard D. Irwin, 1958), especially pp. 104–05.

paid by the government will be lower than that paid by any other borrowers.[136]

Lending to government, therefore, may be voluntary, but the process is hardly voluntary when considered as a whole. It is rather a voluntary participation in future confiscation to be committed by the government. In fact, lending to government *twice* involves diversion of private funds to the government: once when the loan is made, and private savings are diverted to government spending; and again when the government taxes or inflates (or borrows again) to obtain the money to repay the loan. Then, once more, a coerced diversion takes place from private producers to the government, the proceeds of which, after payment of the bureaucracy for handling services, accrues to the government bondholders. The latter have thus become a part of the State apparatus and are engaging in a "relation of State" with the tax-paying producers.[137]

The ingenious slogan that the public debt does not matter because "we owe it to ourselves" is clearly absurd. The crucial question is: Who is the "we" and who are the "ourselves"?

[136]It is incorrect, however, to say that government loans are "riskless" and therefore that the interest yield on government bonds may be taken to be the pure interest rate. Governments may always repudiate their obligations if they wish, or they may be overturned and their successors may refuse to honor the I.O.U.'s.

[137]Hence, despite Buchanan's criticism, the classical economists such as Mill were right: the public debt is a *double* burden on the free market; in the present, because resources are withdrawn from private to unproductive governmental employment; and in the future, when private citizens are taxed to pay the debt. Indeed, for Buchanan to be right, and the public debt to be no burden, two extreme conditions would have to be met: (1) the bondholder would have to tear up his bond, so that the loan would be a genuinely voluntary contribution to the government; *and* (2) the government would have to be a totally voluntary institution, subsisting on voluntary payments alone, not just for this particular debt, but for all in transactions with the rest of society. Cf. Buchanan, *Public Principles of Public Debt*.

Analysis of the world must be individualistic and not holistic. Certain people owe money to certain other people, and it is precisely this fact that makes the borrowing as well as the taxing process important. For we might just as well say that taxes are unimportant for the same reason.[138]

Many "right-wing" opponents of public borrowing, on the other hand, have greatly exaggerated the dangers of the public debt and have raised persistent alarms about imminent "bankruptcy." It is obvious that the government cannot become "insolvent" like private individuals—for it can always obtain money by coercion, while private citizens cannot. Further, the periodic agitation that the government "reduce the public debt" generally forgets that—short of outright repudiation—the debt can be reduced only by *increasing*, at least for a time, the tax and/or inflation in society. Social utility can therefore not be enhanced by debt-reduction, *except* by the method of *repudiation*—the one way that the public debt can be lowered without a concomitant increase in fiscal coercion. Repudiation would also have the further merit (from the standpoint of the free market) of casting a pall on all future government credit, so that the government could no longer so easily divert savings to government use. It is therefore one of the most curious and inconsistent features of the history of politico-economic thought that it is precisely the "right-wingers," the presumed champions of the free market, who attack repudiation most strongly and who insist on as swift a payment of the public debt as possible.[139]

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[138]In the same way, we would have to assert that the Jews killed by the Nazis during World War II really committed suicide: "They did it to themselves."

[139]For the rare exception of a libertarian who recognizes the merit of repudiation from a free-market point of view, *see* Frank Chodorov, "Don't Buy Bonds," *analysis,* Vol. IV, No. 9 (July, 1948), pp. 1–2.

Appendix B
"Collective Goods" and "External Benefits": Two Arguments for Government Activity

One of the most important philosophical problems of recent centuries is whether ethics is a rational discipline, or instead a purely arbitrary, unscientific set of personal values. Whichever side one may take in this debate, it would certainly be generally agreed that economics—or praxeology—cannot *by itself* suffice to establish an ethical, or politico-ethical, doctrine. Economics *per se* is therefore a *Wertfrei* science, which does not engage in ethical judgments. Yet, while economists will generally agree to this flat statement, it is certainly curious how much energy they have spent trying to justify—in some tortuous, presumably scientific, and *Wertfrei* manner—various activities and expenditures of government. The consequence is the widespread smuggling of *unanalyzed*, undefended ethical judgments into a supposedly *Wertfrei* system of economics.[140,141]

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[140]One venerable example, used constantly in texts on public finance (an area particularly prone to camouflaged ethical judgments) is the "canons of justice" for taxation propounded by Adam Smith. For a critique of these supposedly "self-evident" canons, *see* Rothbard, "Mantle of Science."

[141]The analysis of the economic nature and consequences of government ownership in this book is *Wertfrei* and does not involve ethical judgments. It is a mistake, for example, to believe that anyone, knowing the economic laws demonstrating the great inefficiencies of government ownership, would *necessarily* have to choose private over government ownership although, of course, he may well do so. Those who place a high moral value, for example, on social conflict or on poverty or on inefficiency, or those who greatly desire to wield bureaucratic power over others (or to see people subjected to bureaucratic power) may well opt even more enthusiastically for government ownership. Ultimate ethical principles and choices are outside the scope of this book. This, of course, does not mean that the present author deprecates their importance. On the contrary, he believes that ethics *is* a rational discipline.

Two favorite, seemingly scientific, justifications for government activity and enterprise are (*a*) what we might call the argument of "external benefits" and (*b*) the argument of "collective goods" or "collective wants." Stripped of seemingly scientific or quasi-mathematical trappings, the first argument reduces to the contention that A, B, and C do not seem to be able to do certain things without benefiting D, who may try to evade his "just share" of the payment. This and other "external benefit" arguments will be discussed shortly. The "collective goods" argument is, on its face, even more scientific; the economist simply asserts that some goods or services, by their very nature, must be supplied "collectively," and "therefore" government must supply them out of tax revenue.

This seemingly simple, existential statement, however, cloaks a good many unanalyzed politico-ethical assumptions. In the first place, even if there *were* "collective goods," it by no means follows *either* (1) that one agency must supply them or (2) that everyone in the collectivity *must* be forced to pay for them. In short, if X is a collective good, needed by most people in a certain community, and which can be supplied only to all, it by no means follows that every beneficiary must be forced to pay for the good, which, incidentally, he may not even want. In short, we are back squarely in the moral problem of external benefits, which we shall discuss below. The "collective goods" argument turns out, upon analysis, to reduce to the "external benefit" argument. Furthermore, even if only one agency must supply the good, it has not been proved that the *government*, rather than some voluntary agency, or even some private corporation, cannot supply that good.[142]

Secondly, the very concept of "collective goods" is a highly dubious one. How, first of all, can a "collective" want, think, or act? Only an individual exists, and can do these things. There is no existential referent of the "collective" that supposedly wants

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[142]Thus, cf. Molinari, *Society of Tomorrow*, pp. 47–95.

and then receives goods. Many attempts have been made, nevertheless, to salvage the concept of the "collective" good, to provide a seemingly ironclad, scientific justification for government operations. Molinari, for example, trying to establish defense as a collective good, asserted: "A police force serves every inhabitant of the district in which it acts, but the mere establishment of a bakery does not appease their hunger." But, on the contrary, there is no absolute necessity for a police force to defend *every* inhabitant of an area or, still more, to give each one the same *degree* of protection. Furthermore, an absolute pacifist, a believer in total nonviolence, living in the area, would *not* consider himself protected by, or receiving defense service from, the police. On the contrary, he would consider any police in his area a detriment to him. Hence, defense cannot be considered a "collective good" or "collective want." Similarly for such projects as dams, which cannot be simply assumed to benefit everyone in the area.[143]

Antonio De Viti De Marco defined "collective wants" as consisting of two categories: wants arising when an individual is not in isolation and wants connected with a conflict of interest. The first category, however, is so broad as to encompass most market products. There would be no point, for example, in putting on plays unless a certain number went to see them or in publishing newspapers without a certain wide market. Must all these industries therefore be nationalized and monopolized by the government? The second category is presumably meant to apply to defense. This, however, is incorrect. Defense, itself, does not reflect a conflict of interest, but a threat of *invasion*, against

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[143]*Ibid.*, p. 63. On the fallacy of collective goods, *see* S.R., "Spencer As His Own Critic," *Liberty*, June, 1904, and Merlin H. Hunter and Harry K. Allen, *Principles of Public Finance* (New York: Harpers, 1940), p. 22. Molinari had not always believed in the existence of "collective goods," as can be seen from his remarkable "De la production de la sécurité," *Journal des Economistes*, February 15, 1849, and Molinari, "Onzième soirée" in *Les soirées de la Rue Saint Lazare* (Paris, 1849).

which defense is needed. Furthermore, it is hardly sensible to call "collective" that want which is precisely the *least* likely to be unanimous, since robbers will hardly desire it![144] Other economists write as if defense is necessarily collective because it is an immaterial service, whereas bread, autos, etc., are materially divisible and salable to individuals. But "immaterial" services to individuals abound in the market. Must concert-giving be monopolized by the State because its services are immaterial?

In recent years, Professor Samuelson has offered his own definition of "collective consumption goods," in a so-called "pure" theory of government expenditures. Collective consumption goods, according to Samuelson, are those "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good." For some reason, these are supposed to be the proper goods (or *at least* these) for government, rather than the free market, to provide.[145] Samuelson's category has been attacked with due severity. Professor Enke, for example, pointed out that most governmental services simply do not fit Samuelson's classification—including highways, libraries, judicial services, police, fire, hospitals, and military protection. In fact, we may go further and state that *no* goods would ever fit into Samuelson's category of "collective consumption goods." Margolis, for example, while critical of Samuelson, concedes the inclusion of national defense and lighthouses in this category. But "national defense" is surely not an absolute good with only one unit of supply. It consists of specific resources committed in certain definite and concrete ways—and these resources are

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[144]Antonio De Viti De Marco, *First Principles of Public Finance* (London: Jonathan Cape, 1936), pp. 37–41. Similar to De Viti's first category is Baumol's attempted criterion of "jointly" financed goods, for a critique of which *see* Rothbard, "Toward A Reconstruction of Utility and Welfare Economics," pp. 255–60.

[145]Paul A. Samuelson, "The Pure Theory of Public Expenditures," *Review of Economics and Statistics*, November, 1954, pp. 387–89.

necessarily scarce. A ring of defense bases around New York, for example, cuts down the amount possibly available around San Francisco. Furthermore, a lighthouse shines over a certain fixed area only. Not only does a ship within the area prevent others from entering the area at the same time, but also the construction of a lighthouse in one place limits its construction elsewhere. In fact, if a good is really technologically "collective" in Samuelson's sense, it is *not a good at all*, but a natural condition of human welfare, like air—superabundant to all, and therefore *unowned* by anyone. Indeed, it is not the *lighthouse*, but the *ocean itself*—when the lanes are not crowded—which is the "collective consumption good," and which *therefore* remains unowned. Obviously, neither government nor anyone else is normally needed to produce or allocate the ocean.[146]

Tiebout, conceding that there is no "pure" way to establish an optimum level for government expenditures, tries to salvage such a theory specifically for *local* government. Realizing that the taxing, and even voting, process precludes voluntary demonstration of consumer choice in the governmental field, he argues that decentralization and freedom of internal migration renders *local* government expenditures more or less optimal—as we can

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[146]Stephen Enke, "More on the Misuse of Mathematics in Economics: A Rejoinder," *Review of Economics and Statistics*, May, 1955, pp. 131–33; Julius Margolis, "A Comment On the Pure Theory of Public Expenditures," *Review of Economics and Statistics*, November, 1955, pp. 347–49. In his reply to critics, Samuelson, after hastening to deny any possible implication that he wished to *confine* the sphere of government to collective goods alone, asserts that his category is really a "polar" concept. Goods in the real world are supposed to be only blends of the "polar extremes" of public and private goods. But these concepts, even in Samuelson's own terms, are decidedly not polar, but exhaustive. Either A's consumption of a good diminishes B's possible consumption, or it does not: these two alternatives are mutually exclusive and exhaust the possibilities. In effect, Samuelson has abandoned his category either as a theoretical or as a practical device. Paul A. Samuelson, "Diagrammatic Exposition of a Theory of Public Expenditure," *Review of Economics and Statistics*, November, 1955, pp. 350–56.

say that free market expenditures by firms are "optimal"—since the residents can move in and out as they please. Certainly, it is true that the consumer will be better off if he can move readily out of a high-tax, and into a low tax, community. But this helps the consumer only to a degree; it does not solve the problem of government expenditures, which remains otherwise the same. There are, indeed, other factors than government entering into a man's choice of residence, and enough people may be attached to a certain geographical area, for one reason or another, to permit a great deal of government depredation before they move. Furthermore, a major problem is that the world's total land area is fixed, and that governments have universally pre-empted all the land and thus universally burden consumers.[147]

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[147]Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy*, October, 1956, pp. 416–24. At one point, Tiebout seems to admit that his theory would be valid only if each person could somehow be "his own municipal government." *Ibid*., p. 421.

In the course of an acute critique of the idea of competition in government, the Colorado Springs *Gazette-Telegraph* wrote as follows:

> Were the taxpayer free to act as a customer, buying only those services he deemed useful to himself and which were priced within his reach, then this competition between governments would be a wonderful thing. But because the taxpayer is not a customer, but only the governed, he is not free to choose. He is only compelled to pay. . . . With government there is no producer-customer relationship. There is only the relation that always exists between those who rule and those who are ruled. The ruled are never free to refuse the services of the products of the ruler. . . . Instead of trying to see which government could best serve the governed, each government began to vie with every other government on the basis of its tax collections. . . . The victim of this competition is always the taxpayer. . . . The taxpayer is now set upon by the federal, state, school board, county and city governments. Each of these is competing for the last dollar he has. (Colorado Springs *Gazette-Telegraph*, July 16, 1958)

We come now to the problem of external benefits—the major justification for government activities expounded by economists.[148] Where individuals simply benefit themselves by their actions, many writers concede that the free market may be safely left unhampered. But men's actions may often, even inadvertently, benefit others. While one might think this a cause for rejoicing, critics charge that from this fact flow evils in abundance. A free exchange, where A and B mutually benefit, may be all very well, say these economists; but what if A does something voluntarily which benefits B as well as himself, but for which B pays nothing in exchange?

There are two general lines of attack on the free market, using external benefits as the point of criticism. Taken together, these arguments against the market and for governmental intervention or enterprise cancel each other out, but each must, in all fairness, be examined separately. The first type of criticism is to *attack A for not doing enough for B*. The benefactor is, in effect, denounced for taking his own selfish interests exclusively into account, and thereby neglecting the potential indirect recipient waiting silently in the wings.[149] The second line of attack is to *denounce B for accepting a benefit without paying A in return*. The recipient is denounced as an ingrate and a virtual thief for accepting the free gift. The free market, then, is accused of

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[148]The problem of "external costs," usually treated as symmetrical with external benefits, is not really related: it is a consequence of failure to enforce fully the rights of property. If A's actions injure B's property, and the government refuses to stop the act and enforce damages, property rights and hence the free market are not being fully defended and maintained. Hence, external costs (e.g., smoke damage) are failures to maintain a fully free market, rather than *defects* of that market. *See* Mises, *Human Action*, pp. 650–53; and de Jouvenel, "Political Economy of Gratuity," pp. 522–26.

[149]For some unexplained reason, the benefits worried over are only the *indirect* ones, where B benefits inadvertently from A's action. Direct *gifts*, or charity, where A simply donates money to B, are not attacked under the category of external benefit.

injustice and distortion by both groups of attackers: the first believes that the selfishness of man is such that A will not act enough in ways to benefit B; the second that B will receive too much "unearned increment" without paying for it. Either way, the call is for remedial State action; on the one hand, to use violence in order to force or induce A to act more in ways which will aid B; on the other, to force B to pay A for his gift.

Generally, these ethical views are clothed in the "scientific" opinion that, in these cases, free-market action is no longer optimal, but should be brought back into optimality by corrective State action. Such a view completely misconceives the way in which economic science asserts that free-market action is *ever* optimal. It is optimal, not from the standpoint of the personal ethical views of an economist, but from the standpoint of the free, voluntary actions of all participants and in satisfying the freely expressed needs of the consumers. Government interference, therefore, will necessarily and always move *away* from such an optimum.

It is amusing that while each line of attack is quite widespread, each can be rather successfully rebutted by using the essence of the *other* attack! Take, for example, the first—*the attack on the benefactor.* To denounce the benefactor and implicitly call for State punishment for insufficient good deeds is to advance a moral claim by the recipient upon the benefactor. We do not intend to argue ultimate values in this book. But it should be clearly understood that to adopt this position is to say that B is entitled peremptorily to call on A to do something to benefit him, and for which B does not pay anything in return. We do not have to go all the way with the second line of attack (on the "free rider"), but we can say perhaps that it is presumptuous of the free rider to assert his right to a post of majesty and command. For what the first line of attack asserts is the moral right of B to exact gifts from A, by force if necessary.

Compulsory thrift, or attacks on potential savers for not saving and investing enough, are examples of this line of attack. Another is an attack on the user of a natural resource that is being depleted. Anyone who uses such a resource at all, whatever the extent, "deprives" some future descendant of the use. "Conservationists," therefore, call for lower present use of such resources in favor of greater future use. Not only is this compulsory benefaction an example of the first line of attack, but, if this argument is adopted, logically no resource subject to depletion could *ever* be used at all. For when the future generation comes of age, *it too* faces a future generation. This entire line of argument is therefore a peculiarly absurd one.

The second line of attack is of the opposite form—a denunciation of the recipient of the "gift." The recipient is denounced as a "free rider," as a man who wickedly enjoys the "unearned increment" of the productive actions of others. This, too, is a curious line of attack. It is an argument which has cogency only when directed against the first line of attack, i.e., against the free rider *who wants compulsory free rides*. But here we have a situation where A's actions, taken purely because they benefit himself, *also* have the happy effect of benefiting someone else. Are we to be indignant because happiness is being diffused throughout society? Are we to be critical because more than one person benefits from someone's actions? After all, the free rider did not ask for his ride. He received it, unasked, as a boon because A benefits from his own action. To adopt the second line of attack is to call in the gendarmes to apply punishment because too many people in the society are happy. In short, am I to be taxed for enjoying the view of my neighbor's well-kept garden?[150]

One striking instance of this second line of attack is the nub of the Henry Georgist position: an attack on the "unearned increment" derived from a rise in the capital values of ground land. We have seen above that as the economy progresses, real

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[150]"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 leisure. Are they entitled to tax me for these benefits because I cannot 'surrender' them?" (S.R., "Spencer As His Own Critic").

land rents will rise with real wage rates, and the result will be increases in the real capital values of land. Growing capital structure, division of labor, and population tend to make site land relatively more scarce and hence cause the increase. The argument of the Georgists is that the landowner is not morally responsible for this rise, which comes about from events external to his landholding; yet he reaps the benefit. The landowner is therefore a free rider, and his "unearned increment" rightfully belongs to "society." Setting aside the problem of the reality of society and whether "it" can own anything, we have here a moral attack on a free-rider situation.

The difficulty with this argument is that it proves far too much. For which one of us would earn anything like our present real income were it not for external benefits that we derive from the actions of others? Specifically, the great modern accumulation of capital goods is an inheritance from all the net savings of our ancestors. Without them, we would, regardless of the quality of our own moral character, be living in a primitive jungle. The inheritance of money capital from our ancestors is, of course, simply inheritance of shares in this capital structure. We are all, therefore, free riders on the past. We are also free riders on the present, because we benefit from the continuing investment of our fellow men and from their specialized skills on the market. Certainly the vast bulk of our wages, if they could be so imputed, would be due to this heritage on which we are free riders. The landowner has no more of an unearned increment than any one of us. Are all of us to suffer confiscation, therefore, and to be taxed for our happiness? And *who* then is to receive the loot? Our dead ancestors, who were our benefactors in investing the capital?[151]

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[151]There is justice as well as bluntnesss in Benjamin Tucker's criticism:

> "What gives value to land?" asks Rev. Hugh O. Pentecost [a Georgist]. And he answers: "The presence of population —the community. Then rent, or the value of land,

An important case of external benefits is "external economies," which could be reaped by investment in certain industries, but which would not accrue as profit to the entrepreneurs. There is no need to dwell on the lengthy discussion in the literature on the actual range of such external economies, although they are apparently negligible. The suggestion has been persistently advanced that the government subsidize these investments so that "society" can reap the external economies. Such is the Pigou argument for subsidizing external economies, as well as the old and still dominant "infant industries" argument for a protective tariff.

The call for state subsidization of external economy investments amounts to a *third line* of attack on the free market, i.e., *that B, the potential beneficiaries, be forced to subsidize the benefactors A, so that the latter will produce the former's benefits.* This third line is the favorite argument of economists for such proposals as government-aided dams or reclamations (recipients taxed to pay for their benefits) or compulsory schooling (the taxpayers will eventually benefit from others' education), etc. The recipients are again bearing the onus of the policy; but here they are not criticized for free riding. They are now being "saved" from a situation in which they would not have obtained certain benefits. Since they would not have paid for them, it is difficult to understand exactly *what* they are being saved from. The third line of attack therefore agrees with the first that the free market does not, because of human selfishness, produce enough external-economy actions; but it joins the second line of attack in placing the cost of remedying the situation on the strangely unwilling recipients. If this subsidy takes place, it is obvious that the recipients are no longer free riders: indeed, they are simply

morally belongs to the community." What gives value to Mr. Pentecost's preaching? The presence of population—the community. Then Mr. Pentecost's salary, or the value of his preaching, morally belongs to the community. (Tucker, *Instead of a Book*, p. 357) being coerced into buying benefits for which, acting by free choice, they would not have paid.

The absurdity of the third approach may be revealed by pondering the question: Who benefits from the suggested policy? The benefactor A receives a subsidy, it is true. But it is often doubtful if he benefits, since he would otherwise have acted and invested profitably in some other direction. The State has simply compensated him for losses which he would have received and has adjusted the proceeds so that he receives the equivalent of an opportunity forgone. Therefore A, if a business firm, does not benefit. As for the recipients, they are being forced by the State to pay for benefits that they otherwise would not have purchased. How can we say that they "benefit"?

A standard reply is that the recipients "could not" have obtained the benefit even if they had wanted to buy it voluntarily. The first problem here is by what mysterious process the critics know that the recipients would have liked to purchase the "benefit." Our only way of knowing the content of preference scales is to see them revealed in concrete choices. Since the choice concretely was *not* to buy the benefit, there is no justification for outsiders to assert that B's preference scale was "really" different from what was revealed in his actions.

Secondly, there is no reason why the prospective recipients *could* not have bought the benefit. In all cases a benefit produced can be sold on the market and earn its value product to consumers. The fact that producing the benefit would not be profitable to the investor signifies that the consumers do not value it as much as they value the uses of nonspecific factors in alternative lines of production. For costs to be higher than prospective selling price means that the nonspecific factors earn more in *other* channels of production. Furthermore, in possible cases where some consumers are not satisfied with the extent of the market production of some benefit, they are at perfect liberty to subsidize the investors *themselves*. Such a voluntary subsidy would be equivalent to paying a higher market price for the benefit and would reveal their willingness to pay that price. The fact that, in any case, such a subsidy has not emerged eliminates any justification for a coerced subsidy by the government. Rather than providing a benefit to the taxed "beneficiaries," in fact, the coerced subsidy inflicts a loss upon them, for they could have spent their funds themselves on goods and services of greater utility.[152]

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[152]As Mises states:

> . . . the means which a government needs in order to run a plant at a loss or to subsidize an unprofitable project must be withdrawn either from the taxpayers' spending and investing power or from the loan market. . . . What the government spends more, the public spends less. Public works . . . are paid for by funds taken away from the citizens. If the government had not interfered, the citizens would have employed them for the realization of profit-promising projects the realization of which is neglected merely on account of the government's intervention. Yet this nonrealized project would have been profitable, i.e., it would have employed the scarce means of production in accordance with the most urgent needs of the consumers. From the point of view of the consumers the employment of these means of production for the realization of an unprofitable project is wasteful. It deprives them of satisfactions which they prefer to those which the government-sponsored project can furnish them. (Mises, *Human Action*, p. 655)

Ellis and Fellner, in their discussion of external economies, ignore the primordial fact that the subsidization of these economies must be at the expense of funds usable for greater satisfactions elsewhere. Ellis and Fellner do not realize that their refutation of the Pigou thesis that increasing-cost industries are over-expanded destroys any possible basis for a subsidy to the decreasing-cost industries. Howard S. Ellis and William Fellner, "External Economies and Diseconomies," in *Readings in Price Theory* (Chicago: Blakiston Co., 1952), pp. 242–63.

Power and Market

Government and the Economy

1

Defense Services on the Free Market

ECONOMISTS HAVE REFERRED INNUMERABLE TIMES to the "free market," the social array of voluntary exchanges of goods and services. But despite this abundance of treatment, their analysis has slighted the deeper implications of free exchange. Thus, there has been general neglect of the fact that free exchange *means* exchange of titles of ownership to property, and that, therefore, the economist is obliged to inquire into the conditions and the nature of the property ownership that would obtain in the free society. If a free society means a world in which no one aggresses against the person or property of others, then this implies a society in which every man has the absolute right of property in his own self and in the previously unowned natural resources that he finds, transforms by his own labor, and then gives to or exchanges with others.[1] A firm property right in one's own self and in the resources that one finds, transforms, and gives or exchanges, leads to the property structure that is found in free-market capitalism. Thus, an economist cannot fully analyze the exchange structure of the free market without setting forth the theory of property rights, of justice in property, that would have to obtain in a free-market society.

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[1]Murray N. Rothbard, *Man, Economy, and State* (Princeton, N.J.: D. Van Nostrand, 1962; 2004 by the Mises Institute). [PUBLISHER'S NOTE: Page numbers in footnotes citing *Man, Economy, and State* refer to the present edition.]

In our analysis of the free market in *Man, Economy, and State*, we assumed that no invasion of property takes place there, either because everyone voluntarily refrains from such aggression or because whatever method of forcible defense exists on the free market is sufficient to prevent any such aggression. But economists have almost invariably and paradoxically assumed that the market must be kept free by the use of invasive and unfree actions—in short, by governmental institutions outside the market nexus.

A supply of defense services on the free market would mean maintaining the axiom of the free society, namely, that there be no use of physical force except in *defense* against those using force to invade person or property. This would imply the complete absence of a State apparatus or government; for the State, unlike all other persons and institutions in society, acquires its revenue, not by exchanges freely contracted, but by a system of unilateral coercion called "taxation." Defense in the free society (including such defense services to person and property as police protection and judicial findings) would therefore have to be supplied by people or firms who (*a*) gained their revenue voluntarily rather than by coercion and (*b*) did not—as the State does—arrogate to themselves a compulsory monopoly of police or judicial protection. Only such libertarian provision of defense service would be consonant with a free market and a free society. Thus, defense firms would have to be as freely competitive and as noncoercive against noninvaders as are all other suppliers of goods and services on the free market. Defense services, like all other services, would be marketable and marketable only.

Those economists and others who espouse the philosophy of *laissez faire* believe that the freedom of the market should be upheld and that property rights must not be invaded. Nevertheless, they strongly believe that defense service *cannot* be supplied by the market and that defense against invasion of property must therefore be supplied outside the free market, by the coercive force of the government. In arguing thus, they are caught in an insoluble contradiction, for they sanction and advocate massive invasion of property by the very agency (government) that is supposed to defend people against invasion! For a *laissez-faire* government would necessarily have to seize its revenues by the invasion of property called taxation and would arrogate to itself a compulsory monopoly of defense services over some arbitrarily designated territorial area. The *laissez-faire* theorists (who are here joined by almost all other writers) attempt to redeem their position from this glaring contradiction by asserting that a purely free-market defense service *could not* exist and that therefore those who value highly a forcible defense against violence would have to fall back on the State (despite its black historical record as *th*e great engine of invasive violence) as a necessary evil for the protection of person and property.

The *laissez-faireists* offer several objections to the idea of free-market defense. One objection holds that, since a free market of exchanges presupposes a system of property rights, therefore the State is needed to define and allocate the structure of such rights. But we have seen that the principles of a free society *do* imply a very definite theory of property rights, namely, self-ownership and the ownership of natural resources found and transformed by one's labor. Therefore, no State or similar agency contrary to the market is needed to define or allocate property rights. This can and will be done by the use of reason and through market processes themselves; any other allocation or definition would be completely arbitrary and contrary to the principles of the free society.

A similar doctrine holds that defense must be supplied by the State because of the unique status of defense as a necessary precondition of market activity, as a function without which a market economy could not exist. Yet this argument is a *non sequitur* that proves far too much. It was the fallacy of the classical economists to consider goods and services in terms of large *classes*; instead, modern economics demonstrates that services must be considered in terms of *marginal units*. For all actions on the market are marginal. If we begin to treat whole classes instead of marginal units, we can discover a great myriad of necessary, indispensable goods and services all of which might be considered as "preconditions" of market activity. Is not land room vital, or food for each participant, or clothing, or shelter? Can a market long exist without them? And what of paper, which has become a basic requisite of market activity in the complex modern economy? Must all these goods and services therefore be supplied by the State and the State only?

The *laissez-faireist* also assumes that there must be a single compulsory monopoly of coercion and decision-making in society, that there must, for example, be one Supreme Court to hand down final and unquestioned decisions. But he fails to recognize that the world has lived quite well throughout its existence without a single, ultimate decision-maker over its whole inhabited surface. The Argentinian, for example, lives in a state of "anarchy," of nongovernment, in relation to the citizen of Uruguay—or of Ceylon. And yet the private citizens of these and other countries live and trade together without getting into insoluble legal conflicts, despite the absence of a common governmental ruler. The Argentinian who believes he has been aggressed upon by a Ceylonese, for example, takes his grievance to an Argentinian court, and its decision is recognized by the Ceylonese courts—and vice versa if the Ceylonese is the aggrieved party. Although it is true that the separate nation-States have warred interminably against each other, the private citizens of the various countries, despite widely differing legal systems, have managed to live together in harmony without having a single government over them. If the citizens of northern Montana and of Saskatchewan across the border can live and trade together in harmony without a common government, so can the citizens of northern and of southern Montana. In short, the present-day boundaries of nations are purely historical and arbitrary, and there is no more need for a monopoly government over the citizens of one country than there is for one between the citizens of two different nations.

It is all the more curious, incidentally, that while *laissez-faireists* should by the logic of their position, be ardent believers in a single, unified world government, so that no one will live in a state of "anarchy" in relation to anyone else, they almost never are. And once one concedes that a single world government is *not* necessary, then where does one logically stop at the permissibility of separate states? If Canada and the United States can be separate nations without being denounced as being in a state of impermissible "anarchy," why may not the South secede from the United States? New York State from the Union? New York City from the state? Why may not Manhattan secede? Each neighborhood? Each block? Each house? Each *person*? But, of course, if each person may secede from government, we have virtually arrived at the purely free society, where defense is supplied along with all other services by the free market and where the invasive State has ceased to exist.

The role of freely competitive judiciaries has, in fact, been far more important in the history of the West than is often recognized. The law merchant, admiralty law, and much of the common law began to be developed by privately competitive judges, who were sought out by litigants for their expertise in understanding the legal areas involved.[2] The fairs of Champagne and the great marts of international trade in the Middle Ages enjoyed freely competitive courts, and people could patronize those that they deemed most accurate and efficient.

Let us, then, examine in a little more detail what a free-market defense system might look like. It is, we must realize, impossible to blueprint the exact institutional conditions of any market in advance, just as it would have been impossible 50 years ago to predict the exact structure of the television industry today. However, we can postulate some of the workings of a freely competitive, marketable system of police and judicial

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[2]*See* Bruno Leoni, *Freedom and the Law* (Princeton, N.J.: D. Van Nostrand, 1961). *See also* Murray N. Rothbard, "On Freedom and the Law," *New Individualist Review*, Winter, 1962, pp. 37–40.

services. Most likely, such services would be sold on an advance subscription basis, with premiums paid regularly and services to be supplied on call. Many competitors would undoubtedly arise, each attempting, by earning a reputation for efficiency and probity, to win a consumer market for its services. Of course, it is possible that in some areas a single agency would outcompete all others, but this does not seem likely when we realize that there is no territorial monopoly and that efficient firms would be able to open branches in other geographical areas. It seems likely, also, that supplies of police and judicial service would be provided by insurance companies, because it would be to their direct advantage to reduce the amount of crime as much as possible.

One common objection to the feasibility of marketable protection (its *desirability* is not the problem here) runs as follows: Suppose that Jones subscribes to Defense Agency X and Smith subscribes to Defense Agency Y. (We will assume for convenience that the defense agency includes a police force and a court or courts, although in practice these two functions might well be performed by separate firms.) Smith alleges that he has been assaulted, or robbed, by Jones; Jones denies the charge. How, then, is justice to be dispensed?

Clearly, Smith will file charges against Jones and institute suit or trial proceedings in the Y court system. Jones is invited to defend himself against the charges, although there can be no subpoena power, since any sort of force used against a man not yet convicted of a crime is itself an invasive and criminal act that could not be consonant with the free society we have been postulating. If Jones is declared innocent, or if he is declared guilty and consents to the finding, then there if no problem on this level, and the Y courts then institute suitable measures of punishment.[3] But what if Jones challenges the finding? In that case, he can either take the case to his X court system, or take it directly

[3]Suppose that Smith, convinced of Jones' guilt, "takes the law into his own hands" rather than go through the court procedure? What then? In

to a privately competitive Appeals Court of a type that will undoubtedly spring up in abundance on the market to fill the great need for such tribunals. Probably there will be just a few Appeals Court systems, far fewer than the number of primary courts, and each of the lower courts will boast to its customers about being members of those Appeals Court systems noted for their efficiency and probity. The Appeals Court decision can then be taken by the society as binding. Indeed, in the basic legal code of the free society, there probably would be enshrined some such clause as that the decision of any two courts will be considered binding, i.e., will be the point at which the court will be able to take action against the party adjudged guilty.[4]

Every legal system needs some sort of socially-agreed-upon cutoff point, a point at which judicial procedure stops and punishment against the convicted criminal begins. But a single monopoly court of ultimate decision-making need not be imposed and of course cannot be in a free society; and a libertarian legal code might well have a two-court cutoff point, since there are always two contesting parties, the plaintiff and the defendant.

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itself this would be legitimate and not punishable as a crime, since no court or agency may have the right, in a free society, to use force for defense beyond the selfsame right of each individual. However, Smith would then have to face the consequence of a possible countersuit and trial by Jones, and he himself would have to face punishment as a criminal if Jones is found to be innocent.

[4]The Law Code of the purely free society would simply enshrine the libertarian axiom: prohibition of any violence against the person or property of another (except in defense of someone's person or property), property to be defined as self-ownership plus the ownership of resources that one has found, transformed, or bought or received after such transformation. The task of the Code would be to spell out the implications of this axiom (e.g., the libertarian sections of the law merchant or common law would be co-opted, while the statist accretions would be discarded). The Code would then be applied to specific cases by the free-market judges, who would all pledge themselves to follow it.

Another common objection to the workability of free-market defense wonders: May not one or more of the defense agencies turn its coercive power to criminal uses? In short, may not a private police agency use its force to aggress against others, or may not a private court collude to make fraudulent decisions and thus aggress against its subscribers and victims? It is very generally assumed that those who postulate a stateless society are also naive enough to believe that, in such a society, all men would be "good," and no one would wish to aggress against his neighbor. There is no need to assume any such magical or miraculous change in human nature. Of course, some of the private defense agencies will become criminal, just as some people become criminal now. But the point is that in a stateless society there would be no regular, *legalized* channel for crime and aggression, no government apparatus the control of which provides a secure monopoly for invasion of person and property. When a State exists, there does exist such a built-in channel, namely, the coercive taxation power, and the compulsory monopoly of forcible protection. In the purely free-market society, a would-be criminal police or judiciary would find it very difficult to take power, since there would be no organized State apparatus to seize and use as the instrumentality of command. To create such an instrumentality *de novo* is very difficult, and, indeed, almost impossible; historically, it took State rulers centuries to establish a functioning State apparatus. Furthermore, the purely free-market, stateless society would contain within itself a system of built-in "checks and balances" that would make it almost impossible for such organized crime to succeed. There has been much talk about "checks and balances" in the American system, but these can scarcely be considered checks at all, since every one of these institutions is an agency of the central government and eventually of the ruling party of that government. The checks and balances in the stateless society consist precisely in the *free market*, i.e., the existence of freely competitive police and judicial agencies that could quickly be mobilized to put down any outlaw agency.

It is true that there can be no absolute guarantee that a purely market society would not fall prey to organized criminality. But this concept is far more workable than the *truly* Utopian idea of a strictly limited government, an idea that has never worked historically. And understandably so, for the State's built-in monopoly of aggression and inherent absence of free-market checks has enabled it to burst easily any bonds that well-meaning people have tried to place upon it. Finally, the worst that could possibly happen would be for the State to be reestablished. And since the State is what we have *now*, any experimentation with a stateless society would have nothing to lose and everything to gain.

Many economists object to marketable defense on the grounds that defense is one of an alleged category of "collective goods" that can be supplied only by the State. This fallacious theory is refuted elsewhere.[5] And two of the very few economists who have conceded the possibility of a purely market defense have written:

> If, then, individuals were willing to pay sufficiently high price, protection, general education, recreation, the army, navy, police departments, schools and parks might be provided through individual initiative, as well as food, clothing and automobiles.[6]

Actually, Hunter and Allen greatly underestimated the workability of private action in providing these services, for a compulsory monopoly, gaining its revenues out of generalized coercion rather than by the voluntary payment of the customers, is bound to be strikingly less efficient than a freely competitive, private enterprise supply of such services. The "price" paid would be a great gain to society and to the consumers rather than an imposed extra cost.

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[5]*Man, Economy, and State*, pp. 1029–36.

[6]Merlin H. Hunter and Harry K. Allen, *Principles of Public Finance* (New York: Harper & Bros., 1940), p. 22.

Thus, a truly free market is totally incompatible with the existence of a State, an institution that presumes to "defend" person and property by itself subsisting on the unilateral coercion against private property known as taxation. On the free market, defense against violence would be a service like any other, obtainable from freely competitive private organizations. Whatever problems remain in this area could easily be solved in practice by the market process, that very process which has solved countless organizational problems of far greater intricacy. Those *laissez-faire* economists and writers, past and present, who have stopped short at the impossibly Utopian ideal of a "limited" government are trapped in a grave inner contradiction. This contradiction of *laissez faire* was lucidly exposed by the British political philosopher, Auberon Herbert:

> A is to compel B to co-operate with him, or B to compel A; but in any case co-operation cannot be secured, as we are told, unless, through all time, one section is compelling another section to form a State. Very good; but then what has become of our system of Individualism? A has got hold of B, or B of A, and has forced him into a system of which he disapproves, extracts service and payment from him which he does not wish to render, has virtually become his master—what is all this but Socialism on a reduced scale? . . . Believing, then, that the judgment of every individual who has not aggressed against his neighbour is supreme as regards his actions, and that this is the rock on which Individualism rests—I deny that A and B can go to C and force him to form a State and extract from him certain payments and services in the name of such State; and I go on to maintain that if you act in this manner, you at once justify State-Socialism.[7]

[7]Auberon Herbert and J.H. Levy, *Taxation and Anarchism* (London: The Personal Rights Association, 1912), pp. 2–3.

2

Fundamentals of Intervention

1. Types of Intervention

We have so far contemplated a free society and a free market, where any needed defense against violent invasion of person and property is supplied, not by the State, but by freely competitive, marketable defense agencies. Our major task in this volume is to analyze the effects of various types of violent intervention in society and, especially, in the market. Most of our examples will deal with the State, since the State is uniquely the agency engaged in regularized violence on a large scale. However, our analysis applies to the extent that any individual or group commits violent invasion. Whether the invasion is "legal" or not does not concern us, since we are engaged in praxeological, not legal, analysis.

One of the most lucid analyses of the distinction between State and market was set forth by Franz Oppenheimer. He pointed out that there are fundamentally two ways of satisfying a person's wants: (1) by production and voluntary exchange with others on the market and (2) by violent expropriation of the wealth of others.[1] The first method Oppenheimer termed "the economic means" for the satisfaction of wants; the second

[1]A person may receive gifts, but this is a unitary act of the giver, not involving an act of the receiver himself.

method, "the political means." The State is trenchantly defined as the "organization of the political means."[2]

A generic term is needed to designate an individual or group that commits invasive violence in society. We may call *intervener*, or *invader*, one who intervenes violently in free social or market relations. The term applies to any individual or group that initiates violent intervention in the free actions of persons and property owners.

What types of intervention can the invader commit? Broadly, we may distinguish three categories. In the first place, the intervener may command an individual subject to do or not to do certain things when these actions directly involve the individual's person or property *alone*. In short, he restricts the subject's use of his property when exchange is not involved. This may be called an *autistic intervention*, for any specific command directly involves only the subject himself. Secondly, the intervener may enforce a coerced *exchange* between the individual subject and himself, or a coerced "gift" to himself from the subject. Thirdly, the invader may either compel or prohibit an exchange between a *pair* of subjects. The former may be called

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[2]See Franz Oppenheimer, *The State* (New York: Vanguard Press, 1914):

> 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. . . . The state is an organization of the political means. (pp. 24–27)

See also Albert Jay Nock, *Our Enemy, the State* (Caldwell, Idaho: Caxton Printers, 1946), pp. 59–62; Frank Chodorov, *The Economics of Society, Government, and the State* (mimeographed MS., New York, 1946), pp. 64 ff. On the State as engaging in permanent conquest, *see ibid.*, pp. 13–16, 111–17, 136–40.

a *binary intervention*, since a hegemonic relation is established between two people (the intervener and the subject); the latter may be called a *triangular intervention*, since a hegemonic relation is created between the invader and a *pair* of exchangers or would-be exchangers. The market, complex though it may be, consists of a series of exchanges between pairs of individuals. However extensive the interventions, then, they may be resolved into unit impacts on either individual subjects or pairs of individual subjects.

All these types of intervention, of course, are subdivisions of the *hegemonic* relation—the relation of command and obedience—as contrasted with the contractual relation of voluntary mutual benefit.

Autistic intervention occurs when the invader coerces a subject without receiving any good or service in return. Widely disparate types of autistic intervention are: homicide, assault, and compulsory enforcement or prohibition of any salute, speech, or religious observance. Even if the intervener is the State, which issues the edict to all individuals in the society, the edict is still *in itself* an autistic intervention, since the lines of force, so to speak, radiate from the State to each individual alone. Binary intervention occurs when the invader forces the subject to make an exchange or a unilateral "gift" of some good or service to the invader. Highway robbery and taxes are examples of binary intervention, as are conscription and compulsory jury service. Whether the binary hegemonic relation is a coerced "gift" or a coerced exchange does not really matter a great deal. The only difference is in the type of coercion involved. Slavery, of course, is usually a coerced *exchange*, since the slaveowner must supply his slaves with subsistence.

Curiously enough, writers on political economy have recognized only the third category as intervention.[3] It is understandable

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[3]This is to be *inferred from*, rather than discovered in explicit form in, their writings. As far as we know, no one has systematically categorized or analyzed types of intervention.

that preoccupation with catallactic problems has led economists to overlook the broader praxeological category of actions that lie outside the monetary exchange nexus. Nevertheless, they are part of the subject matter of praxeology—and should be subjected to analysis. There is far less excuse for economists to neglect the *binary* category of intervention. Yet many economists who profess to be champions of the "free market" and opponents of interference with it have a peculiarly narrow view of freedom and intervention. Acts of binary intervention, such as conscription and the imposition of income taxes, are not considered intervention at all nor as interferences with the free market. Only instances of triangular intervention, such as price control, are conceded to be intervention. Curious schemata are developed in which the market is considered absolutely "free" and unhampered despite a regular system of imposed taxation. Yet taxes (and conscripts) are paid in money and thus enter the catallactic, as well as the wider praxeological, nexus.[4]

In tracing the effects of intervention, one must take care to analyze all its consequences, direct and indirect. It is impossible in the space of this volume to trace all the effects of every one of the almost infinite number of possible varieties of intervention, but sufficient analysis can be made of the important categories of intervention and the consequences of each. Thus, it must be remembered that acts of binary intervention have definite triangular repercussions: an income tax will shift the pattern of exchanges between subjects from what it otherwise would have been. Furthermore, all the consequences of an act must be considered; it is not sufficient to engage in a "partial-equilibrium"

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[4]A narrow view of "freedom" is characteristic in the present day. In the political lexicon of modern America, "left-wingers" often advocate freedom in the sense of opposition to autistic intervention, but look benignly on triangular intervention. "Right-wingers," on the other hand, severely oppose triangular intervention, but tend to favor, or remain indifferent to, autistic intervention. Both groups are ambivalent toward binary intervention.

analysis of taxation, for example, and to consider a tax completely apart from the fact that the State subsequently spends the tax money.

2. Direct Effects of Intervention on Utility

A. Intervention and Conflict

The first step in analyzing intervention is to contrast the *direct* effect on the utilities of the participants, with the effect of a free society. When people are free to act, they will always act in a way that they believe will maximize their utility, i.e., will raise them to the highest possible position on their value scale. Their utility *ex ante* will be maximized, provided we take care to interpret "utility" in an ordinal rather than a cardinal manner. Any action, any exchange that takes place on the free market or more broadly in the free society, occurs because of the expected benefit to each party concerned. If we allow ourselves to use the term "society" to depict the pattern of *all* individual exchanges, then we may say that the free market "maximizes" social utility, since everyone gains in utility. We must be careful, however, not to hypostatize "society" into a real entity that means something else than an array of all individuals.

Coercive intervention, on the other hand, signifies *per se* that the individual or individuals coerced would not have done what they are now doing were it not for the intervention. The individual who is coerced into saying or not saying something or into making or not making an exchange with the intervener or with someone else is having his actions changed by a threat of violence. The coerced individual loses in utility as a result of the intervention, for his action has been changed by its impact. Any intervention, whether it be autistic, binary, or triangular, causes the subjects to lose in utility. In autistic and binary intervention, each individual loses in utility; in triangular intervention, at least one, and sometimes both, of the pair of would-be exchangers lose in utility.

Who, in contrast, gains in utility *ex ante*? Clearly, the intervener; otherwise he would not have intervened. Either he gains in exchangeable goods at the expense of his subject, as in binary intervention, or, as in autistic and triangular intervention, he gains in a sense of well-being from enforcing regulations upon others.

All instances of intervention, then, in contrast to the free market, are cases in which one set of men gains *at the expense* of other men. In binary intervention, the gains and losses are "tangible" in the form of exchangeable goods and services; in other types of intervention, the gains are nonexchangeable satisfactions, and the loss consists in being coerced into less satisfying types of activity (if not positively painful ones).

Before the development of economic science, people thought of exchange and the market as always benefiting one party at the expense of the other. This was the root of the mercantilist view of the market. Economics has shown that this is a fallacy, for on the market *both* parties to any exchange benefit. On the market, therefore, there can be no such thing as *exploitation*. But the thesis of a conflict of interest *is* true whenever the State or any other agency intervenes on the market. For then the intervener gains only at the expense of subjects who lose in utility. On the market all is harmony. But as soon as intervention appears and is established, conflict is created, for each may participate in a scramble to be a net gainer rather than a net loser—to be part of the invading team, instead of one of the victims.

It has become fashionable to assert that "Conservatives" like John C. Calhoun "anticipated" the Marxian doctrine of class exploitation. But the Marxian doctrine holds, erroneously, that there are "classes" on the free market whose interests clash and conflict. Calhoun's insight was almost the reverse. Calhoun saw that it was the intervention of the State that *in itself* created the "classes" and the conflict.[5] He particularly perceived this in the

[5]"Castes" would be a better term than "classes" here. Classes are any collection of units with a certain property in common. There is no reason

case of the binary intervention of *taxes*. For he saw that the proceeds of taxes are used and spent, and that some people in the community must be net payers of tax funds, while the others are net recipients. Calhoun defined the latter as the "ruling class" of the exploiters, and the former as the "ruled" or exploited, and the distinction is quite a cogent one. Calhoun set forth his analysis brilliantly:

> 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. . . .
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> 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

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for them to conflict. Does the class of men named Jones necessarily conflict with the class of men named Smith? On the other hand, *castes* are State-made groups, each with its own set of violence-established privileges and tasks. Castes necessarily conflict because some are instituted to rule over the others.

> 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, be the taxes ever so equally laid. . . .
>
> 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.
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> 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. . . .[6]

"Ruling" and "ruled" apply also to the forms of government intervention, but Calhoun was quite right in focusing on taxes and fiscal policy as the keystone, for it is taxes that supply the resources and payment for the State in performing its myriad other acts of intervention.

All State intervention rests on the binary intervention of taxes at its base; even if the State intervened nowhere else, its taxation would remain. Since the term "social" can be applied

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[6]John C. Calhoun, *A Disquisition on Government* (New York: Liberal Arts Press, 1953), pp. 16–18. Calhoun, however, did not understand the harmony of interests on the free market.

only to every single individual concerned, it is clear that, while the free market maximizes social utility, no act of the State can ever increase social utility. Indeed, the picture of the free market is necessarily one of harmony and mutual benefit; the picture of State intervention is one of caste conflict, coercion, and exploitation.

B. Democracy and the Voluntary

It might be objected that all these forms of intervention are really not coercive but "voluntary," for in a democracy they are supported by the majority of the people. But this support is usually passive, resigned, and apathetic, rather than eager—whether the State is a democracy or not.[7]

In a democracy, the nonvoters can hardly be said to support the rulers, and neither can the voters for the losing side. But even those who voted for the winners may well have voted merely for the "lesser of the two evils." The interesting question is: Why do they have to vote for *any* evil at all? Such terms are never used by people when they act freely for themselves, or when they purchase goods on the free market. No one thinks of his new suit or refrigerator as an "evil"—lesser or greater. In such cases, people think of themselves as buying positive "goods," not as resignedly supporting a lesser bad. The point is that the public never has the opportunity of voting on the State

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[7]As Professor Lindsay Rogers has trenchantly written on the subject of public opinion:

> Before Great Britain adopted conscription in 1939, only thirty-nine percent of the voters were for it; a week after the conscription bill became law, a poll showed that fifty-eight percent approved. Many polls in the United States have shown a similar inflation of support for a policy as soon as it is translated to the statute books or into a Presidential order. (Lindsay Rogers, "'The Mind of America' to the Fourth Decimal Place," *The Reporter*, June 30, 1955, p. 44)

system itself; they are caught up in a system in which coercion over them is inevitable.[8]

Be that as it may, as we have said, *all* States are supported by a majority—whether a voting democracy or not; otherwise, they could not long continue to wield force against the determined resistance of the majority. However, the support may simply reflect apathy—perhaps from the resigned belief that the State is a permanent if unwelcome fixture of nature. Witness the motto: "Nothing is as permanent as death and taxes."

Setting all these matters aside, however, and even granting that a State might be enthusiastically supported by a majority, we still do not establish its voluntary nature. For the majority is not society, is not everyone. Majority coercion over the minority is still coercion.

Since States exist, and they are accepted for generations and centuries, we must conclude that a majority are at least passive supporters of all States—for no minority can for long rule an actively hostile majority. In a certain sense, therefore, *all* tyranny is majority tyranny, regardless of the formalities of the government structure.[9, 10] But this does not change our analytic

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[8]This coercion would exist even in the most *direct* democracies. It is doubly compounded in representative *republics*, where the people never have a chance of voting on issues, but only on the men who rule them. They can only reject men—and this at very long intervals—and if the candidates have the same views on issues, the public cannot effect any sort of fundamental change.

[9]It is often stated that under "modern" conditions of destructive weapons, etc., a minority *can* tyrannize permanently over a majority. But this ignores the fact that these weapons can be held by the majority, or that agents of the minority can mutiny. The sheer absurdity, for example, of the current belief that a few million could really tyrannize over a few hundred million *active* resistants is not often realized. As David Hume profoundly stated:

> Nothing appears more surprising . . . than the easiness with which the many are governed by the few and the implicit submission with which men resign their own

conclusion of conflict and coercion as a corollary of the State. The conflict and coercion exist no matter how many people coerce how many others.[11]

C. Utility and Resistance to Invasion

To our comparative "welfare-economic" analysis of the free market and the State, it might be objected that when defense agencies restrain an invader from attacking someone's property, they are benefiting the property owner at the expense of a *loss of utility* by the would-be invader. Since defense agencies enforce rights on the free market, does not the free market *also* involve a gain by some at the expense of the utility of others (even if these others are invaders)?

In answer, we may state first that the free market is a society in which all exchange voluntarily. It may most easily be conceived as a situation in which no one aggresses against person or property. In that case, it is obvious that the utility of all is maximized on the free market. Defense agencies become necessary only as a defense against invasions of that market. It is the invader, *not* the existence of the defense agency, that inflicts

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> sentiments and passions to those of their rulers. When we enquire by what means this wonder is effected, we shall find that because Force is always on the side of the governed, the governors have nothing to support them but opinion. It is, therefore, on opinion that government is founded; and this maxim extends to the most despotic and most military governments. (David Hume, *Essays, Literary, Moral and Political* [London, n.d.], p. 23)

See also Etienne de La Boétie, *Anti-Dictator* (New York: Columbia University Press, 1942), pp. 8–9. For an analysis of the types of opinion fostered by the State in order to obtain public support, *see* Bertrand de Jouvenel, *On Power* (New York: Viking Press, 1949).

[10]This analysis of majority support applies to any intervention of rather long standing, carried on frankly and openly, whether or not the groups are labeled "States."

[11]*See* Calhoun, *Disquisition on Government*, pp. 14, 18–19, 23–33.

losses on his fellowmen. A defense agency existing without an invader would simply be a voluntarily established insurance against attack. The existence of a defense agency does *not* violate the principle of maximum utility, and it still reflects mutual benefit to all concerned. Conflict enters only with the invader. The invader, let us say, is in the process of committing an aggressive act against Smith, thereby injuring Smith for his gain. The defense agency, rushing to the aid of Smith, of course, injures the invader's utility; but it does so only to counteract the injury to Smith. It does help to maximize the utility of the non-criminals. The *principle* of conflict and loss of utility was introduced, *not* by the existence of the defense agency, but by the existence of the invader. It is still true, therefore, that utility is maximized for all on the free market; whereas to the extent that there is invasive interference in society, it is infected with conflict and exploitation of man by man.

D. The Argument from Envy

Another objection holds that the free market does not really increase the utility of all individuals, because some may be so smitten with envy at the success of others that they really lose in utility as a result. We cannot, however, deal with hypothetical utilities divorced from concrete action. We may, *as praxeologists*, deal only with utilities that we can deduce from the concrete behavior of human beings.[12] A person's "envy," unembodied in action, becomes pure moonshine from the praxeological point of view. All that we know is that he has participated in the free market and to that extent benefits by it. How he feels about the exchanges made by *others* cannot be demonstrated to us

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[12]Elsewhere, we have named this concept "demonstrated preference," have traced its history, and have directed a critique against competing concepts. *See* Murray N. Rothbard, "Toward a Reconstruction of Utility and Welfare Economics" in Mary Sennholz, ed., *On Freedom and Free Enterprise* (Princeton, N.J.: D. Van Nostrand, 1956), pp. 224 ff.

unless he commits an invasive act. Even if he publishes a pamphlet denouncing these exchanges, we have no ironclad proof that this is not a joke or a deliberate lie.

E. Utility *Ex Post*

We have thus seen that individuals maximize their utility *ex ante* on the free market and that the direct result of an invasion is that the invader's utility gains at the expense of a loss in utility by his victim. But what about utilities *ex post*? People may *expect* to benefit when they make a decision, but do they actually benefit from its results? The remainder of this volume will largely consist of analysis of what we may call the "indirect" consequences of the market or of intervention, supplementing the above direct analysis. It will deal with chains of consequences that can be grasped only by study and are not immediately visible to the naked eye.

Error can always occur in the path from *ante* to *post*, but the free market is so constructed that this error is reduced to a minimum. In the first place, there is a fast-working, easily understandable test that tells the entrepreneur, as well as the income-receiver, whether he is succeeding or failing at the task of satisfying the desires of the consumer. For the entrepreneur, who carries the main burden of adjustment to uncertain consumer desires, the test is swift and sure—profits or losses. Large profits are a signal that he has been on the right track; losses, that he has been on a wrong one. Profits and losses thus spur rapid adjustments to consumer demands; at the same time, they perform the function of getting money out of the hands of the bad entrepreneurs and into the hands of the good ones. The fact that good entrepreneurs prosper and add to their capital, and poor ones are driven out, insures an ever smoother market adjustment to changes in conditions. Similarly, to a lesser extent, land and labor factors move in accordance with the desire of their owners for higher incomes, and more value-productive factors are rewarded accordingly.

Consumers also take entrepreneurial risks on the market. Many critics of the market, while willing to concede the *expertise* of the capitalist-entrepreneurs, bewail the prevailing ignorance of consumers, which prevents them from gaining the utility *ex post* that they expected to have *ex ante*. Typically, Wesley C. Mitchell entitled one of his famous essays: "The Backward Art of Spending Money." Professor Ludwig von Mises has keenly pointed out the paradoxical position of so many "progressives" who insist that consumers are too ignorant or incompetent to buy products intelligently, while at the same time touting the virtues of democracy, where the same people vote for politicians whom they do not know and for policies that they hardly understand.

In fact, the truth is precisely the reverse of the popular ideology. Consumers are not omniscient, but they do have direct tests by which to acquire their knowledge. They buy a certain brand of breakfast food and they don't like it; so they don't buy it again. They buy a certain type of automobile and they do like its performance; so they buy another one. In both cases, they tell their friends of this newly won knowledge. Other consumers patronize consumers' research organizations, which can warn or advise them in advance. But, in all cases, the consumers have the direct test of results to guide them. And the firm that satisfies the consumers expands and prospers, while the firm that fails to satisfy them goes out of business.

On the other hand, voting for politicians and public policies is a completely different matter. Here there are no direct tests of success or failure whatever, neither profits and losses nor enjoyable or unsatisfying consumption. In order to grasp consequences, especially the indirect consequences of governmental decisions, it is necessary to comprehend a complex chain of praxeological reasoning, such as will be developed in this volume. Very few voters have the ability or the interest to follow such reasoning, particularly, as Schumpeter points out, in political situations. For in political situations, the minute influence that any one person has on the results, as well as the seeming remoteness of the actions, induces people to lose interest in political problems or argumentation.[13] Lacking the direct test of success or failure, the voter tends to turn, not to those politicians whose measures have the best chance of success, but to those with the ability to "sell" their propaganda. Without grasping logical chains of deduction, the average voter will never be able to discover the error that the ruler makes. Thus, suppose that the government inflates the money supply, thereby causing an inevitable rise in prices. The government can blame the price rise on wicked speculators or alien black marketeers, and, unless the public knows economics, it will not be able to see the fallacies in the ruler's arguments.

It is ironic that those writers who complain of the wiles and lures of advertising do not direct their criticism at the advertising of political campaigns, where their charges would be relevant. As Schumpeter states:

> The picture of the prettiest girl that ever lived will in the long run prove powerless to maintain the sales of a bad cigarette. There is no equally effective safeguard in the case of political decisions. Many decisions of fateful importance are of a nature that makes it impossible for the public to experiment with them at its leisure and at moderate cost. Even if that is possible, however, judgment is as a rule not so easy to arrive at as it is in the case of the cigarette, because effects are less easy to interpret.[14]

It might be objected that, while the average voter may not be competent to decide on policies that require for his decision chains of praxeological reasoning, he *is* competent to pick the

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[13]Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Bros., 1942), pp. 258–60. *See also* Anthony Downs, "An Economic Theory of Political Action in a Democracy," *Journal of Political Economy*, April, 1957, pp. 135–50.

[14]Schumpeter, *Capitalism, Socialism and Democracy*, p. 263.

experts—the politicians and bureaucrats—who will decide on the issues, just as the individual may select his own private expert adviser in any one of numerous fields. But the point is precisely that in government the individual does not have the direct, personal test of success or failure for his hired expert that he does on the market. On the market, individuals tend to patronize those experts whose advice proves most successful. Good doctors or lawyers reap rewards on the free market, while the poor ones fail; the privately hired expert tends to flourish in proportion to his demonstrated ability. In government, on the other hand, there is no concrete test of the expert's success. In the absence of such a test, there is no way by which the voter can gauge the true *expertise* of the man he must vote for. This difficulty is aggravated in modern-style elections, where the candidates agree on all the fundamental issues. For issues, after all, *are* susceptible to reasoning; the voter *can*, if he so wishes and he has the ability, learn about and decide on the issues. But what can any voter, even the most intelligent, know about the true *expertise* or competence of individual candidates, especially when elections are shorn of virtually all important issues? The voter can then fall back only on the purely external, packaged "personalities" or images of the candidates. The result is that voting purely on candidates makes the result even less rational than mass voting on the issues themselves.

Furthermore, the government itself contains inherent mechanisms that lead to poor choices of experts and officials. For one thing, the politician and the government expert receive their revenues, not from service voluntarily purchased on the market, but from a compulsory levy on the populace. These officials, therefore, wholly lack the pecuniary incentive to *care* about serving the public properly and competently. And, what is more, the vital criterion of "fitness" is very different in the government and on the market. In the market, the fittest are those most able to serve the consumers; in government, the fittest are those most adept at wielding coercion and/or those most adroit at making demagogic appeals to the voting public.

Another critical divergence between market action and democratic voting is this: the voter has, for example, only a 1/50 millionth power to choose among his would-be rulers, who in turn will make vital decisions affecting him, unchecked and unhampered until the next election. In the market, on the other hand, the individual has the absolute sovereign power to make the decisions concerning his person and property, not merely a distant, 1/50 millionth power. On the market the individual is continually demonstrating his choice of buying or not buying, selling or not selling, in the course of making absolute decisions regarding his property. The voter, by voting for some particular candidate, is demonstrating only a relative preference over one or two other potential rulers; he must do this within the framework of the coercive rule that, whether or not he votes at all, *one* of these men will rule over him for the next several years.[15]

Thus, we see that the free market contains a smooth, efficient mechanism for bringing anticipated, *ex ante* utility into the realization of *ex post.* The free market always maximizes *ex ante* social utility as well. In political action, on the contrary, there is no such mechanism; indeed, the political process inherently tends to delay and thwart the realization of any expected gains. Furthermore, the divergence between *ex post* gains through government and through the market is even greater than this; for we shall find that in every instance of government intervention, the *indirect* consequences will be such as to make the intervention appear worse in the eyes of many of its original supporters.

In sum, the free market always benefits every participant, and it maximizes social utility *ex ante*; it also tends to do so *ex post*, since it works for the rapid conversion of anticipations into realizations. With intervention, one group gains directly at the expense of another, and therefore social utility cannot be

[15]For a further discussion of these points, *see Man, Economy, and State*, pp. 886–91.

increased; the attainment of goals is blocked rather than facilitated; and, as we shall see, the indirect consequences are such that many interveners themselves will lose utility *ex post*. The remainder of this work is largely devoted to tracing the indirect consequences of various forms of governmental intervention.

3

Triangular Intervention

A triangular intervention, as we have stated, occurs when the invader compels a pair of people to make an exchange or prohibits them from doing so. Thus, the intervener can prohibit the sale of a certain product or can prohibit a sale above or below a certain price. We can therefore divide triangular intervention into two types: *price control*, which deals with the terms of an exchange, and *product control*, which deals with the nature of the product or of the producer. Price control will have repercussions on production, and product control on prices, but the two types of control have different effects and can be conveniently separated.

1. Price Control

The intervener may set either a minimum price below which a product cannot be sold, or a maximum price above which it cannot be sold. He can also compel a sale at a certain fixed price. In any event, the price control will either be *ineffective* or *effective*. It will be ineffective if the regulation has no current influence on the market price. Thus, suppose that automobiles are all selling at about 100 gold ounces on the market. The government issues a decree prohibiting all sales of autos below 20 gold ounces, on pain of violence inflicted on all violators. This decree is, in the present state of the market, completely ineffective and academic, since no cars would have sold below 20 ounces. The price control yields only irrelevant jobs for government bureaucrats.

On the other hand, the price control may be effective, i.e., it may change the price from what it would have been on the free market. Let the diagram in Figure 1 depict the supply and demand curves, respectively *SS* and *DD*, for the good.

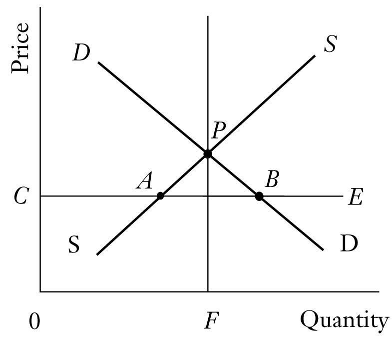

FIGURE 1. EFFECT OF A MAXIMUM PRICE CONTROL

FP is the equilibrium price set by the market. Now, let us assume that the intervener imposes a maximum control price 0*C*, above which any sale becomes illegal. At the control price, the market is no longer cleared, and the quantity demanded exceeds the quantity supplied by the amount *AB*. In the ensuing shortage, consumers rush to buy goods that are not available at the price. Some must do without; others must patronize the market, revived as "black" or illegal, while paying a premium for the risk of punishment that sellers now undergo. The chief characteristic of a price maximum is the queue, the endless "lining up" for goods that are not sufficient to supply the people at the rear of the line. All sorts of subterfuges are invented by people desperately seeking to arrive at the clearance provided by the market. "Under-the-table" deals, bribes, favoritism for older customers, etc., are inevitable features of a market shackled by the price maximum.[1]

It must be noted that, even if the stock of a good is frozen for the foreseeable future, and the supply line is vertical, this artificial shortage will still develop, and all these consequences ensue. The more "elastic" the supply, i.e., the more resources will shift out of production, the more aggravated, *ceteris paribus*, the shortage will be. If the price control is "selective," i.e., is imposed on one or a few products, the economy will not be as universally dislocated as under general maxima, but the artificial shortage created in the particular line will be even more pronounced, since entrepreneurs and factors can shift to the production and sale of other products (preferably substitutes). The prices of the substitutes will go up as the "excess" demand is channeled off in their direction. In the light of this fact, the typical government reason for selective price control—"we must impose controls on this product as long as it is in short supply"—is revealed to be an almost ludicrous error. For the truth is precisely the reverse: price control *creates* an artificial shortage of the product, which continues *as long as* the control is in existence—in fact, becomes ever worse as resources continue to shift to other products.

Before investigating further the effects of general price maxima, let us analyze the consequences of a *minimum* price control, i.e., the imposition of a price above the free-market price. This may be depicted as in Figure 2.

DD and *SS* are the demand and supply curves respectively. *0C* is the control price and *FP* the market equilibrium price. At *0C*, the quantity demanded is less than the quantity supplied, by the amount *AB*. Thus, while the effect of a maximum price is to create an artificial shortage, a minimum price creates an

[1]Bribing is made necessary by government outlawing of the exchange; a bribe is the sale, by the government official, of permission for the exchanges to proceed.

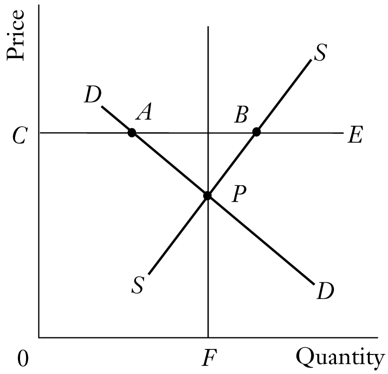

FIGURE 2. EFFECT OF A MINIMUM PRICE CONTROL

artificial unsold surplus. *AB* is the unsold surplus. The unsold surplus exists even if the *SS* line is vertical, but a more elastic supply will, *ceteris paribus*, aggravate the surplus. Once again, the market is not cleared. The artificially high price attracts resources into the field, while, at the same time, it discourages buyer demand. Under selective price control, resources will leave other fields where they serve their owners and the consumers better, and transfer to this field, where they overproduce and suffer losses as a result.

This illustrates how intervention, by tampering with the market, causes entrepreneurial losses. Entrepreneurs operate on the basis of certain criteria: prices, interest rates, etc., established by the free market. Interventionary tampering with these criteria destroys the adjustment and brings about losses, as well as misallocation of resources in satisfying consumer wants.

General, overall price maxima dislocate the entire economy and deny the consumers the enjoyment of substitutes. General price maxima are usually imposed for the announced purpose of "preventing inflation"—invariably while the government is inflating the money supply by a large amount. Overall price maxima are equivalent to imposing a minimum on the purchasing power of the money unit, the *PPM* (see Figure 3).