

# The Journal of **Prices & Markets**

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# Journal of Prices & Markets

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**Aims and Scope**

The Journal of Prices & Markets, published by the Ludwig von Mises Institute of Canada, is a journal that seeks to improve the understanding of the role of markets in the economy. Submissions should seek to shed light on contemporary issues while being grounded in a praxeological reasoning. Prices & Markets welcomes submissions from a variety of fields such as politics, sociology, and psychology, where ever they can bring relevance to economic and financial questions.

**Mission**

It is the mission of the Ludwig von Mises Institute of Canada to educate the public to the importance of placing human choice at the center of economic theory, to encourage a revival of critical historical research, and to advance the Misesian tradition of thought through the defense of the market economy, private property, sound money, and peaceful international relations.

*“Economics is mainly concerned with the analysis of the determination of money prices of goods and services exchanged on the market. In order to accomplish this task it must start from a comprehensive theory of human action. . . . [I]t must not restrict its investigations to those modes of action which in mundane speech are called “economic” actions, but must deal also with actions which are in a loose manner of speech called “noneconomic.” — Ludwig von Mises*



## *Unintended Consequences*

### **Rogoff, Reinhart and Ricardian Equivalence**

David Howden<sup>1</sup>

The largest economics controversy of the year belonged to Ken Rogoff and Carmen Reinhart for their research describing the relationship between economic growth and government debt. Their research, based on their popular book looking at the striking similarities between recurring booms and busts, argued that there is a critical level of debt above which economic growth is compromised (Rogoff and Reinhart 2009, 2010). Loosely stated, they argued that government debt above 90 percent of a country's GDP is harmful to economic growth.

Earlier this year this conclusion was brought into disrepute when a review article argued that Rogoff and Reinhart's study was plagued by "coding errors, selective exclusion of available data, and unconventional weighting of summary statistics lead to serious errors that inaccurately represent the relationship between public debt and GDP growth among 20 advanced economies in

the post-war period" (Herndon, Ash and Pollin 2013).

In the melee that ensued there was a critical point all but lost. There *is* a relationship between debt and growth, and whether Reinhart and Rogoff massaged their numbers to get the result in question is of only secondary importance. Like all great laws in economics, the quantitative relationship is never fixed though the qualitative relationship is definitively identifiable (Mises 1962: 62-63). Just as the basic logic of a binding price floor implies that, for example, a minimum wage will cause some marginal workers to be unemployed, the same logic yields no definitive result.

No self-respecting economist would argue that a 5 percent increase in the minimum wage will decrease employment by 2 percent. By the same reasoning, it befuddles belief that otherwise respectable economists Reinhart and Rogoff would invoke the same reasoning with their 90 percent debt-to-GDP cutoff. (In their defense, this figure was less important in their work than the popular press later made it out to be.)

If Reinhart and Rogoff are guilty of anything, it is of an overly narrow analysis that ignores some important variables. In particular, the exclusive focus on the role of debt on growth, while useful within the restricted confines

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of their study, lacks practical importance when viewed in isolation.

### 1. What's Debt Good For?

Consider the four uses an individual has for his money: consumption, investment, taxes and debt repayment. Consumption improves a person's wellbeing in the present, and investment does so in the future. Taxes fund either government consumption or investment, with the usual problem in identifying how valued either of those activities are.<sup>2</sup> One fact is clear: to the extent that taxes reduce private income they hamper the ability for private individuals to use their earnings to improve their wellbeing. Debt repayment does the same. (My own article "The Quantity Theory of Money" in this issue further explores the implications of debt repayment on consumption and investment activity.)

An individual's wellbeing will be unambiguously highest when he has the largest portion of his income available to spend on consumption or investment activities. This implies that tax *and* debt minimization are both key factors. Note also that wellbeing is not just the social property of having a satisfied and content population; it also translates into higher levels of economic growth. More consumption expenditure today means that businesses must hire more employees and increase production to satisfy these demands. Increasing consumption expenditure might lead to more jobs in the present, but at the expense of the investment needed to increase the rate of economic growth in the future. Investment expenditure has a similar result, though it is aimed at satisfying consumption demands expected to prevail at some future time. The more investment expenditure we made in the present, the greater the rate of economic growth in the future (assuming all goes well, of course).

Taxes and debt repayment, to the extent that they reduce the amount of funding available for consumption and production activities, reduce economic growth and the wellbeing of society's members in the present.

Rogoff and Reinhart look at debt levels and the

relationship to growth, and from this they get a crude measure of the effect of debt repayment on economic growth. I say it is a crude measure because the total level of debt is not the key factor. The amount of debt *being repaid each period* is vital, and this results from the total amount of debt scheduled for repayment and the prevailing interest rate.

However, taxes are also important and Rogoff and Reinhart largely sidestep this issue. This is not to criticize the Harvard economists, as their goal was narrowly focused on looking at the historical role of debt in times of crisis. In drawing policy conclusions, something the press was eager to tease out of their research, one needs to have a comprehensive look at the greater facts at hand.

Very few countries run high public deficits *and* levy high tax rates. The reason is, as we shall see, that it is difficult to do so and the result is often detrimental to growth. Instead, most countries treat the choice as binary: either high taxes and low deficits, or high deficits with low taxes.

One end of the spectrum might be Norway. Well known for its high tax regime, total Norwegian tax receipts totaled 42.2 percent of its economy last year. This small Scandinavian country has chosen to finance its public spending exclusively through taxes. Indeed, last year the Norwegian government ran a budget surplus of 13.9 percent of GDP thus reducing the amount of government debt outstanding. High taxes have removed the necessity for the government to finance itself through borrowing.

Take the opposite end of the spectrum. The United States is widely viewed as a low tax regime, and at 24 percent of its GDP the total tax collections from all levels of government are low relative to many of its developed counterparts. This low level of tax receipts has left the U.S. government dependent on borrowing to make up the remainder. Perhaps unsurprisingly, the United States runs one of the largest government deficits in the developed world, at 11 percent of GDP in 2012. Americans pay low taxes today for their services, but at some point in the future the bill will come due.

### 2. Quibbling about Ricardian Equivalence

In one sense, taxes and deficits are two sides of the same coin. Indeed, the British political economist David Ricardo first hypothesized such a relationship, only to downplay its practical relevance. In a nutshell,

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2 Although even this is debatable. Murray Rothbard (2004: 938-43) argued that all government expenditure is consumption, as it results in either consumption activity via transfer payments or "waste" through investments not aligned with consumer preferences. I prefer a more reserved stance whereby any government expenditure that turns out to be investment is merely accidental.

the hypothesis that now bears his name as “Ricardian equivalence” states that since governments can either raise money through taxes or bond issuances, and that these bonds must be eventually repaid (through taxes), the choice is not binary but unique – taxes now or taxes later.

Under one strict formulation, if a government incurs a large debt today individuals will bolster their savings in the expectation of future higher taxes to pay off the debt. This increase in savings decreases consumption by a similar amount, thus having the same effect as increased taxes would.

I’m not so sure it’s as simple as that (and neither did Ricardo). The people who benefit from the deficit spending today may not live to see their taxes pay off that same debt in the future (Buchanan 1976). Perhaps most importantly, the strict interpretation of Ricardian equivalence views savings and investment as lost economic activity. Similar to how Keynes’ paradox of thrift argued that only consumption expenditure can stimulate an economy, savings are viewed as a “leakage” from the system, and a form of lost income. Yet as Hayek (1931) so succinctly put it, investment in production must come prior to consumption, and thus savings is a necessary step in enabling demand to be fulfilled.

Despite some arguments as to what degree Ricardian equivalence holds quantitatively true, there is a basic truism in its qualitative message. Spending in the

present that is not directed towards consumption and investment activity – including taxes and debt repayment – are net negatives that reduce our wellbeing. In this light we can agree with Mises’ prescient analysis almost one hundred years ago: “it is fundamentally a matter of indifference whether [the government] ... imposes a one-time tax on him of half his wealth or takes from him every year as a tax the amount that corresponds to interest payments on half his wealth” (Mises 1919: 168, as quoted in Garrison 2001: 89).

Consumption improves our wellbeing today, and investment is aimed at improving it in the future. At times government expenditure can take on the appearance of consumption or investment activity, though it can never be valued as highly as voluntarily activities can be. People act to relieve their most pressing needs, and only by voluntarily directing their own income can we be certain that the most dire of these needs has been fulfilled.

Income spent repaying debt, especially public debt, removes the possibility of improving our wellbeing by expenditure on consumption that would directly provide satisfaction. Kenneth Rogoff and Carmen Reinhart have done a great service in making this apparent, and showing that too much debt (and more importantly, debt repayment) compromises growth. A look at the pernicious effects of taxes in reducing our wellbeing would tell a much more complete story.



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## *The More Things Change...*

### **The revolutionary aspect of Bitcoin**

Redmond Weissenberger<sup>1</sup>

*“No State shall enter into any Treaty, Alliance, or confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts;”*

— United States Constitution, Article I, section 10, clause 1

*“DOLLARS OR UNITS--each to be of the value of a Spanish milled dollar as the same is now current, and to contain three hundred and seventy-one grains and four sixteenth parts of a grain of pure, or four hundred and sixteen grains of standard silver.”*

— Coinage Act of 1792

**A**s this writing (November 17th, 2013) the price of one Bitcoin has touched upon \$1000, the largest amount of trade of this “crypto-currency” is occurring in China, the Chicago Fed is remarking on how it does not quite conform to the Austrian Economists definition of money, “*Nor does it truly embody what Hayek and others in the Austrian School of Economics’ proposed*” (Velde, 4) and the US Congress is considering congressional hearings to debate the merits of more direct Bitcoin regulations.

What is important is the revolution created by Bitcoin, a revolution in the true sense of the word. It represents a revolt against the current monetary order.

There is nothing particularly new about digital currencies. The simple fact of the matter is that the majority of currency transactions in today’s modern world involve digital currency units. They may be in dollars, Euros, pounds, pesos, dinar, yen or, increasingly, renminbi, but in the end no paper is being exchanged, no physical media must change hands - only ones and zeros transferred by means of electrical impulses though copper, radio wave, glass fibre and satellite are traded.

In that way, Bitcoin is no different. A digital transaction is occurring, ones and zeros are traveling

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through what in the end is a physical network, and a certain and unique set of information is being sent from one wallet (account) to another.

So what is it about Bitcoin that vexes policy makers?

The concept of crypto-currencies and digital cash has gone back at least until the early 1980s, with the first contribution in the literature appearing in David Chaum's 1983 article, "Blind signatures for untraceable payments." Crypto-currencies such as Bitcoin have been created to solve three problems that have resulted from the state acting in its own interest and destroying the trust that had been created between it and its citizens.

The first such problem can be traced back to 1933 when Franklin Delano Roosevelt issued executive order 6102 "forbidding the Hoarding of gold coin, gold bullion, and gold certificates within the continental United States." This Act resulted in the seizure of all gold from private American citizens under penalty of fine or imprisonment. It also represented a reneging by the U.S. government on its promise to redeem all U.S. dollars at a fixed price of gold, \$20.67 per troy ounce. After this event, only other sovereigns could demand gold, at the newly devalued price of \$35.

The second key event occurred in 1971 when Richard Nixon closed the gold window and reneged on the solemn pledge to redeem US currency to foreign governments for gold. This action was the completion of the devaluation that Roosevelt started in 1933.

The third event ushering in the emergence of alternative digital currencies was the bank bailouts of 2008. These bailouts are the latest government intervention into the markets following the various bubbles and crashes of ever increasing frequency and severity that have followed in the wake of the closing of the gold window and the subsequent virtually unlimited money expansion and the resulting instability in the economy.

Bitcoin is attempting to solve the issue of trust of currency in our modern digital world. Across the West we are seeing the erosion of trust in governments with the slow death of the social democratic welfare state that in its modern form was born within the Prussian state of the late 19<sup>th</sup> century (Ebeling 2008). The Communist countries of the 20<sup>th</sup> century were the first to go, with the Chinese beginning the abandonment of central planning of the economy in the late 1970s and the fall of the Union of Soviet Socialist Republics in 1991. In the West, the

soft socialism of the welfare state did not undermine capital formation to the extent that it did behind the Iron Curtain, and they are consequently lagging in their state sector failures.

Individuals who are waking up to this reality are looking for ways to protect themselves. Within Canada, the faltering government monopoly healthcare system is leading to the rise in healthcare tourism. Since it is not yet illegal to travel for healthcare, private organizations offering "timely alternatives" provide the services necessary for one to take responsibility for his own care. They seek out those that they can trust so they can care for themselves.

For those who are waking up to the reality of the pure fiat, dirty floating currency world that we currently live in, and the very real suffering that it creates and they must endure, they are also searching for solutions, and there are various private individuals and corporations who are attempting to provide a solution.

The reality of our current government paradigm and the ability of the modern state to interfere in the physical world means that such people as Bernard von Nothaus, creator of the liberty Dollar, who Jeffrey Tucker (2013) rightly calls a hero and was labelled a domestic terrorist by the state that actively steals from the forced holders of its monopoly currency:

Attempts to undermine the legitimate currency of this country are simply a unique form of domestic terrorism. While these forms of anti-government activities do not involve violence, they are every bit as insidious and represent a clear and present danger to the economic stability of this country. We are determined to meet these threats through infiltration, disruption, and dismantling of organizations which seek to challenge the legitimacy of our democratic form of government. (US Attorney's Office 2011)

How did we get here?

Bitcoin is not a revolution in the world of currencies in the sense that almost all have a large digital-only component to them. The Canadian dollar, for example, exists almost exclusively as a series of digital

debit and credit entries in the private banking system's balance sheets, and offset by that of the Bank of Canada. What is unique about Bitcoin is its decentralized nature and private creation.

The shift into alternatives to state provided goods and services is already apparent in many facets of the economy – healthcare and defence among others.

Bitcoin represents a recognition amongst a growing minority of the global economy that the current system is more broadly broken.

Indeed, money is the most systemically important asset. It is the common denominator that links all transactions together. Manipulations to it have broad-reaching and severe consequences. Many of these consequences are apparent in the global crisis, which has been sparked by a lack of faith in money, government debt and the financial system at large. Bitcoin is an attempt to

rectify this.

Instead of deriding Bitcoin, governments of the world would do well to learn from it. Bitcoin is a clear symbol that something has gone terribly wrong in the realm of money. It is an attempt at solving a trust problem, how we can trust the soundness of the digital currency. We cannot trust the soundness of state monopoly digital currency, just as the Roman Empire slowly crumbled owing to a lack of trust of the soundness of its own currency (Bartlett 1994). Bitcoin is a revolt against the current monetary order - a stand against inflation of the money supply, a stand against the state monopoly on the production of money and money substitutes physical and digital, a stand against the states desire to destroy networks of trust outside of their control.

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## *Bounded Rationality*

### **No, market-design theory does *not* show “market failure”**

Ben O’Neill<sup>1</sup>

**T**he past year has seen some interesting commentary on the Nobel Prize in economics awarded last year to Professors Lloyd Shapley and Alvin Roth who have been major contributors to a branch of economic theory known as “market design”. This is an interesting branch of economics and gives important insights into the design of transaction systems in markets that are subject to constraints that prevent outside trade and payment.

Shapley and Roth have undertaken some very insightful and useful work in this field, but it is often presented in a language which is highly misleading. Indeed, the very term “market design” grates against the Hayekian idea of spontaneous order under the free market and the Misesian view of the calculation problems in central planning. When coupled with mentions of “market failure”, the term suggests that the allocation process in the market must be consciously designed by

some outside agent, rather than emerging spontaneously from the voluntary choices of participants.

Running with this idea, Ritter and Wiseman (2012) reported on the prize citing a statement from a former student of Professor Roth, who says that Roth “... has spent a lot of time studying markets where things don’t work out. It’s not like we could just buy and sell kidneys, and people can’t buy their way into public schools. So standard economic models don’t apply”.

### **Cases where “markets don’t work out”**

The example given, on the restriction against buying and selling human kidneys, actually gives a hint as to the real state-of-affairs in this area of economic research, and the so-called “market failure” that is addressed. Actually, we *could* just buy and sell human kidneys, if only this wasn’t prohibited by the coercive interference of government. There is no inherent market problem that prevents this kind of transaction from taking place. Rather, what has occurred is that this transaction is prohibited by government statutes, and this is done on the basis of an alleged moral repugnancy in selling human organs — a reason having nothing to do with any failure

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of the free market system.

Roth (2012) discusses this kind of “repugnancy constraint” on markets, noting that this constraint is imposed by government intervention based on the alleged moral repugnancy of the transaction. He also notes that this reaction of repugnancy is often based on concerns about “objectification” of something that people do not wish to see bought and sold, or on an alleged “exploitation” of the poor (pp. 44-45). (Both of these objections derive from Marxist critiques of voluntary trade and monetary transactions.) Roth also notes that these objections run into some cogent rebuttals from economists (pp. 49-50). In particular, the latter objection is contrary to the fact that a voluntary transaction of this kind is welfare-enhancing even from the point of view of the poorer person who sells their own kidney for money.

Roth’s analysis of “repugnancy constraints” discusses the fact that markets are often constrained from operating by government intervention on the basis of the alleged repugnancy of some kind of voluntary transaction. Actually, he does not assert that markets “don’t work out” in these cases, but that they have been *prevented from working* in their normal way by prohibition on a particular kind of transaction.

### **Shapley and Roth’s work on matching-problems**

Much of the insight into market design in these cases spawned from an early algorithm developed by Professor Shapley and another economist to deal with a particular constrained market problem (Shapley and Gale 1962). They considered a hypothetical situation where a group of equal numbers of men and women want to pair up to marry one another, and each person has some ranking-order for the how desirable each partner is to them. The problem here is that some men might prefer the same women and some women might prefer the same men, such that the satisfaction of one removes a desirable partner from the other. Moreover, the problem is designed in such a way that it does not allow consideration of any outside benefits. (Perhaps the couples take the view that outside payment would undermine the display of love shown in the coupling.)

Roth (1982) looks at various properties that are desirable in this pairing allocation and determines whether these desirable properties can be achieved. He begins by looking at whether a particular pairing arrangement is

“unstable” or not. A pairing arrangement is defined to be unstable if there is a man and a woman who are not paired together, but they would both prefer to be paired with each other than with their present partner. (This is unstable because presumably they will each leave their present partner to be together). He shows that regardless of the underlying preferences of the men and women in the matching problem, there will always be at least one stable pairing arrangement available (p. 620, Theorem 1). This achieves a standard property of the free market system, where stability is ensured by the fact that all voluntary transactions are allowed.

Roth also looks at another desirable property of a pairing system called “truthful revelation”. Once the rules of the matching system are set by the market designer, the various men and women will compete to get a desirable partner. Ideally, we would like for it to be in each person’s strategic best interests to tell the truth about his or her preference ranking for partners under this system. After all, if there is an incentive for a person to lie, this makes it hard to establish who really wants who, and this loss of information means that the pair matching does not work well. Again, this is a standard property of the free market system, where the price system signals costs to producers and consumers and they reveal their preferences implicitly through their transactions and abstention from other transactions.

Roth shows that regardless of the underlying preferences of the men and women in the matching problem, it is always possible to create a matching system that removes any incentives to lie (p. 623, Theorem 4). In particular, it is possible to create a system which gives the best stable pairing from the point of view of either the men or the women (but not both) and in this case, that group has no incentive to lie about their preferences (pp. 620-621, 623-624, Theorems 2 and 5).

So the question is, is it possible to have both of these desirable properties together? In other words, in the context of constrained matching problems, is it possible to create a pairing system that is both stable and removes any incentive to lie for the general case of this matching problem? The answer, unfortunately, is no (p. 622, Theorem 3). Roth’s work shows that it is possible to choose a stable pairing that is the best stable pairing for the men, or it is possible to choose a stable pairing that is the best stable pairing for the women, but these will not necessarily coincide. Moreover, having set this system of

market design, it is impossible to remove incentives for the unfortunate group to lie — this may be an optimal strategy for some people in that group. Unlike the case prevailing in a free market system, these two desirable properties cannot be simultaneously achieved.

Shapley and Roth's subsequent work has parlayed this basic idea into the development of algorithms that try to minimise the undesirable aspects of constrained markets. This has been applied in the constrained market for organ donation (no sales allowed) and the constrained market for university entry (no purchase of entry allowed). Through "market design" the economists are able to reduce—but not eliminate—the damage done by the imposition of the initial constraint.

### **Implications of this work**

Roth and Shapley have often presented their work as a method of dealing with so-called "market failures", though what they mean when they use this term is curious indeed (see e.g., Roth 2008). An examination of each of the situations they describe in their work shows that they are actually talking about situations where there is a direct government provision of services under a self-imposed constrained arrangement, or a government intervention into the market which creates the constraint. Professor Roth explains his particular interest in the problem of "market design" by noting that his attempts to improve the functioning of various markets have tended to run up against repugnancy arguments claiming that certain free-market transactions are inappropriate (ibid, p. 50). He has therefore developed his theory as a means of coping with these constraints as best as can be done.

It is extremely wrongheaded for this work to be presented as antithetical to the free-market, with

talk of "market failure" and other nonsense. In fact, the foundational work done in this area by Roth actually proves that this centralised market design cannot replicate basic desirable properties that arise on the free market. Any "market design" in this area will either be unstable, or will create incentives for market participants to lie about their true preferences in order to get their preferred result. Each stable arrangement identified by the work in Shapley and Roth will either be suboptimal from the point of view of one group or another, meaning that the designed market lacks the optimal pairing properties that are standard when dealing with an unconstrained free market.

Even setting aside these problems, there are also further problems imposed by constraints on the sale of goods. In markets like those for human organs there will be an entire class of would-be providers of goods that are removed from the market by the constraint. Anyone who is willing to sell their organs, but not donate them, is removed from the market by the constraint, and is thereby removed from the matching problem analysed in "market design".

There are two aspects of great value in the work of the present Nobel prize winners. The first is to allow them to alleviate the damage done by government intervention to some degree, by improving the allocation of goods under artificially imposed constraints. The second is in demonstrating that *even with this optimal solution under the constraint*, the situation is still worse than would arise if these outside constraints were not imposed by governments in the first place. Proper interpretation of the field of "market design" shows that it provides a second-best outcome in cases where the best approach — the free market — has been peremptorily removed by government intervention.



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## *The Quantity Theory of Money*

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**Abstract:** For an innocuous statement based on a trivial tautology, the quantity theory of money is sorely battered. This paper has three goals. First, it exposes the various flavours of the quantity theory as special cases of a simple application of the law of diminishing marginal utility. Second, it provides an overview of some typically controversial aspects of the quantity theory. Finally, it reformulates the quantity theory in light of these now resolved controversies. Although I use the term “quantity theory of money”, by the end of this article I reformulate the concept as an “exchange theory of velocity”.

**Key Words:** Quantity theory of money; velocity; bank-created credit; credit; deleveraging

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**A**lthough I have chosen “The Quantity Theory of Money” as the title for this article, I do not particularly like it. The name and the theory, perhaps the most famous theory in all economic science and definitely the most famous to be formalized in the 20<sup>th</sup> century, carries with it much baggage. This article takes its title to keep some semblance of consistency in terminology, but as should be clear the theory developed by the end will bear only superficial resemblance to the more accepted doctrine of the quantity theory. More correctly, by the end of this paper we shall see that the traditional formulation of the quantity theory of money, presented in its various guises, is but a special case of a broad theory of prices, unduly restricted by some unnecessary and detrimental assumptions.

All debates and controversies surrounding the quantity theory of money (QTM) distil to ill-defined terms and concepts. The equation of exchange, the logical statement through which the QTM emerges, is tautologically true – both by way of its interlocking definitions and the way that its terms are defined (Yeager 1994: 159-60). As a simple accounting identity, the nominal value of spending over a period of time must equal the volume of money spent to settle these transactions. Problems with the application of this simple insight have traditionally come from poorly explained causal relationships joining the terms in question.<sup>2</sup>

The present paper starts from the ground up. It first defines the terms in question and which heretofore have received relatively scant treatment compared to the theory’s conclusions. In defining terms this reformulation, for lack of a more original verb, of the QTM shares much in common with existing presentations.

One area of departure in the present paper is the focus on the “velocity of money”. As the lone unobserved variable in the equation of exchange, velocity has been typically treated as a balancing item – the necessary product when one divides nominal spending by the money supply. Though still treating velocity as an unobserved variable, this paper redefines it in such a way that it is not subject to relegation as a place holder in the general theory. We will also see that changes to money’s velocity

have a greater degree of bearing on other variables – both independent (e.g., certain components of the money supply) and dependent (e.g., credit expansion and the level of nominal spending).

The QTM is sorely battered, especially so as this recession wears on. Its detractors have no lack of fodder for their attacks. The rapid expansions of the money supplies of various nations over the past few years have resulted in a steadiness of inflation and inflationary expectations and have had little affect on nominal spending. Just as John Maynard Keynes developed the marginal propensity to consume as a backlash against the QTM to explain the dramatic drop in incomes and prices during the Great Depression, so too does the current malaise provide an opportunity to provide an alternative to a damaged piece.

### **The Quantity Theories of Money**

The four famous letters in the equation  $MV = PY$ , are among the first that the budding economist learns. No sooner than he learns the identity, however, is it likely that he sheds the term “equation of exchange” from his memory to replace it with the “quantity theory of money”. N. Gregory Mankiw’s widely popular intermediate macroeconomics text, for example, introduces the equation of exchange to many young economists (Mankiw 2009: 86-89). After devoting three pages to explaining the variables, Mankiw makes the jump to assuming velocity is constant and thus providing the foundation for the more common quantity theory of money. This subsequent theory, although sharing the same foundation as the equation of exchange, is a causal statement explaining inflation by changes to the supply of money. After a brief formulation of the aggregate demand function in terms of the equation of exchange (Mankiw 2009: 269-71) the remainder of the book couches all discussions of the equation’s relevance in terms of the quantity theory of money.

Broadly speaking there are two ways to express the equation of exchange. Both make similar statements, though in different ways. Both rely on a vacuous conceptualization of velocity to act as a placeholder variable to make the relationship between money flows and income balance.

Irving Fisher’s version of the QTM started from the formulization of the truth that over any period of time, the volume of money expenditures must equal the sum of cash payments received (Fisher 1911). The former is the

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<sup>2</sup> Laidler (1991: 302-04) argues that there are also ideological controversies in the development of the QTM, as authors used it as a platform for policy prescriptions. Notable among these was the Monetarist ideal in need of a theory linking money supply growth to inflation, or Joan Robinson’s (1970) argument that inflation is everywhere and always a political phenomenon.

product of the quantity of money  $M$ , and how quickly it circulates to settle transactions  $V$ . The latter is determined by the gross number of transactions occurring  $T$ , at the average price of each transaction  $P$ . Fisher's income approach to the equation of exchange written as  $MV = PT$ , is not the QTM, though it is the accounting identity that forms the basis for the theory.

The QTM emerges from this foundation once one makes some basic assumptions about the nature of the variables and their interactions with one another. Thus, if one assumes velocity to be constant than inflation becomes always and everywhere a monetary phenomenon.

The "Cambridge" or transactions approach to the QTM argues that if any economy has a given stock of money, the purchasing power of this stock is determined by the demand to hold it. The first and perhaps most precise formulation of this version claimed that the demand to hold money would vary proportionately with nominal income (Keynes 1923). Altering some variables to change nominal spending into nominal income as the product of real national income  $Y$  and some appropriate price level  $P$ , the product must equilibrate with the stock of money  $M$  as,

$$M = kPY$$

which can be rewritten as

$$M(1/k) = PY.$$

The left-hand side expresses a money supply function which must by necessity result in the money demand expressed on the right-hand side.

The similarities between the income and transactions versions are more than superficial. Provided there is a stable relationship between the volume of transactions and real national income, there will also be a stable relationship between Fisher's transactions velocity of circulation  $V$ , and the Cambridge income velocity  $1/k$ .<sup>3</sup>

Indeed, both formulations say the same truth – the only distinction is in defining the terms. Although both denoted as  $M$ , the money supplies in question are distinct (Friedman 1970: 200). Fisher's transactions approach makes use of an  $M$  primarily concerned with money for transactions purposes, and the most

important quality of money is that it is transferred. The income version places emphasis on money held. Fisher is concerned with all transactions in the economy, while the income approach concerns itself more narrowly with only those generating final income. Likewise, the price levels suggested by each  $P$  differ in that the former version relies on an abstract price level for all goods transacted for, while the Cambridge version looks at prices for only finished goods, the sales of which generate income.

If three of the variables change, by definition each of the velocities will also differ. Fisher's  $V$  is a residual that equilibrates the volume of money circulating to settle transactions with that stock of money broadly defined as being used in payment – it is a transactions velocity. The income approach shares the similarity that  $V$  is a residual, though it serves to equilibrate the amount of money directed at generating only income-related output, and thus it represents an income velocity.

It is not that either approach is any more correct than the other: they are both simple tautologies. The vacuous nature of each approach should be apparent. Defining the terms without regard to some basic fundamentals of what the essence of each term results in an empty conclusion. Consider that

[w]e can readily imagine a "chairs" version of the equation of exchange. In  $CV_c = PQ$ ,  $P$  and  $Q$  would be the same as before,  $C$  would be the number of chairs in existence in the country on average during a year, and  $V_c$  would be the "velocity" of chairs, meaning the ratio of nominal income to the number of chairs. Thanks to interlocking definitions,  $CV_c = PQ$  is just as formally valid as  $MV = PQ$ ; but because of facts about how money functions that are not also true of chairs, the money version of the equation has a usefulness that the chairs version lacks. (Yeager 1994: 160)

Yeager's illustration demonstrates the point, yet also suffers the same deficiency as the traditional renditions of the QTM. As simple tautologies they are unassailable. However, it is not that money is special that makes the traditional QTMs more appealing than a chairs version. The QTM has always been developed without much mind for what money actually is, and instead focuses after the fact on what money must necessarily be in order to satisfy the equation. For example, in both versions above

<sup>3</sup> Indeed, in an early formulation of the Cambridge version, Pigou (1917: 174) noted as much, remarking that "It is thus evident that there is no conflict between my [Cambridge] formula and that embodied in the quantity theory."

	Included in TMS	Excluded from TMS
M1	(1) Currency	(1) Traveller's checks
	(2) Demand deposits	
	(3) Other checkable deposits, e.g., NOW accounts	
M2	(1) Savings deposits (including <u>MMDAs</u> )	(1) Money market mutual funds
	(2) Small-denomination time deposits	
Memorandum Items	(1) Demand Deposits Due to Foreign Commercial Banks	
	(2) Demand Deposits Due to Foreign Official Institutions	
	(3) U.S. Government Demand Deposits and Note Balances	

Table 1: Components of the true money supply  
Source: Salerno (1987)

the initial emphasis is on defining the nominal sum of expenditure on the right-hand side of the equation, whether nominal income or gross transactions. It is from that point that money is appropriately defined and then velocity is introduced as a placeholder.<sup>4</sup>

It may strike the reader as strange that the quantity theory of *money* leaves the definition of money until the end. If the QTM is in need of reformulation, it must be pursued so as to make clear at the outset why each item of the reformulation is necessary and how it interacts with the other variables in the theory.

### Agreeing on Terms

Present depictions of the QTM suffer a similar

4 Of course, Yeager must realize this as he notes that “[o]ne might quibble over exactly what counts as a chair, just as over what counts as money, but such quibbles would be relatively peripheral to the logic and usefulness of either equation (1994: 160). Bagus and Howden (2012a) bring up a similar point, noting that a chairs version of the QTM is not strictly comparable to the money version, despite being logically consistent – the number of chairs circulating confers a direct utility from their use value while money, and particularly fiat money, offers no such affect on utility.

infliction – by defining their terms only loosely, they result in a theory which, although logically quite valid and unassailable, is of such a special case as to have almost no bearing on the monetary world. I shall start by defining what money is used for, and why it is held. In this way, the subsequent QTM I will develop will abide by “Wallace’s dictum”: namely, that money should not be a primitive in a monetary model (Wallace 1998). By first defining money and its uses, I will then define more narrowly the other three terms that must interlock to form the theory.

### *Money*

Ludwig von Mises (1949: 14, 249) argued that money is held only to satisfy felt uncertainty.<sup>5</sup> Thus, if an individual was certain of all future expenditures – both in terms of time and amount – he would have no need to hold money and incur its opportunity cost. In making this argument, Mises took the opportunity cost for granted without demonstrating what that cost would be.

5 Of course, Mises did not also focus narrowly on money in only this role, but also more broadly as a unit of account, especially in his equilibrium construct, the evenly rotating economy (Mises 1949: 244-51). On this point see Howden (2009: 8fn8).

Money is a unique financial asset. It is the only asset which redeems on-demand and at par value. Money is the only asset which serves as the final means of settlement for contractual obligations and is generally accepted as such by the economic community. By these standards, we can define the money supply that is available to provide final payment for all purchases.

The common M measures of the money supply include some assets which qualify as money as per our criteria above, and some which do not qualify. Following Rothbard (1963: 87-91) and Salerno (1987), the following table outlines those types of “money” which are usually grouped into each M category, and whether they will be included in our definition of the “true money supply” (TMS). Notably, traveler’s checks are excluded as money because they are not the final means of settlement, and money market mutual funds do not count as they are not necessarily instantly redeemable, fixed statutorily at par value, or the final means of settlement. (The reader interested in further details surrounding the inclusion or exclusion of an item may consult Salerno 1987.) It is commonly said that “money is as money does”, and serving as a means of payment is not the only role money serves. Per Mises (1949: 249) money is also that asset which is held as an uncertainty hedge. This form of money has an appearance of idleness as it is typically represented as a deposited sum which is only used by an individual upon an unforeseen event.

Thus money serves two distinct roles and it is useful to distinguish between them when defining the money supply. One common division is made between holding money for reservation purposes and exchange purposes, as in Rothbard (1962: 756-62). The former is held as a hedge against perceived future uncertainty; the latter to facilitate payments. Although it is difficult to disentangle the two motives for holding money, there are some cash balances that are clearly held to serve one role rather than the other.

Vault cash held by banks, for example, is a sum of money which is only held for precautionary motives. Banks do not use this sum to facilitate payments per se, and as such we can treat it as a quantity of money not used for settlement of exchange obligations.

We can separate the total money supply into two categories, 1) that sum which functions as the means of settlement and 2) that sum held to ease felt uncertainty.<sup>6</sup>

<sup>6</sup> This separating of the demand for money into the demand

The former is not held but circulates continually through the economy as it serves to settle transactions. The former has no circulation, although its level will be adjusted as felt uncertainty changes or as an unforeseen expense occurs that requires financing.

In sum, the total amount of money available at any period to facilitate transactions is the true money supply less the reservation demand for money:  $TMS - M_R$

### *Quantities*

That sum of money which circulates to settle transactions has a partial counterpart in the quantity of goods produced in the area over which this money circulates. Final goods consist of final consumers’ goods  $C$  and final capital goods  $K$ . The common gross domestic product figures are summaries of these final output levels, whereby consumers’ and capital goods are also included with the level of government spending and net exports.

In addition to expenditures on final goods in an economy there is also much expenditure on goods in process. Menger (1976: chap. 1) distinguished between different “orders” of capital as a way to differentiate final output from those goods produced but still some distance away from final consumption. In his terminology, higher order goods are those furthest from completion for final use while lower orders are those closest to final use. (Use in this case can be for either consumption or investment use, depending on whether the good is a consumers’ or a capital good.) Goods of the lowest order, the zeroth order, are those available for final use (i.e.,  $C + K$ ).

For our purposes we will consider that money settles transactions for all:  $(C + K)$  plus all goods of a higher order, or intermediate goods,  $N$ .<sup>7</sup>

Besides monetary expenditures on goods, we can also consider that money is used to settle debt transactions.

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to hold money as a reservation fund, and the demand to trade money to facilitate payments does much to rectify the misgiving of the quantity theory noted by Wallace (1998: 21fn3), “[W]ho is holding and trading the money in the quantity equation?”

<sup>7</sup> Traditionally, intermediate goods were called “circulating capital”, a term I reject here because of the confusion that may arise by calling an unfinished consumers’ good a type of capital. In a similar vein, I reject the term accepted by the United Nations System of National Accounts, US National Income and Product Accounts, and the European System of Accounts, of “intermediate consumption” for the similar confusion created by referring to unfinished capital goods as a form of consumption.

Debt payments have typically been excluded from the equation of exchange on the basis that they represent a wealth transfer from one party to another. We include them here as they are just one means through which one can spend his money income on. Likewise income can be used to facilitate new equity purchases  $E_t$ .

Thus the total of transactions that money can be used to facilitate the payment of includes five categories – consumers and capital goods produced in each period, intermediate goods still in progress, any net debt repayment, and any net purchases of equities.

The common gross domestic product figure captures the first two of these components. GDP limits itself, however, by not including the intermediary goods produced and as such represents income earned in a period but not the total of all transactions. Broader based figures such as gross output or gross domestic expenditure, both of which include all intermediary transactions as well as final ones, are a much more accurate representation of total money expenditure in an economy during any period of time (Skousen 2012). These two figures too are deficient for our purposes, however, as they lack the inclusion of money expenditure on net debt repayment and equity purchases.

Thus the sum of all monetary transactions in the economy is given as:

$$C_t + I_t + N_t + (\text{net debt repayment})_t + (\text{net equity purchases})_t$$

*Prices*

Of the variables discussed so far, prices are the easiest to conceptually define yet the most difficult to integrate into the analysis. Each transaction has a price. In general these prices are determined in one of two ways. They may transpire at par value, that is, some pre-defined value not subject to change. Alternatively prices can be established at market value, that is, as per the whims of supply and demand at any given time and very much subject to change.

Since every quantity transacted for must have an associated price, we see that debt transactions are settled at par value while the sum of GDE components and equity transactions is determined at market.

Par value is conceptually easy to analyze, and as it is not subject to change by market forces there is no

change in these prices from period to period. To speak of price inflation, for example, is of no meaning with debt-based transactions.

Market prices must be summated in some way to obtain an average price at which all market-value transactions take place at. This exercise is fraught with peril, as numerous critiques concerning the relevance of price level computations makes clear (Anderson 2001). Still, the concept of the general price level is not offensive and indeed it can be concretely defined within the context of the total of nominal spending which has occurred over a time period.

When combined with the transactions occurring in the economy above we find that total expenditures equals,

$$p(C_t + I_t + N_t) + (\text{net debt repayment})_t + (\text{net equity purchases})_t$$

where  $p$  is some sufficiently designed and weighted average price level for all goods and services transactions.

Since  $p$  itself is a contentious issue, it may prove instructive to just reckon all transactions not in specific quantity and price terms, but as the resultant product of money expenditures by way of some aggregate spending figure. Thus, as GDE is just the current money value of all expenditures on consumer, capital and intermediate goods, we can rewrite the above as:

$$GDE_t - \Delta L_t + \Delta E_t$$

where  $\Delta L_t$  represents the change in the total level of indebtedness in the economy and  $\Delta E_t$  represented net new equity purchases, both during some time period  $t$ . A positive  $\Delta L_t$  implies that the total amount of debt is increasing (i.e., the economy in the aggregate is leveraging) while a negative value implies that the total amount of debt is decreasing (i.e., a decrease in the degree to which the aggregate economy is levered), and thus requires some monetary expenditure to cover those loans not re-backed by fresh debt issuances.

*Velocity*

Finally we reach the velocity of circulation variable. Velocity can be viewed in one of two ways. In typical expositions of the equation of exchange it is an equilibrating variable, the result of nominal spending divided by the money stock. In this way it also contains an error component (Friedman 1987). While there is little wrong with this approach to defining the “velocity” of money, it is not very fecund: it serves only to satisfy the other terms in the equation.

An alternative approach is to recognize that velocity is a real variable. By real I do not mean to imply that its value hinges solely on non-monetary factors. Instead I mean that it is reasonable to refer to the rate at which each unit of money circulates as its velocity. It really does exist outside of the narrow confines of economic theorizing.

In order to make it a meaningful concept, however, there are some barriers to address.

The first is that velocity is an unobserved variable. The fungibility of money implies that no one unit can be tracked easily to see how many times it changes hands. This is not only an applied problem with currency, but it is impossible given the transfer of perfect money substitutes such as money deposits. Any reckoning of money’s velocity of circulation must be made in a roundabout way.

Second, the velocity of circulation will critically hinge on what role money is performing. Debates and controversies surrounding the applicability of meaning of velocity in past renditions of the equation of exchange have often centred on this point – what is money and why is it used?

This barrier has already been addressed because we have not used an ad hoc definition of money. Money for our purposes uses both its roles – that of facilitating exchanges and as being held as an uncertainty hedge. As a result, velocity is the ratio of total expenditures to the stock of money available to settle transactions:

$$V = (GDE_t - \Delta L_t + \Delta E_t) / (TMS - MR).$$

Taken in such a way, velocity is a half-way point between its more typical definitions. On the one hand it is a transactions velocity, like in the income tradition, as it looks at the necessary speed at which money must circulate to facilitate all monetary transactions. On the other hand it has an affinity to the Cambridge tradition as it incorporates the demand to hold money as a reservation

balance.

## Accounting for Unbacked Debt

Debt has typically been excluded from various equations of exchange because it represents a wealth transfer and not an outright use of purchasing power. I have included debt repayment as a use of money above, and as such one might also note that a corresponding change to the money supply should be made to include such a factor – if debt affects the right-hand side of the equation is it not reasonable that it too should affect the left-hand side also?

This is not an unreasonable claim, but has heretofore been addressed unsatisfactorily. Traditional expositions of the QTM exclude debt transactions for one of two reasons. On the one hand they do not represent the final means of payment. Thus, even though a good or service can be “purchased” by incurring a debt, this is just delaying the inevitability of repayment. Accounting for debt-based transactions is unnecessary as the use of debt just shifts the period of payment, but does not significantly alter the fundamental nature of eventual payment.

On the other hand, it is commonly viewed that debt-based transactions do not represent gains in purchasing power. Rather, they are a strict transfer from one spender to another in the economy (as in Salerno 2006: 49). This is true for some though not all debt obligations. In particular, there are two lending operations that do not entail a sacrifice in expenditure by the “lending” side of the exchange.

The first case we shall look at is lending from foreign sources. Financial inflows through the current account are the result of a foreigner lending money or buying a financial asset in order to finance domestic expenditure. The current account represents a funding source financed through debt that does not have an offsetting decrease in expenditure by someone in the domestic economy. (Though there is an expenditure decrease in the foreign economy by the lender.) As a result, negative current account balances act as a “free lunch” of sorts. They are free in the sense that a foreigner has enabled someone in the domestic economy to spend income which has not been lent through some other member of the domestic economy. The nature of this free lunch is, however, fleeting. Positive current account balances will reverse this state of affairs, and imply that



a domestic citizen is using his own savings to finance a foreign expenditure. The renunciation in expenditure in the domestic economy will result in an increase in funding for expenditure purposes in a foreign economy.

As a result of current account flows we can see that the means of payment available to settle a transaction is not limited to the stock of money in the economy at any given point in time. It is also comprised of expenditure “gifts” provided by foreigners on the current account. Domestic individuals will have to repay these “gifts” at some point in time, which will result as the current account turns positive and the flow of funding turns outward.

The second “lending” operation that we must account for is the maturity mismatch that results from bank-created credit. The fractional-reserve banking system makes use of deposited funds to finance its lending operations. These deposits, however, are not the bank’s to use. They are the result of a conscious decision on the part of depositors to hold a sum of money as an uncertainty hedge (Huerta de Soto 2006; Bagus and Howden 2009; 2012b; 2013; forthcoming).

I have used quotations above when referring to the nature of fractional-reserve bank lending practices because it is distinct from usual lending activities. All other loans in the economy are enacted through a temporary renunciation on the claim to an asset. When an investor purchases a \$1,000 bond, for example, he gives up the use and availability of those thousand dollars for the maturity of the bond, and the company borrowing the sum gains the use of the same.

Note that this renunciation of the use of the lent sum is not apparent if the loan is financed through a deposit. The depositor may not be actively using his deposited funds at any given time, though he is still using them in the sense that he is awaiting an uncertain event to make their use necessary (Bagus and Howden 2013: 239-41). This original step in the fractional-reserve money creation cycle may not seem insurmountable to the traditional variants of the QTM because there is no spending taking place with the original deposit at the time in question (i.e., a deposit only represents money that *might* be spent in the future contingent on a now uncertain event).

Subsequent iterations of the fractional-reserve cycle are of greater consequence. The original loan financed with a deposit is itself ultimately deposited in an account. From there a fraction of it will fund a subsequent

loan, and the usual fractional-reserve credit creation process proceeds. Each of these iterations represents an expenditure financed with a loan which did not entail a renunciation of expenditure on the part of the “lender” (who was, after all, the original depositor).

As a result, during any given period an expansion in the amount of bank-created credit will represent a “free lunch” in much the same way as funds entering the country on current account. As such, during any given time period the current account balance  $CA_t$  and the amount of new bank-created credit  $B_t$  must be included in the means of payment use to settle all transactions. Also note, however, that there is no concept of “circulation” with either of these funding sources unlike is the case with money.

### Putting it all Together

We are now in a position where we can put the terms together to construct a new equation of exchange.

On the payments side of the equation we find that

$$(TMS - MR)V - CA_t + \Delta B_t.$$

A negative current account balance represents a positive financial account inflow, implying a “payment” for goods and services not stemming from a domestic source or representing a domestic transfer of purchasing power.  $\Delta B_t$  represents the change in bank credit over some time period  $t$ , while the term  $TMS - M_R$  represents the amount of the total money supply available for transactions motives less the amount held to satisfy the reservation demands.

Since the expenditure side is just the sum of debt repayment, new net equity purchases and gross expenditures (represented by GDE), the complete equation of exchange becomes:

$$(TMS - M_R)V - CA_t + \Delta B_t \equiv GDE_t - \Delta L_t + \Delta E_t.$$

The right-hand side of the equation includes all transactions that require money to settle. The left-hand side implies that payment for such services comes not just from the amount of available money set aside to satisfy peoples’ transactions demand circulating at its own velocity  $V$ , but also the amount of unbacked funding in the form of the current account and new bank-created credit.

At this point the equation is still stated as an

equality. What is lacking is a dose of causality to point to how the equation should be rewritten, and which variables are dependent on or independent of each other.

Traditionally, economists have treated the money supply as being a given in the QTM, mostly owing to the fact that it is exogenously fixed in a commodity standard or central bank controlled fiat regime. In our rendition, the relevant money supply for settlement purposes is chosen by individuals. This is a result of the choice to hold money to satisfy the reservation demand, which thereby reduces the portion of the TMS which can circulate for transactions purposes.

In fact, there are four avenues through which an individual can direct his money income: 1) money can be held to satisfy the desire for an uncertainty hedge, 2a) money can be used to facilitate the purchase of consumers and capital goods in the present (both of which are a form of “consumption” expenditure to the extent that they confer a benefit in the present), or 2b) money can facilitate the movement of intermediate goods in a production process, which will confer a benefit in the future, 3) money can be used to settle the payment of services rendered in the past and financed through a debt, and finally, 4) money can be injected into equity markets by stock purchases, in effect purchasing a claim on future profits. Thus money is a separate class of goods used to facilitate the payment of past, present and future services through its role as medium of exchange, in contrast to the ability of consumers goods to confer benefits in the present or equity investments, capital and intermediate goods to confer their benefits in the future.<sup>8</sup>

The ability to pay for services with credit reduces the need for an individual to hold a sum of money to satisfy his reservation demand (Salerno 2006: 48). As credit, especially short-term credit, enables a funding source in not just routine but also emergency situations, an individual is able to direct a greater portion of his money supply to facilitating transactions and dedicate a smaller amount to fulfilling his need for a security hedge.

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8 This fact gives rise to the trichotomy of goods in existence – medium of exchange, consumers and capital goods (Mises 1971:79). Claims that money is a form of capital good because it is not directly consumed are misplaced (for example, in Barnett and Block 2005; 2007) as they fail to recognize that money’s role is not in directly satisfying future wants, but in facilitating our wants in both the present and future. To this more typical characterization of money’s role we can also add that money serves to settle the payment for our past wants, as is the case when it is used to settle a debt.

Indeed, Rothbard (1962: 826-27) refers to very short-term credit as a form of “quasi money” because of its ability to substitute for an individual’s cash balance held for the reservation demand.

Taking this two-pronged approach to defining the money supply by dividing cash balances into transactions and reservation demands does much to rectify the immediate problem in the equation of exchange that Laidler (1991: 296) identifies, namely, how best to define money. Previous attempts to define the relevant money supply relied either on an overly narrow or too broad definition of money. One way to solve the apparent problem of the indeterminate nature of the monetary stock was to define it as the aggregate whose demand function is mostly stable (Laidler 1969). The relevant monetary stock for transactions purposes is very malleable and unstable, and is determined not only or even principally by the supply of assets serving as money but rather by the amount that people desire to spend after satisfying their reservation demand. Indeed, due to its role in eradicating the continual threat of felt uncertainty, satisfying the reservation demand for money may be the first decision an individual makes with his income prior to assessing the additional expenditure avenues he can explore (Bagus and Howden 2013: 236).

Finally, I wish to comment on price formation. It is not the flow of spending that determines the price level, and neither is it some exogenously determined level of output which is available to direct this spending stream to (Salerno 2006: 51). Rather, it is money prices and the four spending options available to individuals – 1) “purchasing” a reservation stock of money, 2) purchasing consumers, capital or intermediate goods, 3) debt repayment, or 4) new equity purchases – that determine the stream of money spending. This causality is perhaps the starkest difference between the QTM presented here and the more typical versions of it (our version finds affinity in this sense with the “theory of money prices” found in Salerno 2006).

It is not the total value of money spent that determines the aggregate level of expenditure in an economy, but the other way ‘round. The level of expenditures that all participants incur will determine to what extent money must circulate to satisfy these transactions. Recognizing this point eliminates the uncertainty and circularity of the reasoning in Friedman and Schwartz (1963: 695) whereby the bulk of the causality in the QTM runs from the money supply to economic

## Conclusion

activity in the long run, while in the short run there is also a case for the corollary. Actually, the truth lies somewhere in the middle. The money supply for transactions purposes and the amount of desired expenditure are co-determined in the sense that once one decides how much money to hold in his reservation balance, the expenditure decision is one of allocating the remaining income among the four expenditure options.

Finally, the average price level for all transactions comprising  $GDE$  is useful to include as a practical matter. Instead of dividing gross expenditures into their component parts, it is easier to recognize that  $GDE_t$  is the sum of all money transactions for goods and services at their respective prices. Substituting we get:

$$V = (PQ - \Delta L_t + \Delta E_t + CA_t - \Delta B_t) / (TMS - M_R),$$

where  $PQ = Cp_c + Kp_k + Np_n$ .

Instead of being a vacuous concept devoid of any real importance except for its role in equilibrating the equation, velocity here becomes the necessary result of people's conscious expenditure decisions. Evidence pointing to the determinants of the behaviour of velocity gain a theoretical underpinning. Is the velocity of circulation determined or at least influenced by the nominal interest rate (Laidler 1989), real interest rate (Friedman 1956), the expected inflation rate (Laidler 1991), or is it a passively determined variable (Keynes 1923)? Maybe the velocity of money is systematically related though mostly insensitive to interest rates, as evidence contained in Friedman (1987) suggests. In my rendition of the QTM there is no need for discussion as to the degree of influence of one determinant on velocity, just as in standard price theory there is no need to discuss the degree to which certain factors determine prices, e.g., preferences as opposed to incomes.

What is clear is that velocity is necessarily determined by all variables on the right hand-side of the equation. *Ceteris paribus*, velocity will increase if: 1) the general price  $P$  level rises, 2) the quantity  $Q$  of goods and services transacted for increases, 3) total indebtedness or issues of bank-created credit decrease (in which case both  $\Delta L_t$  and  $\Delta B_t$  are negative), 4) net equity purchases, 5) positive current account balances, 6) the true money supply  $TMS$  declines, or 7) the stock of money held in reservation balances  $M_R$  increases.

I will end by listing the advantages of using the quantity theory of money developed herein over other approaches. Before doing so, however, I wish to reiterate my hesitation in using the chosen title of this article. The quantity theory of money, loosely stated in all of its variants, is just a statement about how changes to the money supply affect the general price level. Stated in such a way it is really just a formalization of the law of diminishing marginal utility. As the units of a good increase (in this case money) the usefulness of each unit decreases (the value of each subsequent unit decreases). The law of diminishing marginal utility can be formalized for money in a way that it cannot be for other goods owing to the fungible nature of the money supply. All units are valued equally, thus instead of each subsequent unit being valued less than its predecessors, all units will see their value diminished equally. If this is the contribution of the quantity theory of money I would hazard to say that the pages of spilled ink over its validity and importance are much ado about not much.

I would have preferred to call this article "The Monetary Exchange Theory of Velocity", but I doubt many would understand it in the way I intend. "Exchange" in this title refers not narrowly to those that create income but more broadly to those that settle expenditures that will satisfy the purchaser in the past, present and future. It concerns velocity as this is the explained variable. Thought of this way, the traditional QTM would be better stated as the "Quantity Theory of Prices".

This title too is deficient in its use of the "theory". There is nothing conjectural about any of the variants of the QTM, the present case included. It is a tautology not in need of empirical testing. As such, from here forward I prefer to call the statement created here as the "Exchange Theorem of Velocity" (ETV). Admittedly this is not as catchy as the Quantity Theory of Money, but it is more honest.

$$V = PQ - \Delta L_t + \Delta E_t + CA_t - \Delta B_t / (TMS - MR)$$

The reasons for favouring ETV over the QTM are as follows:

1. The price level  $P$  removes distortions that may result from relying on debt-based financing. Prices are composed of those goods that trade at par value, and those

that trade at market. The debt-based portion of exchanges housed in the numerator of the ETV ( $CA_t - (\Delta B_t + \Delta L_t)$ ) trades at a price, but that price is par and set in advance. As such this variable is not subject to change by alterations to aggregate goods' expenditure  $PQ$  or the amount of money directed to the transactions portion of the money supply. On the other hand, the price level  $P$  is useful in a new way that is not immediately apparent in traditional QTM's owing to its relevance to the prices of goods and services, accounting for expenditures made to settle prior debts.

2. The money supply in the ETV is better defined than in other variants. Transactions versions of the QTM focus narrowly on money's role as a medium of exchange. Income versions require money to be held as a cash balance. The ETV approach makes use of both roles and as such produces a velocity that incorporates money's ability to facilitate transactions as well as serve as an uncertainty hedge through a cash balance.

3. The ETV shares with the transactions versions of the QTM a broad focus on all monetary exchanges.

4. That old couplet that economists over a certain age will remember becomes useful again: "Money's a matter of functions four, a Medium, a Measure, a Standard, a Store" (Milnes 1919: 55). In the ETV, money functions as a medium of exchange as the residual  $TMS - M_R$ ; money serves as a store of value in the reservation demand  $M_R$ ; money is a measure of value as the nominal amount of current goods and services' expenditure  $PQ$ ; finally, money in the ETV acts as the standard of deferred payments for all those loans incurred in the past which are being settled in the present. These debts include foreign loans on current account, banking sector debt from demand deposit deleveraging and broader financial sector debt through changes to  $\Delta L_t$ .

5. Importantly, loans as a funding source are accounted for due the recognition that not all loans represent a renunciation of purchasing power by someone in the economy.

a) Loans on current account are a transfer of purchasing power. Since they are cross-border there is a "free lunch" created for recipients of such loans, at least until they are repaid. Upon repayment (i.e., when the current account

turns positive) domestic individuals trade away their purchasing power to a foreign individual.

b) Through its ability to create unbacked credit, the fractional-reserve banking system allows for expenditures to occur which also do not represent a strict transfer of purchasing power. As a result, any change in bank-created credit over the time period in question will also represent a "free lunch" – money exchanges will be facilitated that did not require a reduction in spending by some other member of the economy. Since the credit facilities of the fractional-reserve banking system are well-known for their ability to instigate crises, an understanding of deleveraging and leveraging through bank lending enables us to better understand the effects on prices in general and changes to the velocity of circulation that must result.

6. Prices are not sticky by assumption, as in much Keynesian literature.<sup>9</sup> At the same time, prices are not the variable necessarily enticing changes to the level of expenditure. Instead the price level  $P$  is the result of the conscious choice among individuals to divide their incomes between repayment for past expenditures  $\Delta L_t$ , payment for present consumption, capital and intermediate goods expenditures  $PQ$ , payment for new equity purchases  $\Delta E_t$ , and repayment of foreign debt incurred in the past  $CA_t$ . In this way the ETV is influenced by Hülsmann (1997) and Bagus and Howden (2011) who argue that prices are not the variable guiding purchase decisions but are rather the result of the demands to change the quantities of goods consumed and produced. It differs from this conclusion in the sense that prices in the ETV also serve as a constraint on how many goods can be purchased relative to the reservation demand for money  $M_R$ .

7. The ETV rectifies the failure of the QTM during the recent spate of unorthodox monetary policies to explain the lack of price inflation in the face of large expansions of money supply. One explanation that follows from the ETV is that new money creation was absorbed by the stock market as equities were the recipients of much of this fresh money creation (as in Machlup 1940: chap. 4 esp. 47-48). ]

<sup>9</sup> Keynesians do not have a monopoly on this claim. A recent attempt to formulate an equation of exchange more amenable to the Austrian economist includes some degree of short-term price stickiness (Evans and Thorpe forthcoming).

8. Finally and perhaps most importantly is the emphasis placed on velocity as an explained variable. No longer is it merely included as an error variable that must necessarily balance the relationship between the money supply and the amount of aggregate expenditure it produces. Although conceptually similar to its QTM variants, velocity in the ETV is the necessary outcome that individuals consciously create through their demand to expend income. Furthermore, it is negatively related to debt creation – including international, bank-created and more conventional – and as a result is determined by the propensity to borrow, which ultimately relies on interest and expected inflation rates. As a result velocity is a proxy for the propensity to spend – both in terms of consumption and investment expenditures. One implication of this final point is a new method to identify periods of recession that do not rely the interaction between prices and quantities of goods produced (as is the case with GDP), but rather on the desire (or ability) of individuals to make expenditures. This final possibility is elaborated on in Howden (2013).

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## *Federal Reserve Independence: A Centennial Review*

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**Abstract:** Implicit in monetary models and policy prescriptions is the assumption that the Fed is independent of political and bureaucratic influence. We challenge this assumption. We consider three channels through which the independence of the Fed has been compromised over its 100-year history; debt accommodation, political influence, and the bureaucratic structure of the Fed. Future research needs to address how these separate influences have become operational, the mechanism of their operation, and their interaction. We argue that contextualized anecdotal histories are necessary to corroborate the existing empirical studies and to inform future studies.

**Key Words:** Federal Reserve, central bank independence, monetary policy, robust political economy

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*“...If Government wanted money, it should be obliged to raise it in the legitimate way; by taxing the people; by the issue and sale of exchequer bills, by funded loans; or by borrowing from any of the numerous banks which might exist in the country; but in no case should it be allowed to borrow from those, who have the power of creating money.”* — David Ricardo, 1824 [2004], 283

## 1. Introduction

Robust political economy sets out to incorporate the concerns for the epistemic and motivational limitations of humankind into political economy expositions (Boettke and Lesson 2004). The dearth of attention given to these concerns in prevailing monetary models and policy prescriptions suggest that the economics profession largely holds the Fed to be independent and thus assumes the role of Adam Smith’s ‘man of system’ as it sets out to find the technically optimal monetary policy course (Bernanke 2010; Smith, 1759[1976], VI.ii.2.17; Toma 1991, 158). Rather than entering as fundamental parameters, considerations for robust political economy often appear only as afterthoughts in monetary expositions. This professional stance is likely due to both the independent design of the Fed and the economic profession’s role in managing it.

Yet, the performance record of the Fed over its century existence suggests that even in comparison to the flawed National Banking system, the Fed has failed to achieve macroeconomic stability (Selgin, Lastrapes, and White 2012).<sup>3</sup> The economics profession has either been unable to properly specify policy models for the Fed or it has been unable to remain independent of political influence. While we hold that there exist insurmountable epistemic complexities in crafting optimal monetary policy—and that these complexities are likely to be the underlying reason for the ensuing motivational problems—the Fed’s unwillingness to adhere to the accepted monetary policy rule leading up to the financial crisis demonstrates even a modern failure to remain independent of influence (Taylor 2009).

To better understand the channels through which pressures are exerted on the Fed, as well as the extent of these influences, we survey the existing theoretical and empirical evidence, building on previous surveys (Caporale and Grier 1998; Williams 1990). We separate the influences on the Fed into three distinct categories; deficit accommodation, political influence, and the influence from the bureaucratic structure of the Fed itself.

<sup>3</sup> For a critical comment see Miron (2012).

A proper accounting of these influences suggests that the concerns of political economy need to be incorporated into monetary structures, models, and prescriptions.

## 2. Debt Accommodation

Buchanan and Wagner (1977[2000], Ch. 8) famously argued that inflation is caused by the expansion of the money supply in order to accommodate budget deficits. Blinder (2000, 1429) wrote from his experience at the Fed:

...outsized fiscal deficits and/or large accumulations of public debt (relative to GDP) put upward pressure on interest rates, which may induce a more accommodative policy from the central bank.

The entanglement of politics and public debt is not a new problem. Adam Smith warned about the ‘juggling tricks’ that nations would engage in cycling through debt, deficits, and debasement (Boettke and Beaulier 2009). Rather than reforming their unsustainable deficit spending, politicians would prefer to turn to inflation (Smith 1776[1976], V.iii.61). Alan Greenspan (2007, 35) recalls that, in the classroom, Arthur Burns summarized inflation succinctly as “Excess government spending...”

Using a simple analysis of data from 1946–1974, Buchanan and Wagner find that the Fed has accommodated budget deficits by increasing its holding of government securities, concluding that “The ‘facts’ suggest that the actions of the Federal Reserve Board have not been independent of the financing needs of the federal government” (1977[2000], 120). This fits with the well-established empirical finding that effective fiscal policy requires accommodative monetary policy (Blinder 1982; Canzoneri, Cumby, and Diba 2011; Fair 1978; Freedman et al. 2010).

However, early studies examining the effect of budget deficits on monetary growth or inflation, were

mixed. Hamburger and Zwick (1981), Niskanen (1978), and Levy (1981) found a relationship, while King and Plosser (1985), Faust and Irons (1999), Dwyer (1985), and Barro (1978) did not. McMillin and Beard (1982) and McMillin (1981) found the evidence inconclusive. Bradley (1985, 411) criticized these earlier studies:

...the reduced-form money-growth equation cannot determine if the money supply response to an increase in federal debt comes from the private sector or from the monetary authority. Money growth which is generated from the accommodation of increased money demand has a different set of consequences than money growth which is initiated by the monetary authority.

Bradley (1985, 429) avoided this complication by using direct data from the Fed's policy instruments rather than the money supply. He found evidence that deficits do lead to expansionary monetary policy. Blinder (1983), using budget deficits and reserves from 1961-1981, also found a relationship.

### 3. Political Influence

Political influence, outside the context of deficit accommodation, can also be exerted on the Fed in order to boost reelection chances or to provide accommodation for specific fiscal policy initiatives. This influence can exert itself through both the executive and legislative branches.

#### 3.1 Executive Branch Influence

Since the Banking Act of 1935, seven of the twelve members of the Board have been appointed by the President to serve 14 year terms, though it is customary for Board members to retire before they serve a full term (Morris 2002, Ch. 5). Since 1977, the President also selects two members of the Board to be the Chairman and Vice Chairman for four years. Starting in 2010, the President also appoints a Vice Chairman for Supervision.

These appointments are more than just ceremonial (Krause 1996; Maisel 1973, Ch. 6). The Chairman represents the "public face" of the Fed and holds

tremendous power over the discussions of the FOMC (Silber 2012, 150). In addition, the Chairman holds the final appointment power over all the appointments within the Fed and holds the agenda-setting power (Havrilesky and Katz 1992, 112; Meade and Sheets 2005, 676; Silber 2012, 150). A strategically appointed Vice Chairman can also have an effect on monetary policy by ensuring the administration a staunch advocate on the FOMC (Havrilesky, 1993). Similarly, appointees can be relied on to provide information on the future course of policy.<sup>4</sup> Presidents can also exert significant pressure to resign on unaccommodating board members (Hyman 1976, 299; Kettl 1986, 75; Meltzer 2009a, 135).

Several studies find that appointment power has been used to influence monetary policy (Auerbach 1985; Chappell, Havrilesky, and McGregor 1993; Hakes 1990; Havrilesky 1995a, Chapter 9; Krause 1994; Maisel 1973). Havrilesky and Gildea (1991 & 1992), find that from 1951-1987 presidents have tended to appoint Board members who voted in their favor early on in their administrations, but as elections approached presidents tended to appoint Board members who appeased special interest groups.

There is some dissent. Wallace and Warner (1984) argue that there isn't substantial evidence to declare if there is influence on monetary policy or not looking at the Johnson, Nixon, and Carter administrations. Caporale and Grier (2005a, 87) find that changes in presidential administrations do not result in large changes in monetary policy. Caporale and Grier (1998, 418) don't find evidence from 1961-1996 to support the power of appointment, instead finding that Democratic presidents influence policy even if the Chairman was appointed by a Republican. Over the same range, they also find that Fed insiders provided significantly tighter policy. Woolley (1985, 116) argues that appointment power is important, but has limits.

Governors appointed by Democratic administrations tend to have records of voting for monetary looseness while Governors appointed by Republican administrations tend to vote for tighter monetary policy, fitting with established stereotypes (Havrilesky 1987; Hibbs 1977 & 1987; Keech 1995; Puckett 1984; Woolley 1988).<sup>5</sup> Potts and Luckett (1978) found that

4 Governor James Vardaman, appointed by President Truman, did this throughout the Truman administration (Meltzer 2009a, 88).

5 While the parties do have these stereotypes, each

presidential administrations influenced the ordering of the Fed's priorities in the Fed's Annual Report. Chappell, McGregor, and Vermilyea (2005), using evidence from the voting records, memoranda, and the transcripts of the FOMC during the tenures of Burns and Greenspan, find that partisan influences played an important role in the decisions of FOMC members. In addition, Fed employees have also disclosed that the political influence on monetary policy was frequently discussed off-the-record during the Volcker tenure (Havrilesky 1995a, 35). Weintraub (1978), using evidence from 1953-1977, finds that Fed policy shifted during administration transitions.

Other studies argue that while there is a strong executive branch influence on monetary policy, the pressure does not appear to operate through the appointment process (Caporale and Grier 1998 & 2005b; Grier and Neiman 1987; Beck 1982 & 1984). Thus, there likely are informal channels of influence that the executive branch has utilized to exert influence. For example, while Chappell, Havrilesky, and McGregor (1993) find that appointment power is the primary way a president influences policy, they also find that the current president can influence Board members appointed by previous administrations.

One of these informal channels is through presidential meetings with the Chairman. Weekly meetings between the Chairman and administration officials, that have been a tradition since 1936, are a likely source of influence (Axilrod 2011, 211; Kettl 1986, 57; Reagan 1961, 69; Rubin and Weisberg 2004, 194). While nominally these meetings are to coordinate policy efforts, these coordination efforts tend to impede the operational independence of the Fed (Meltzer 2009a, 88). Particularly since the Fed was explicitly set up independently of the Treasury in order to avoid being pressured into financing profligate government spending (Timberlake 1993, 316 & Ch. 13).

In addition to meetings, administrations can make their desired monetary policy course known through media releases, bringing public pressure to bear on the Fed. Havrilesky (1988) creates an index of monetary policy signals from presidential administrations to the Fed using articles in the *Wall Street Journal* from 1979-1984 that contained administration officials urging Fed officials

to change policy. Havrilesky finds that these signals have an impact on the money supply, though a similar index for congressional influence on the Fed did not. Froyen and Waud (2002), using articles from the *Wall Street Journal* from 1965-1994, find significant effects of administrative signaling to the Fed over the period, but only during the Burns and Volcker tenures for the chairmanship sub-periods.<sup>6</sup>

Executive branch influence on monetary policy is likely to be strongest prior to a presidential election to aid in reelection bids. Committee members appointed by presidents from both parties have been found to exhibit changes in voting patterns as elections approached, suggesting an adjustment of Fed policy to promote the electoral success of their respective party (Bach 1971; Grier 1987; Maisel 1973, Ch. 7). Timberlake (1993, 356) finds evidence that Fed activity before and after elections from 1964-1980 suggest that policy went from restrictive to stimulative during election years, and then to restrictive again following the election.<sup>7</sup> Williams (1990) finds that from 1953-1984 there was a relationship between dips in presidential approval ratings and monetary growth. Tufte (1978, Ch. 2) finds support from 1948-1976 for the claim that the incumbent president uses monetary policy to aid in their reelection. Luckett and Potts (1980) dispute Tufte's evidence, arguing that after normalizing his data for concomitant economic events, the data can't support or reject Tufte's thesis. Belton and Cebula (1994), using a model they construct to measure the underlying behavior of the Fed, find that from 1973-1984 there is some limited evidence to suggest that presidential administrations do exert some influence on monetary policy. Meiselman (1986) finds some evidence in support of presidential election cycles in election years from 1960-1980, but not in the preceding period from 1948-1956.<sup>8</sup> Grier (1987 & 1989) finds that from 1961-1982 there is a significant correlation between presidential election cycles and monetary growth.<sup>9</sup> Golden and Poterba (1980) argue that the gains in popularity from manipulation of monetary policy are too small to be worth presidential manipulation, but Maloney and Smirlock (1981), using Gallup poll presidential approval ratings from 1957-

6 See also Froyen, Havrilesky, and Waud (1997).

7 See also Newton (1983, 112).

8 See Fand (1986) for a comment on Meiselman (1986).

9 Alesina, Cohen, and Roubini (1992) find that Grier (1987 & 1989) holds true until the 1980s, but does not hold true from 1980-1987.

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administration acts independently, so there are limits to Republican and Democrat dummies in these models (Caporale and Grier 1998, 411).

1976, find evidence that incumbent presidents can influence monetary policy to aid reelection bids. Beck (1984) and Maier (2002) argue, however, that there isn't evidence that monetary policy caters to political electoral pressures, though Maier (2002) stresses that discerning between rhetoric and reality in regards to central bank independence makes these measurements difficult.

In a review of political business cycles, Drazen (2000) concludes that "...models based on manipulating the economy via monetary policy are unconvincing both theoretically and empirically..." Drazen crafts a model where monetary formation is separate from the direct control of politicians and finds that monetary authorities can accommodate passively.<sup>10</sup> Several studies have found evidence to support the argument that monetary authorities accommodate fiscally-induced electoral cycles in order to avoid the accusation of being political by allowing swings in the interest rates during election years (Allen 1986; Beck 1987; Drazen 2005; Hellerstein 2007; Laney and Willett 1983; Woolley 1985, Ch. 6).

Beck (1993b, 126) argues that new theories have led to better empirical work and in light of that, that the evidence of presidential influence on Fed policy is conclusive in the affirmative. Havrilesky and Schweitzer (1993) find that FOMC members whose career characteristics reflect a closer connection with the central government tend to cast dissenting votes in favor of monetary easement, and that those with more distant connections tend to cast dissenting votes in favor of monetary tightening. Gildea (1993) finds that FOMC members tend to cast their split-decision votes in the favor of the party of the President who appointed them.

### 3.2 *Legislative Branch Influence*

All presidential appointments to the Fed must be approved by the Senate. Waller (1992) finds that this approval power can be significant, especially when the Senate and the White House are controlled by dissenting parties and as elections approach. The Chairman must also report at least twice a year to Congress. Since 1975, this report has included the Fed's monetary supply targets as well as the Fed's explanations for any deviations from previously set monetary supply targets.

Based off his thirty-four years of experience working at the Fed, Axilrod (2011, 11) stated, "The Fed

is essentially a creature of the Congress and responsible to that arm of government." Axilrod argues that the lack of strong formal channels of legislative monitoring and control is countered by strong informal channels.

In making the case for greater congressional control of the Fed, Pierce (1978) argues that Congressional means of control over the Fed have not resulted in measurable impacts on monetary policy. However, Grier (1991) found evidence that Congress does in fact exert influence over monetary policy, finding a significant correlation between changes in the leadership of the SBC and monetary base growth. Similarly, Beck (1993a, 140) argues that while the evidence is hardly conclusive, Congress is not a primary determinant of short-run monetary policy. Belton and Cebula (1994) find that from 1973-1984 congress was able to exert influence on money growth, but not on policy outcomes.

With so many committees in the legislative branch directly or indirectly affected by the issues of money and credit, it is difficult to prevent legislators from attempting to meddle with the Fed (Price 1962, 160). Despite the absence of formal monitoring mechanisms, congressional members can monitor the Fed's performance through media outlets, constituent feedback, and congressional testimony, audits, and reports (Clifford 1965, 362).

Committee members can informally mandate time-consuming public hearings for the chairman, making the Fed their economic policy scapegoat so that congress can pursue short-term electorally focused economic policy without being blamed for the subsequent poor economic performance (Grier 1991; Hetzel 1986, 798 & 1993; Kane 1980 & 1982; Maisel 1973, 155). Greenspan (2007, 150) recalled that oftentimes congressional hearings became "...a theater in which I was a prop – the audience was the voters back home." It might be precisely because the Fed is nominally an independent agency that the public does not perceive the relationship between deficits and inflation, and thus don't hold elected officials accountable for monetary mischief (Buchanan and Wagner 1977[2000], 114).

At times, congressional threats against the Fed have included threats of auditing the Fed's expenditures, putting the Secretary of the Treasury back on the Fed Board, threats against the budgetary autonomy of the Fed, threats of shortening the term limits, threats of packing the FOMC, threatening the impeachment of the Chairman and even the entire FOMC, making all FOMC

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<sup>10</sup> See also Drazen (2001) and Walsh (2000).

#### 4. The Fed as a Bureaucracy

voting members politically appointed, the centralization of power on the Board of Governors in DC, reducing the roles of reserve banks, abolition of the FOMC, and even threatening to “...cut the head off the Fed System...” (Clifford 1965, 345; Grier 1991, 206; Harrison 1991, 272; Safire 1975, 492; Havrilesky, Chappell, Gildea, and McGregor 1993, 50; Silber 2012, 203-207; Meltzer 2009a, 227).

Buchanan and Wagner (1977[2000], 122), question whether a monetary authority can be truly independent if legislators can, if pushed, “...modify the effective ‘monetary constitution,’ by imposing specific regulations or, in the limit, by abolishing the independence of the monetary authority itself.” Despite being independent of day-to-day influences from the public, Meltzer (2003, 4) argues that “...the public, acting through its representatives, could insist on structural changes, or, without formally changing structures, demand that the Fed undertake new responsibilities or give up old ones. No institution can be independent of this pressure for change.” As Blinder (2010, 125) writes, “Legislators can change that law any day, and in any way, they choose—including abolishing the Fed entirely, which is precisely what Congress did to the First and Second Banks of the United States. Nor is there any question that Congress has both the right and the duty to oversee the Fed’s operations, which it does through periodic hearings and in other ways.”

Even when the legislative measures were not passed, Meltzer (2009a, 225) argues that they still increase congressional influence by making these measures a constant concern. Havrilesky (1995a) finds that the higher the economy’s misery index, the greater the number of legislative bills introduced that threaten to restructure or control the Fed.<sup>11</sup> Havrilesky (1995a) also finds that the expressed opinions of the SBC during the Chairman’s biannual hearing had an effect on the funds rate in the following month. Caporale and Grier (1998) find that from 1961-1996 the SBC leadership had a measurable influence on the real interest rate and that monetary growth is higher under Democratic SBC leadership (Grier 1986, 541).

Perhaps one reason the Fed has been so susceptible to exogenous pressures is because of its structure as a bureaucratic entity interested in prestige, budget-maximization, and self-preservation. One of the reasons that the Fed is so responsive to political pressures is because of the genuine uncertainty inherent in the tasks they are assigned (Buchanan and Wagner 1977[2000], 123). When faced with having to make tough and often inaccurate predictions, based upon constantly changing data and circumstances, decision-makers are more wont to respond to these bureaucratic pressures. Kane (1993) argues that it is precisely the bureaucratic self-interest inherent in the Fed that prevents monetary reform. An example of this type of public pressure on the Fed occurred when Arthur Burns was the Chairman in 1971. Burns expressed concern that there was a “...campaign... to write me letters to urge more expansion. I will make good on my promises” (Meltzer 2009b, 795). Burns agreed to undertake “...vigorous but sustainable expansion” in exchange for a promise from Nixon to “...keep them off your back” (Meltzer 2009b, 795).

The structure of the Fed within the economics profession also provides a significant channel of influence on monetary policy. The Fed, being one of the largest U.S. employers of economists—and monetary economists in particular—can hold significant sway over the economics profession (Auerbach 2008, 141; Grim 2009; White 2005). In addition to the employment of economists in officer, economist, statistician, and staff positions, the Fed also gives out hundreds of consultant contracts and visiting scholar positions, and has significant power over tenure and promotion, prestige, and even journal access within the economics profession (Grim 2009). In 1993, the Fed employed around 500 economists, not including several research grants given out to a few hundred more (Auerbach 2008, 142). Friedman (as quoted by Auerbach 2008, 142), in a letter to Auerbach, expressed grave concern over this:

I cannot disagree with you that having something like 500 economists is extremely unhealthy. As you say, it is not conducive to independent, objective research. You and I know there has been

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11 Overall congressional challenges to the Fed’s structure have demonstrated a very low success rate of succeeding (Havrilesky 1995b, 96), which could be due to either the Fed delivering the desired monetary policy, or, the ineffectiveness of congressional challenges.

ensorship of the material published. Equally important, the location of the economists in the Fed has a significant influence on the kind of research they do, biasing that research toward noncontroversial technical papers on method as opposed to substantive papers on policy and results.

Reportedly, the jobs at the Fed are quite lucrative compared to academic jobs, with higher salaries and better journal access, statistical assistance, and research time (Auerbach 2008, 143). Shughart II and Tollison (1983) find a positive relationship between the number of Fed employees and the monetary base, arguing that the money supply is expanded to support the bureaucratic growth of the Fed. Similarly, Toma (1982) argues that the self-financing nature of the Fed, and thus their ability to generate discretionary profits, influences monetary policy. Toma and Toma (1985a) find that Fed Banks that generated negative publicity for the Fed saw a decrease in their total annual budget growth rates.

Auerbach (2008, 143) reports that all Fed publications have to be "...sent to the Board in Washington for editing and approval." Reportedly, Alan Blinder's tenure as the Vice Chairman of the Fed was short-lived because he challenged the views of senior staff (Grim 2009). Even Nobel Laureate Paul Krugman was reportedly uninvited to Fed conferences he had previously attended after he criticized the Fed (Grim 2009). In addition to being able to influence research, the Fed, due to its regulatory power over the banking industry, also discourages criticism of its policies from the banking industry itself (Allison 2012, 34).

Conformity, group-think, and cognitive dissonance have all been found to be problems at the Fed (Eichengreen 2010; Epstein and Carrick-Hagenbarth 2011 & 2012; Marcussen 2006, 189; Mayer 1993; Shiller 2008). White (2005) analyzed the potential influence that the Fed might have on the economics profession:

...an academic economist who values the option to someday receive an offer from the Fed, either to become a staff economist or a visiting scholar, faces a subtle disincentive to do regime-challenging research. To repeat Fettig's

(1993) characterization of Milton Friedman's view: 'if you want to advance in the field of monetary research ... you would be disinclined to criticize the major employer in the field.' ...Fed-sponsored research generally adheres to a high level of scholarship, but it does not follow that institutional bias is absent or that the appropriate level of scrutiny is zero.

Perhaps this is why Friedman (1982, 102) observed, that "With perhaps a few minor exceptions, the system has repeatedly been unable or unwilling to change its methods of operation in order to benefit from its own experience." The economics profession has failed to apply the basic concepts of economics to an institution largely under the economic profession's control and recognize the structure of incentives within the bureaucratic structure of the Fed.

#### 4.2 *Special Interest Group Influence*

When presidents appoint, with the approval of the Senate, seven of the twelve members of the Board, they are required to appoint "...a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country" (Fed Act Section 10:1). Thus, channels through which the private sector, especially financial institutions, can influence Fed policy also exist. In fact, Rothbard (1984) argues that the establishment of the Fed itself was fashioned by the financial industry as a cartelizing device, similar to how other industries turned to government control for monopolies and cartels created through government oversight (also see Bagus and Howden 2012).

Ostensibly, the selection of the Board, according to a 1935 House Committee on Banking, is meant to create "...not the opinion of a majority of special interests, but rather the well-considered judgment of a body that takes into consideration all phases of the national economic life" (Reagan 1961, 70). This proves to be far more difficult in practice. While the representation of the Board is mandated to represent different geographic interests and industrial interests, at times there have been attempts to change the industries represented (Reagan 1961, 70).

A 1976 staff report for the House Committee on Banking found the Fed to be dominated by big businesses and the banking industry (Reuss 1976). Similarly, a 2011 GAO report found that there were multiple potential conflicts of interests with commercial entities and a lack of transparency in regards to the Fed's financial crisis undertakings.<sup>12</sup> Epstein and Carrick-Hagenbarth (2010 & 2011) find many relationships between financial economists and private-sector financial institutions. Auerbach (2008, 55) details how the Greenspan Fed had issues with employees receiving expensive meals, gifts, and sports tickets, as well as a revolving door between the regulated and the regulators. Calabria (2012) suggests this trend has continued with Obama's appointment of New York investment banker Jerome Powell as Governor in 2012. Allison (2012), Zingales (2012), Sheehan (2010), and Taylor (2009 & 2012) all explain how the actions of the Fed in the wake of the financial crisis were plagued with special interest group pressures.

## 5. Conclusion

The influence on the Fed through these separate channels must enter as fundamental parameters, not afterthoughts, into monetary models for the policy prescriptions that follow to be relevant. As measured by the extent to which our monetary policy theories (*and theorists!*) are directly employed to conduct monetary policy, relevancy is, in fact, the purpose behind our monetary expositions. As Caporale and Grier (1998) conclude, the "...results are too strong to be swept aside..." Even "...the very appearance of political accommodation may threaten the viability of the Fed as a central banker" (Munger and Roberts 1993, 89). The ostensible autonomy of the Fed

has likely been cultivated by precisely the groups capable of exerting influence on its policy (Beck 1993a; Havrilesky 1991b, 65; Meltzer 1982).

Yet, we are also forced to admit that shortcomings in the empirical studies on Fed independence do exist. While we believe the progression of the literature in measuring these separate influences has resulted in more refined and better informed empirical studies, the lack of more comprehensive empirical studies suggest that empirical complexities abound. Studies that fail to account for other areas of influence being exerted on the Fed, and the way that they interact, fall disconcertingly short of capturing the full extent of the pressures being exerted on the Fed. It is likely that pressures from each of these separate channels have influenced Fed policy. It is also likely that the type and magnitude of this influence has varied across time in different political and economic circumstances, making it extremely difficult to craft a complete model of influence on the Fed. For example, a key piece of a president's platform that may require accommodation outside of the electoral cycle may bias electoral cycle studies. Other economic and social problems may detract politicians at varying times and to varying extents away from the concerns of monetary policy. In addition, the very models and tools that the Fed employs to carry out its desired policies—however imbued—change over time, further complicating empirical studies.

Historical context is necessary for understanding when these separate influences were operational, the mechanism of their operation, and their effects and interaction with each other. Anecdotal work would corroborate the existing empirical studies and perhaps convince the economics profession—despite its deeply vested interest in maintaining the current monetary structures—to apply the basic concepts of robust political economy to our monetary expositions.

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12 [http://www.sanders.senate.gov/imo/media/doc/d1218%20\(2\).pdf](http://www.sanders.senate.gov/imo/media/doc/d1218%20(2).pdf)

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## *A French Predecessor of the “Austrian” Theory of the Business Cycle – Marcel Labordère on the American Crisis of 1907*

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**Abstract:** The history of economic thought has not been generous with Marcel Labordère. Either he has been neglected or he has been treated as a rather insignificant representative of the overinvestment theory of the business cycle. Yet, it can be argued that he anticipated the main components of the Austrian Theory of the Business Cycle. Four years before Ludwig von Mises he applied Knut Wicksell’s distinction between the money rate of interest and the natural rate of interest to an explanation of the *mal*investments (not *over*investments) that emerge in the production structure during the boom phase. The main problem of his theory is that Labordère chose a rather confusing manner of representation. The present paper therefore arranges his arguments and works out his valuable contribution.

**Key words:** Austrian business cycle theory; malinvestment; Ludwig von Mises

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## 1. Introduction

The Austrian business cycle theory (ABCT) essentially rests upon two cornerstones: the capital theory first indicated by Carl Menger ([1871] 2007) and later developed by Böhm-Bawerk (1930); and Wicksell's ([1898] 1936) idea of a cumulative process of inflation (or deflation) kicked off by a divergence between the natural rate of interest and the money rate of interest. In 1912, Ludwig von Mises ([1912] 1953) combined these two theories in his Habilitation treatise (see Wagner 1999, p. 67), thusly creating what would later become known as the ABCT. Although the ABCT has later been restated and reformulated several times by Mises himself and others, the following exposition relates to the original version of 1912 because it much more resembles Labordère's theory than do later versions. Besides, recent research has shown that the original formulation of the ABCT is more consistent than later versions anyhow (Braun 2012).

In the present paper, it is argued that the independent French gentleman Marcel Labordère had published fundamentally the same theory in 1908 in the paper "Autour de la Crise Americaine" [About the American Crisis] in the *Revue de Paris*. The paper was later reprinted under the title "Autour de la Crise Americaine de 1907 ou Capitaux-réels et Capitaux-apparents" [About the American Crisis of 1907 or Real Capital and Apparent Capital] (Labordère 1948). It contained all important elements of the Austrian theory of the business cycle and combined them in an explanation of the American economic crisis of 1907. While section 2 contains some background information on Marcel Labordère and his paper, sections 3 and 4 present Labordère's line of reasoning. They work out the existing parallels between the business cycle theories of the Austrians and Labordère and, in this, concentrate on the two cornerstones of the ABCT mentioned above. Section 3 focuses on the "real" side of the question and deals with the processes that are expected to arise within the capital structure of an economy during the business cycle. The present paper demonstrates that there is strong agreement between the two theories on account of both assuming that, during the boom, too many long-term investments are undertaken compared to short-term investments, resulting in a lack of real funding at some point. Section 4 relates to the monetary side of the question and clarifies how both the Austrians and

Labordère blame the cause for the malinvestments that occur during the business cycle, described in section 3, on misinformation provided by the interest rate set by the banking system.

## 2. Marcel Labordère and the classification of his business cycle theory

Little is known about the man who seems to have anticipated a theory that earned Friedrich von Hayek the Nobel Prize in 1974. Presley (1979) analyzes the sparse correspondence Labordère conducted with John Maynard Keynes and Dennis Robertson, the only two economists with whom he had close contact. Apparently, Labordère was a self-taught economist who ventured into writing for French periodicals on monetary matters as a consequence of losses he incurred in reckless business and speculation during the American boom of 1906 and 1907 (Presley 1979, pp. 803 f.). Presley (1979, p. 804) does not provide us with Labordère's date of birth, but he must have been born in either 1868 or 1869, as he died in Paris in 1946, 77 years of age. Robertson (1948) describes him as "a very strange but very likeable old man, rather deaf and with a long white beard, much absorbed in a religion strangely compounded of Buddhism and Islam, and with peculiar political views which debarred him from accepting food or drink at my hands." With Keynes Labordère seems to have been on rather intimate terms. According to Felix (1999, p. 232), Keynes found "a sympathetic pen pal" in Labordère, and "[t]he two corresponded for the pure pleasure of it for a third of a century." It is not sure whether Keynes had some influence on the development of Labordère's economic thought after the latter had published his 1908 article. Presley (1979, p. 809) writes that by 1935 Labordère had abandoned his original position for what appears to be a more Keynesian point of view. Yet, according to the same author (Presley 1979, p. 804), by 1938 Labordère regarded Röpke's (1936) *Crises and Cycles* "as a book that he could unreservedly endorse," which seems to indicate that he didn't change his point of view too much.

Concerning Labordère's business cycle theory of 1908 Robertson (1948) states that Labordère "always disclaimed any particular originality for this article." But, on the other hand, as Robertson continues, "he did not appear to have any acquaintance with the works of those economists whose approach has most affinity with his

own.” These short and somewhat contradictory utterances contain all that we know about potential influences on Labordère’s theory. In contrast, it seems quite certain that Labordère had great influence on others. According to Presley (1979, p. 807), there is little doubt that Labordère’s article on the American crisis of 1907 had a “fundamental influence” on the theory of the crisis put forward by Robertson (1915).

Presley (1979, pp. 805 f.) classifies Labordère’s business cycle theory as an over-investment theory, much like the theory developed by Spiethoff (1902). He (1979, p. 810) concludes in saying that “the name of Marcel Labordère therefore is yet another name to add to that group of economists who believed that the crisis was caused by over-investment.” The following discussion will reveal that this is a misclassification as Labordère was not concerned about *over*-investment, but rather about *mal*-investment. In this, he anticipated Austrian Business Cycle Theory (ABCT). According to Mises (1949, p. 556) “[t]he essence of the credit-expansion boom is not overinvestment, but investment in wrong lines, i.e., malinvestment.”

It goes without saying that the following discussion does not read anything into Labordère’s article that it does not actually contain. On the relevant points, his arguments are illustrated by means of direct quotes. However, his thoughts are arranged in a more coherent manner. His own exposition is at times a bit clumsy. To give an example, his elucidation of credit expansion is not followed up by a discussion of the money rate of interest and its relationship to the natural rate of interest, as one would expect. Instead, he inserts an imaginary dialogue between an American and a European banker about their respective banking systems. When he later comes to introduce the two interest rates, he does not directly refer to the process of credit expansion any further. Any reader not conversant with the problems dealt with would be at a loss with his arguments if they weren’t streamlined considerably.

### 3. The role of capital theory

One of Carl Menger’s contributions to economic science was his de-homogenization of the production process. Whereas earlier generations of economists only distinguished between consumption and production *per*

*se*, Menger ([1871] 2007) introduced the idea that the production process is separated into several successive, time consuming stages (see Skousen 2007). He did so, of course, not to build a basis for the explanation of the business cycle, but in order to explain the value-formation of producer goods. Eugen von Böhm-Bawerk, his most well-known student, took over Menger’s vision of the production process and erected his opus magnum, *The Positive Theory of Capital*, on this foundation; his treatment of capital, in particular, builds upon Menger’s contribution. According to Böhm-Bawerk (1930, p. 22), capital is nothing more than the “complex of intermediate products which appear on the several stages of the roundabout journey” of the production process. He also argued – as part of his explanation of the existence of interest – that production processes that are more “roundabout”, that is, that take a longer time until they produce consumable output or, in still other words, that encompass a higher amount of intermediate stages, are more productive than shorter or less “roundabout processes” – at least when they are “wisely chosen” (Böhm-Bawerk 1930, pp. 78 ff.). More roundabout production processes would be very profitable for entrepreneurs as these processes are supposed to be more productive. Yet, according to Böhm-Bawerk, it is not at the discretion of entrepreneurs to effortlessly start more roundabout production processes. The precondition of any extension of the production process is that, while the process is still ongoing, the subsistence of the participating factors of production – especially workers – is ensured. A *subsistence fund* is necessary, the function of which is “to maintain the community from the time that their original productive powers are put in motion till these powers obtain their final and mature fruits” (Böhm-Bawerk 1930, p. 319). In short, longer production processes are more productive, but they can only be undertaken if they can be financed by an ample amount of the means of subsistence.

Mises ([1912] 1953) employs this capital theory in order to illustrate the changes that, in the course of the trade cycle, appear within the production structure and that, in his point of view, cause the boom and later the bust. He argues that the whole boom–bust–cycle is characterized by a collective error of judgment concerning the available amount of means of subsistence, that is, the subsistence fund. The boom in investments during the upswing of the trade cycle rests upon the illusion of an increase of the subsistence fund (Mises [1912] 1953, pp. 361 f.). Based on this illusion – and given that longer

production processes are more productive than shorter ones – long-term investments, in particular, will be undertaken, and thus the “average period of production” will be lengthened (*ibid.*, p. 361). Now, if the subsistence fund had indeed increased, the economy would become more productive and reach a higher level of real income. It would be possible to provide the people participating in the lengthened production processes with the consumer goods they want and need; however, if, as we have assumed, the increase of the subsistence fund was only an illusion,

[a] time must necessarily come when the means of subsistence available for consumption are all used up although the capital goods employed in production have not yet been transformed into consumption goods. [...] The means of subsistence will prove insufficient to maintain the labourers during the whole period of the process of production that has been entered upon (Mises ([1912] 1953, p. 362).

As a consequence, the production process has to be modified again. Some of the new projects turn out to be malinvestments that have to be abandoned, which is the same as to say that an economic crisis breaks out. The next section deals with the question as to how the illusion of an increase of the available subsistence fund can come about. What we are concerned with in this section is how Mises and Labordère conceived the nature of systematic malinvestments in the production structure. Mises’s exposition, as we have seen, heavily draws on Böhm-Bawerk’s capital theory.

It remains to be presented how Marcel Labordère envisioned the problems that occur in the economy during the boom and bust cycle. In order to be able to focus on the “real” economy, that is, on the production structure, without money complicating the issue, he begins with a moneyless economy. A rich countryman, who owns a large acreage and directs many bondmen, manages the production process in his small economy. Labordère (1908, pp. 650 f.) focuses on the problem that is also essential to Böhm-Bawerk’s capital theory. On the one hand, long-term investments in fixed capital – like an irrigation plant, an artificial fishpond, or a new vineyard – promise to be the more productive the more roundabout

they are. Although Labordère is not completely explicit on this point, it clearly shines through in the following passage:

Of these kinds of fixed real capital, each will commence to procure a net real income to the granary or the cellars [of the countryman] *at a different date*. In consequence, these fixations of capital exhibit, *according to their category* [i.e., according to the length of the respective investment period] a more or less differing profitability (Labordère 1908, p. 651, emphasis added).

On the other hand, Labordère’s countryman must be careful not to commence an excess of roundabout processes. It is necessary in this world as well to provide the bondmen (and himself) with sustenance until the final product is obtained. In order to express this thought, Labordère (1908, pp. 650 f.) introduces the term “disposable capital” (*capitaux disponibles*). This term has exactly the same function as Böhm-Bawerk’s “subsistence fund” and constitutes the share of the product of nature – that is, in our countryman’s world, of consumer goods – that can be handed over to bondmen while they work on the longer processes (*ibid.*).

In the following, Labordère explains the boom-bust-cycle in a way very similar to Mises. He bases his theory on the relationship between fixed capital – which represents higher productivity – and disposable capital – which stands for the subsistence fund. As long as the countryman is reasonable and stays within the limits drawn by the disposable capital, new and productive investments can be undertaken and finished as the years go by (*ibid.*). Labordère thus describes what Roger Garrison (2001, pp. 57 ff.) would later call “sustainable growth.”

His discussion of the business cycle, that is, unsustainable growth, begins with the assumption that the countryman, in spring, after some favourable seasons of sustainable growth, becomes very confident in his abilities and starts several investment projects at the same time. He desiccates a moor, plants a forest, lays out a vineyard, clears a heather of stones, and finally even starts to build a new village in order to house additional families (*ibid.*, p. 652). In Labordère’s (1908, p. 652) own words, the countryman “has made fixed real capital out of disposable real capital”

(...*d'un pareil capital disponible en nature, il eut fait un capital fixe en nature*). However, if the countryman should happen to be too optimistic concerning the supply of disposable capital, start too many long-term investment projects, and/or overconfidently increase his own consumption, he will end up with too little disposable capital.

At the end of the summer, he realized that his provisions, his reserves of wheat, wine, and all the products the abundance of which made him proud, in other words, that his disposable real capital dwindled (Labordère 1908, p. 652 f.).

What the countryman has to do now, according to Labordère (1908, pp. 652 f.), is to abort several of his projects halfway through, leaving the half-finished buildings to the winter and the snow. He (*ibid.*, p. 653) puts it drastically in saying that the “thing that is half-finished dies and thus washes away every trace of human efforts which it represents.” Furthermore, the countryman not only has to possibly sacrifice his new projects, but even part of his wealth. In order to provide his bondmen, who are now employed to exert the most important current tasks necessary for the next season, with their daily subsistence, he has to sacrifice many sheep and cattle, thus reducing the provisions for the next season (Labordère 1908, p. 653).

In a second step, Labordère (1908, p. 655) leaves the small economy of the countryman and analyzes a whole city state which “offers a complexity of industries which does not fall behind the one the United States of America could offer in 1907.” However, he again abstracts from money, assuming something similar to a socialist administration (*ibid.*). Thus, he is able to once again concentrate on the real side of the issue. According to him, the reason for a crisis in the city state is the same as in the case of the rich countryman; crises appear when “one wants to accomplish too many things too quickly at the same time” (Labordère 1908, p. 658). In order to avoid a crisis, therefore, one has to make sure that not an excess of disposable real capital is transformed into fixed real capital. He illustrates this point by means of the following example: the construction of a new railway line necessitates not only steel, copper, lead, and the rails. At the same time, “proportioned amounts of cotton cloth, sugar,

alcohol, bread flour, necessary for the real wages of the construction workers,” must be in place (Labordère 1908, p. 657). Both the consumer goods and the producer goods mentioned above “must form a harmonious ensemble” (*ibid.*). A crisis breaks out when the harmony between fixed and disposable capital is disturbed. When the disposable capital necessary for the continuation of the production of the railway line does not come forward in the right proportions because too many long-term projects have been started, there is a “rupture of the equilibrium, a crisis, a partial halt in the economic machine” (Labordère 1908, p. 657). At this point it becomes clear that Labordère does not promote an *over*-investment theory of the business cycle, as Presley (1979, p. 805 f.) and Dupont and Reus (1992, p. 77, n. 20) maintain. He does not argue that *too much* has been invested during the boom, but that the investments have been *in the wrong lines*.

What is called overproduction is not an overproduction in the absolute sense (humanity cannot produce too many goods): it is a disproportion in the production of different goods, it is a rupture in the harmony of production. It is, if you will, a rupture in the harmony of the work of humanity; one organ of production becoming too large at the costs of the others; it is the disturbed harmony of the organs. If one wants to see things poetically, it is an episode of war between the Future and the Present: between the Future that wants to move on too quickly and to equip the world for a grown humanity too quickly, and the Present that is in need of something to eat before and that wants to enjoy life. During the convulsions of the crisis, the Future [...] wrests all it can from the Present – everything that the Present has carelessly committed itself to deliver. But the Present will not concur any more. The devastating Chimaera is vanquished and collapses... (Labordère 1908, pp. 657 f.).

According to Labordère (1908, p. 661) – and in conformance with the ABCT (Skousen 2007, pp. 255 ff.)

– the crisis, once it has broken out, cannot be overcome by any means other than saving. He (1908, p. 661) explicitly states that “[t]hings being what they are [i.e. the crisis], only saving will give back to our City without money the supplies of goods, in harmony and proportion.”

He argues that the disproportion between fixed and disposable real capital cannot be healed any other way; most notably, an increase in the *production* of circulating capital, i.e., of consumer goods, is out of the question. That is because the possibility of producing additional consumer goods rests upon the pre-existence of consumer goods in the same way the production of fixed capital does. Therefore, the production of additional circulating capital cannot begin before additional savings have increased the reserves of commodities of our city state by means of which the workers can be paid (Labordère 1908, pp. 660 f.).

#### 4. Credit expansion and the natural rate of interest

So far we have been focusing on the real side of the issue. We presented the way Labordère explained the occurrence of an economic crisis in real terms, that is, in terms of the production and distribution of real goods. His point is that, to avoid a crisis, it is necessary that the different commodities are produced in harmonious proportions. If too many long-term projects are started – i.e., excessive investment in fixed capital – a time will come when the means of subsistence for the participating workers – circulating capital – do not suffice. In this case, the crisis cannot be avoided and some of the long-term projects end up as malinvestments.

In this section, we deal with the question as to how Labordère thought the disproportion in production comes about. In this regard, he anticipates Mises’s ([1912] 1953) application of Wicksell’s ([1898] 1936) distinction between the natural rate of interest and the money rate of interest in the problem of the business cycle.

Like Labordère, Wicksell dealt with a moneyless economy in order to express some of his ideas. In such an economy, goods would be lent and borrowed “in kind,” not in money. The interest rate that competition would bring about in this imaginary economy could be called the “natural rate of interest on capital” (Wicksell [1898] 1936, pp. 102 f.). It would depend “on all the thousand and one things which determine the current economic position of a community” (ibid., p. 106) or, in other words, real factors.

That is because, in his (ibid., p. xxvi) opinion, the supply of real capital is limited by “purely physical conditions.” For the case of a *monetary* economy Wicksell ([1898] 1936, p. 104) argued that, as long as the banking system loans money at the natural rate of interest, the conditions of equilibrium are fulfilled in precisely the same manner as in the moneyless economy. However, as soon as the money rate of interest differs from the natural rate, “the economic equilibrium of the system is *ipso facto* disturbed” (ibid., p. 105, emphasis by Wicksell). The trouble is that the natural rate of interest is unobservable and indeterminate; it is, as Wicksell ([1898] 1936, p. 168) admits, an unknown. Therefore, the deviation of the money rate from the natural rate of interest can happen easily, all the more as the supply of money credit by the banks, as opposed to the supply of real capital, “is in theory unlimited and even in practice is held within fairly elastic boundaries (ibid., p. xxvi).”

Now, in Wicksell’s ([1898] 1936, p. xxvi) theory, a persistent deviation between the two rates of interest leads to a continuous and progressive change in commodity prices. If the money rate of interest should be lower than the natural rate, commodity prices must rise and vice versa (ibid., p. 106). Yet, Wicksell did not extend his theory to an explanation of the business cycle. This was accomplished, in 1912, by Ludwig von Mises. Whereas Wicksell only paid attention to the development of the price level, Mises established a connection between the divergence in the two interest rates and the real economy. According to him ([1912] 1953, p. 366 ff.), when banks reduce the rate of interest below the natural rate by means of an artificial expansion of credit, a force is automatically set in motion which ultimately eliminates the divergence between the two rates – via an economic crisis.

His argument is the following: the natural rate of interest depends, on the supply side, on the size of the available subsistence fund. “The greater the fund of means of subsistence in a community, the lower the rate of interest” (ibid., p. 347). As it is the size of the subsistence fund that, according to Mises, limits the length of the production processes, the natural rate of interest thus indicates to entrepreneurs how long the production processes can reasonably become. If people save a lot, the natural rate of interest will be low and entrepreneurs can start more roundabout production processes.

However, as the natural rate of interest cannot be observed, the only way open to entrepreneurs is to orient

themselves by the money rate of interest. Consequently, when the banking system reduces the money rate of interest below the natural rate by means of an artificial credit expansion, “entrepreneurs are enabled and obliged to enter upon longer processes of production” (ibid., pp. 360 f.). The additional and artificial kind of credit Mises (ibid., p. 264) calls “*circulation credit*.” He contrasts it to “*commodity credit*” which is based on real savings. The expansion of circulation credit, by artificially reducing the money rate of interest, traps entrepreneurs into thinking that the subsistence fund has increased, and, therefore, they base their plans upon the illusion that more means of subsistence are available allowing for more long-term investments. They subsequently adapt the production structure in a way that was shown in section 3 to lead to malinvestments and, in the end, a bust. In the monetary economy, the lack of means of subsistence at the turn of the crisis expresses itself in a rise in the prices of consumer goods as compared to producer goods. This induces banks to increase the money rate of interest again, thus making it apparent to entrepreneurs that many of the started projects have been based upon an illusion and, therefore, end up being malinvestments (Mises [1912] 1953, pp. 361 ff.).

Now, Marcel Labordère essentially explains the influence of the banking system on the production structure in the same way Mises does. Like the latter, he looks for an explanation of how the illusion of the available subsistence fund or, in his words, disposable real capital, comes about. As will be remembered, he (1908, p. 661) also thought that crises “are born [...] out of the wrong perception which a human society has, at a given moment, of its actual resources, of its real resources actually disposable.” According to him, an illusion about the available disposable real capital can emerge once money is allowed for in his model of the economy presented above. He adds that, in our monetary economy, money seems to be part of disposable real capital, but that we have good reasons for calling it “*apparent disposable capital*”. In his opinion, the amount of money in existence does not bear a necessary and constant relation to disposable real capital (ibid., p. 661). The key reason for this is the working of the modern banking system. In order to illustrate his point, Labordère (1908, pp. 661 f.) describes the well-known money multiplier, i.e., the way how banks create deposits on the basis of reserves. This additional money “is born in a deposit” and, regarding its origin, should be

should be called “*apparent disposable capital*” (capitaux-apparents disponibles) (ibid., p. 662). It will be noted that this concept is very similar to and serves the same purpose as Mises’s “*circulation credit*.”

Like Wicksell and Mises, Labordère argues that the difference between the actually available disposable real capital and the apparent disposable capital manifests itself in a divergence of the money interest rate from the natural interest rate. Theoretically, he states, there exists a rate of interest that indicates the available amount of disposable real capital. He (1908, p. 669) calls it the “(theoretical) rate of real interest” (taux de l’intérêt réel (théorique)), but it should be clear that this rate conforms to Wicksell’s natural rate. However, he continues, as the amount of real capital cannot be determined for the whole society, there is no collective demand and no collective supply for it and, consequently, no rate of real interest can ever be observed. It is an imaginary rate – but it still does exist (ibid.). On the other hand, the supply and the demand for apparent disposable capital – that is, money – are visible, and the relation between the two manifests itself in the “*apparent interest rate*” (taux de l’intérêt apparent) (ibid., pp. 669 f.). This rate can be understood as the counterpart of Wicksell’s money rate set by the banking system.

In Labordère’s theory of the business cycle, the boom is characterized by a low apparent interest rate – which indicates an (apparently) huge amount of disposable capital – whereas the (theoretical) rate of real interest is marked by extreme tensions – which indicate the (true) scarcity of disposable capital. The apparent interest rate

does not show any sign of extraordinary tension and therefore ceases to give any serious information about the real situation. In other words, before the crisis, the gap between the (theoretical) rate of real interest and the apparent interest rate is very large; the curve of the (theoretical) rate of real interest runs considerably above the curve of the apparent rate: it is the moment when the public believes in an extreme prosperity and, misled by the abundance of apparent disposable capital, in an extreme abundance of money (ibid., p. 669, tenses matched to the context).



According to Labordère, the United States was living through a boom of the described kind before the crisis broke out in 1907. The banks had created a massive amount of deposits by lending money against everything they could get hold of. By means of easy credit, they fueled positive expectations about the future, induced entrepreneurs to produce, and encouraged speculation (ibid., pp. 662 f.). However, what the United States did, in his (ibid., p. 664) words, is “they accumulated, in the form of deposits in the banks, a mass of apparent disposable capital out of any proportion with their disposable real capital.” The Americans were living in a fool’s paradise made out of apparent disposable capital (ibid., p. 668). Yet, at the advent of the crisis, nature insisted on its rights. It became necessary that the apparent disposable capital would incarnate in actual commodities so that the massive projects could be executed. At this moment, “the truth must re-appear underneath the fraudulent manifestation; the truth, that is to say, the disposable real capital” (ibid., p. 668).

Labordère (1908, pp. 671 f.) concludes with some short remarks on the issue of whether economic crises can be prevented. In his opinion, the causes of crises lie in the precedent period of prosperity where the subsistence fund – the “disposable real capital” – has been malinvested. According to him, the only method to avoid a crisis would be to follow the fluctuations of disposable real capital and the theoretical rate of real interest. However, as these magnitudes cannot be observed in practice, he recommends anchoring the amount of apparent disposable capital – meaning especially bank deposits – in gold reserves. “The stock of gold represents reason. [...] [W]hen the bank deposits form a mass which is out of proportion with the stock of gold reserves, one has reason to worry” (ibid., p. 672). Even in this point he anticipated the Austrians who, in contrast to the Keynesians and the monetarists, argue that economic crises must be explained endogenously as a result of malinvestments undertaken during the preceding boom and, as a correlate of their ABCT, also demand that the monetary system keeps close contact to gold (Mises ([1912] 1953, pp. 413 ff.).

## 5. Conclusion

It was the purpose of this paper to demonstrate that Marcel Labordère anticipated the ABCT, and did so in a more than cursory manner. His theory of the business

cycle combines the same two elements that are also central to the ABCT as developed by Mises in 1912. Labordère analyzes the effects an artificial lowering of the money rate of interest by means of credit expansion has on the production structure of the economy. He argues that the main problem of a boom caused by an excessively low rate of money interest will be noticed in the malinvestments that follow. Cheap credit induces entrepreneurs to start more long-term investments in fixed real capital without making sure that enough short-term investments guarantee the frequent replenishment of disposable real capital. At the turning point of the crisis, the lack of disposable real capital makes itself known as it becomes impossible to continue the long-term projects.

The weakness of Labordère’s article is certainly the confusing exposition which is likely due to the fact that he was not a professional economist. He did not build upon the work of others and, therefore, it might well be that he was not as aware of the connection between the different elements of his arguments as he could have been. Labordère does not systematically assemble the components of his theory and, therefore, partly leaves it to the reader to put them together into a coherent whole. This seems to indicate why his contribution has remained nearly unnoticed up to the present day and why those who dealt with it classified his business cycle theory as stressing over-investment when it actually maintains malinvestments as the cause of the crisis.

From a present-day perspective, the most interesting contribution of Labordère’s article is his discussion of the business cycle in an economy managed by one single person. In a clear and precise manner it demonstrates what exactly Austrian economists intend to convey when elaborating on “malinvestments” that occur during the boom. Even a single person can undertake multiple plans that do not harmonize with each other and, therefore, can – in theory – instigate a business cycle.

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## *Non-excludability, Externalities, and Entrepreneurship: An Overview of the Austrian Theory of Common Goods*

Jakub Bożydar Wiśniewski<sup>1</sup>

**Abstract:** According to the neoclassical economic theory, common goods would be underproduced by the market in the absence of a monopoly of force capable of coercing every able member of society to contribute to their provision. By applying both the methodological tools developed by the Austrian School of Economics and the tools used to investigate the institutional robustness of various systems of political economy, I shall argue, first, that the neoclassical characteristics of common goods are based on a number of false assumptions or unacceptable oversimplifications, and second, that even if they were correct as stated, they would not establish the desirability of the existence of a monopoly of force.

**Key words:** Monopoly; common goods; externalities

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## 1. Introduction

Perhaps the most common argument describing a putatively beneficial function performed by a monopoly of force refers to its alleged ability to supply society with certain crucial, otherwise unattainable classes of goods. There are many names to designate such goods and many ways to categorize them, but for my purposes I shall regard them as falling into two relatively broad classes – club and common goods, which together constitute the category of public goods.

Various theorists writing on the subject in question identify the said goods according to various characteristics – Malkin and Wildavsky (1991) provide an illuminating insight into the degree to which there is no final agreement on the matter. While in general the literature on public goods is “terminologically over-endowed” (Hummel 1990, p. 90), which engenders a great deal of semantic confusion, I believe that it is fair to say that since the publication of Samuelson’s classic articles on the subject (Samuelson 1954, 1955), one strand of terminological convention has come to dominate the picture. According to this convention, club goods are defined as possessing the characteristic of joint (or non-rival) consumption (Buchanan 1965, Olson 1971, Berglas 1976, McNutt 1999), while common goods are defined as possessing the characteristic of non-excludability (or the existence of related externalities) (Musgrave and Musgrave 1980, Kim and Walker 1984, Ostrom 1990).

It is often claimed that these two characteristics give rise to the corresponding two types of market failure – in the case of club goods some people are excluded from consumption even though they would not generate any additional costs for the producer, while in the case of common goods the social gains, including the gains of free riders, outweigh the private gains of the producer, which undermines the incentive to produce in the first place. Thus, a monopoly of force is expected to intervene and coerce every able member of society to contribute financially in order to secure a sufficient supply of the goods in question. Absent such a monopoly, the argument goes, the results are bound to be sub-optimal (see, e.g., Willis 2002, pp. 161-3; Arnold 2004, pp. 720-3; Ayers and Collinge 2004, pp. 555-9).

By applying the methodological tools developed by the Austrian School of Economics, in what follows I shall argue, first, that the above characteristics of common

goods are based on a number of false assumptions or unacceptable oversimplifications, and second, that even if they were correct as stated, they would not establish the desirability of the existence of a monopoly of force, since, even if we were to disregard the positive-normative distinction, the alleged common goods can be produced more efficiently in a purely market-based system.

### 1. A comparative institutional analysis of common goods production

Non-excludable (common-pool) goods are alleged to generate positive externalities – that is, they are said to be capable of benefitting free riders, who cannot be excluded from using what they refuse to pay for. Thus, the crucial question in this context is: is the existence of free riders sufficient for discouraging private individuals from engaging in the production of such goods?

Before exploring this particular issue, let us focus for a while on the following, preliminary objection – one might suggest that I am far too quick in dismissing the possibility of efficient production of common goods by a monopoly of force. One might argue that as soon as the market price system and the underlying intersubjective value determination mechanism is in place, the monopoly of force can estimate the monetary value of the otherwise unproducible common goods by noting the difference in prices of various non-common goods in the period before and after the appearance of the relevant positive externality. Think, for instance, of the difference in the value of a real estate before and after the establishment of an infrastructural network in its vicinity (Smerk 1965, p. 241).

Could the monopoly of force engage in the efficient production of common goods on the basis of the above procedure? As I see it, there seems to be a number of serious problems plaguing this proposal. First of all, since the market data – including most notably the tastes and preferences of consumers – are in constant flux, the managers employed in gathering them would have to engage in the process of endless and constant surveillance of ever-changing prices and even the pre-transaction opinions of prospective buyers and sellers. Moreover, they would have to be able to identify and winnow out every conceivable factor other than the appearance of a specific positive externality that could influence the price of any given surveyed non-common good at the same time

as the externality in question. This is obviously not an insurmountable task for the private sector, where “prices afford a highly effective system of signals that obviate the need for the transmission of detailed, factual information to decision makers” (Kirzner 1988, p. 4), but it appears as a daunting challenge for a centralized, public agency.

Moreover, it has to be realized that even if the employees of the monopoly of force were able to keep up to date with all the relevant prices and capable of eliminating every intervening irrelevant factor from their analysis, their estimation of the would-be price of any given common good would, entrepreneurially speaking, already belong to the past. And while very important for the entrepreneurs, “the prices of the immediate past are for them only the starting point of deliberations leading to forecasts of future prices” (Mises 1996, p. 336). The question to be asked in this connection, then, is: could a manager employed by a centralized, coercive agency appraise future prices just as efficiently as a private entrepreneur? It appears to me that the answer is: yes, he could, provided that he were as independent and unconstrained in his decision-making as a private entrepreneur; that is, if he were free to “establish corporations and other firms, enlarge or reduce their size, dissolve them or merge them with other enterprises; (...) buy and sell the shares and bonds of already existing and of new corporations; (...) grant, withdraw, and recover credits” (ibid., p. 704), as well as bear the full financial consequences of engaging in any of the above activities. This, however, he is incapable of doing by definition, since he is not the owner of the assets he manages, but only their temporary caretaker. As a result, it is difficult to conceive of the possibility that his forecasts (as opposed to his forecasting skills) could be even marginally as accurate as that of a full-blooded businessman.

Hence, we can see the unworkability of the procedure of, say, levying a more or less arbitrary tax on the public in order to finance the production of a given common good and then returning the surplus to the taxpayer as soon as the monetary value of the common good in question is determined on the basis of the increase in value of the goods and assets affected by the relevant, newly emergent positive externality. The crucial point here is that a given amount of money paid in taxes today is not equivalent in value to the same amount of money returned to the taxpayer in the future,<sup>2</sup> and since a manager employed

by a monopoly of force is in no position to appraise the future value of tax money on the basis of its present value, it can easily be claimed that the whole tax-produce-and-return procedure would result in sub-optimal social outcomes. In fact, in addition to the manager’s inability to determine what constitutes a “due” compensation to the taxpayer, what also raises doubts about the workability of the procedure in question is the fact that imposing a tax on the members of any given society is bound to change the value rankings of its members. Thus, their valuations of the goods and assets affected by the appearance of a given positive externality are going to be conditioned by the preceding tax imposition, and hence useless as a benchmark for determining the “tax-neutral” value of the common good that generates the externality in question.

Furthermore, a point should be made about the unsuitability of the use of econometric equations in the context at hand. The crucial assumption underlying the nature of the events they purport to analyze is the possibility to abstract from them in order to produce a series of random occurrences (i.e., all openings of new segments of road infrastructure, all creations of public parks, etc.) and then study them in terms of ‘class probability’, where “we know, or assume to know, with regard to the problem concerned, everything about the behavior of a whole class of events or phenomena; but about the actual singular events or phenomena we know nothing but that they are elements of this class” (Mises 1996, p. 107). Only provided such an assumption would it be possible to measure the extent to which the introduction of any given common good is supposed to raise the value of the surrounding assets. It is the case, however, that the events in question are in their nature unique and discrete, thus being at most amenable to study in terms of ‘case probability’, where “we know, with regard to a particular event, some of the factors which determine its outcome; but there are other determining factors about which we know nothing” (ibid., p. 110). Not belonging to any homogeneous collectives the probability of occurrence of whose particular members tends asymptotically towards fixed limits, where such limits are not affected by any place selection (Mises 1957, Hoppe 2007), such events are not amenable to analysis in terms of the probability calculus.

Next, it should be borne in mind that any coercive interference with the social system of voluntary

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2 Even if we were to assume that the tastes and preferences of the public are constant over time, intertemporal variation

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in the value attached to any given good would result from the existence of positive time preference (Böhm-Bawerk 1890).

transactions (including interferences aimed at the production of common goods) is bound to generate a number of what might be regarded as negative externalities – e.g., erosion of respect for property rights (Malkin and Wildavsky 1991), diminution of entrepreneurial incentives (Hoppe 1989, ch. 4) and distortionary effects on profit-and-loss calculation (Salerno 1993, p. 131). The disutility thereby created is, of course, a subjective quantity, unamenable to cardinal measurement, but since the processes leading to its creation by definition prevent some mutually beneficial interpersonal interactions, it can nonetheless be objectively identified as a disutility. On the other hand, since the putative utility derived from the existence of positive externalities is also subjective, and since, *ex hypothesi*, people are supposed to be unwilling to pay for the production of common goods, it cannot really be said from the third-personal point of view whether the existence of any supposed common good benefits society on the whole.

## **2. Demonstrated-preference-based welfare theory: an exposition**

In addition to the above points, if, pace Rothbard (1956), we confine our analysis of economic efficiency to the study of actual transfers of property titles as revealing the underlying preference rankings of the involved parties (while dismissing the attendant third-party verbal declarations, complaints, approvals, etc., as amenable to psychological investigations only), then the very notion of positive externality turns out to be purely psychological, while the notion of negative externality appears reducible to the effects of violating one's property rights. What follows is that the only potentially efficiency-enhancing role that a monopoly of force could play when it comes to securing the existence of the optimum amount of common goods would be protecting legitimate property titles. However there are ample reasons to be critical of such a proposal too, thus suggesting that the institution in question cannot perform effectively even this comparatively limited, though crucial role (Tannehill and Tannehill 1970, Rothbard 1973, Friedman 1989, Hoppe 1999, Murphy 2002, Stringham 2007, Hasnas 2008).

It should be noted that the above remarks apply equally well to another, slightly different version of the theory of common goods, the one according to which the defining feature of a common good is that the benefits

it produces are 'diffused', i.e., impossible to impute to individual beneficiaries. The following statement encapsulates the view in question: "If it were agreed that the benefits from highway improvements are (...) diffused among inhabitants of a state (...) [then] highways should be supported from the general fund" (Netzer 1952, p. 109).

Against this view, it can be said that if no individual beneficiaries of a given, supposedly common good can be identified, it seems worthwhile to ask whether there are any serious grounds for thinking that any such beneficiaries exist at all. After all, non-action on the part of any given agent can be given a number of mutually exclusive psychological interpretations of how he feels vis-à-vis the putative good in question (Fielding 1979). He might be interpreted as genuinely enjoying its consumption by means of (by definition undetectable) free-riding. But he might equally well be interpreted as being indifferent towards it or even as passively hating its presence. And even if he were to say that he regards the good under consideration as very valuable and that he would willingly pay in taxes for its production and maintenance were it not for the existence of other free riders, who routinely damage its quality, we cannot therefrom conclude that the utility he would derive from coercing other free riders to contribute would exceed the disutility the latter would derive from being coerced. Furthermore, if the notion of diffused benefits is to be treated seriously, what is to stop us from treating literally every good we can think of as a common good? If such benefits are undetectable by the persons concerned, is there a principled reason to deny the claim that they are present in every human activity? Consequently, is there any non-arbitrary stopping point for the monopoly of force tasked with the provision of common goods? What seems to me to testify to the strength of this *reductio ad absurdum* is the fact that presumably very few people would be willing to advocate a centralized, "public" production of, say, evening suits and computer software on the grounds that it cannot be disproved that these goods generate unrealized benefits for people other than their buyers and the immediate surroundings of the latter.<sup>3</sup>

Finally, it could be argued that the notion of diffused benefits was invented in order to bring

<sup>3</sup> It might be claimed, for instance, that the masses benefit greatly from an increase in the availability of all sorts of knowledge due to the proliferation of computer software even though they do not realize the extent of these benefits, since computers have already become quite commonplace objects.

utility theory and welfare economics in line with the mathematical modeling methods espoused by the neoclassicists. If graphs such as cost curves and revenue curves are to be analyzable by means of differential calculus, they have to be plotted as smoothly continuous, which results in depicting economic action as consisting of a series of infinitely small steps. This, in turn, is entirely consistent with the claim that economic benefits, even if infinitely small and thus unnoticeable, can nonetheless be regarded as “real” (Block 1983, p. 22). However, this attempt at imparting mathematical elegance to economics comes at the price of falsifying the image of human action, which “can occur only in discrete, non-infinitely-small steps, steps large enough to be perceivable by a human consciousness” (Rothbard 1960, p. 167). In other words, as long as any given event remains unnoticed by the person concerned, it does not enter her realm of decision making and hence cannot be regarded as in any meaningful sense beneficial to her.

It might be argued in response that neoclassical economists are justified in using continuous functions to represent various aspects of human action since in a repeated game setting actions and their results do become increasingly small, the consequence being that a function will become more continuous (though perhaps not “fully” continuous) as long as the action is repeatable. However, there are a number of problems with this suggestion. First, repeated game settings can be justifiably thought of as artificial environments, thus having little relevance for analyzing the operation of human action in the realm of everyday, real-world scenarios. Second, there seems to be something inherently dubious in talking about repeatability of action in the sense of fitting its particular instances into homogeneous classes of events, since every instance of human action is a paradigmatic example of a unique event, caused to happen by a unique, time-bound and agent-relative set of beliefs, desires, judgments, and preferences. Finally, if we analogize repeated game settings to institutional frameworks whose formation leads to the emergence of highly conditioned patterns of behavior, the existence of such frameworks can be plausibly regarded not as an economic good, but rather as a “*general condition of human action and human welfare*” (Rothbard 2004, p. 5). Consequently, it cannot be thought of as imparting any benefit to an agent, but rather as being a condition of that agent benefiting from the consumption of scarce goods. In the context under discussion, the same can be said about

unnoticeable positive externalities.

### 3. Demonstrated-preference-based welfare theory: criticisms and answers

The above considerations seem to me to make a strong case for the superiority of the approach confined to the study of preferences demonstrated in concrete actions over the neoclassical approach.

It might be argued, however, that my preferred method faces a number of conceptual difficulties as well. Firstly, if no objective interpersonal comparisons of utility can be made, then even if it can be claimed that every voluntary transaction is utility enhancing, it does not necessarily follow that no coerced transaction can be even more utility enhancing. In other words, while it is true that every voluntary transaction increases the utility of all transacting parties (hence being a positive-sum game and a Pareto-superior solution) and that every coerced transaction increases the utility of the coercer and decreases the utility of the coerced (hence being a non-positive-sum game and a Pareto-inferior solution), it cannot be denied that if in the latter case the coercer is a “utility monster” (Nozick 1974, p. 41), an enormous amount of utility he derives from the act of coercion might be sufficient for outweighing the disutility incurred by the coerced. To generalize this point, even though within the analytical framework under consideration we can regard every voluntary transaction as efficient, by the same token we cannot regard every coerced transaction as *inefficient* – we can at most suspend our judgment concerning the efficiency of the latter (Caplan 1999). This, in turn, leaves us with a somewhat disconcerting conclusion that we cannot consider, say, Soviet war communism as a disastrously ineffective economic system.

I believe that the above criticism rests on a misunderstanding of what Pareto-inferiority really means. Pareto-inferior scenarios are not those in which both parties to a given transaction lose, but precisely those in which one party gains and the other loses, and this can happen only as a result of one party coercing the other to do something against the latter’s will. A scenario in which both parties to a transaction lose in the *ex ante* sense is praxeologically impossible, since “acting man is eager to substitute a more satisfactory state of affairs for a less satisfactory. His mind imagines conditions which suit him better, and his action aims at bringing about this

desired state” (Mises 1996, p. 13). Thus, it appears to me that the only useful and informative way of understanding the concept of Pareto-inferiority is the one in which we apply it to social interactions whose results, given the impossibility of performing interpersonal comparisons of utility, are indeterminate (as opposed to positive, characteristic of Pareto-superior interactions).

In view of the above clarifications, we can see that within the subjectivist, demonstrated-preference-based framework of thinking about welfare economics, Soviet war communism can be considered disastrously ineffective in the sense that under such a regime all (or most) social interactions are coerced and thus no (or very few) increases in social utility can be said to take place. Under a free enterprise system, on the other hand, every social interaction can be said to increase social utility, because under such a system every social interaction is a voluntary exchange of legitimate property titles. Consequently, within the framework in question it is perfectly justifiable to regard free enterprise arrangements as highly conducive to economic efficiency.

Another criticism of the approach adopted here says that since the coerced cannot, by definition, demonstrate by their actions that they prefer not being coerced (since they are rendered passive by coercion), in view of the methodological framework under consideration it cannot be determined what happens to the utility of the coerced. In every non-voluntary transaction, the coercer is the only active party, i.e., according to the critic, the only party capable of demonstrating through its actions whether it prefers the post-coercion state to the pre-coercion state. Furthermore, since the coercer clearly demonstrates that he prefers the post-coercion state to the pre-coercion state, we seem to reach a troubling and counterintuitive conclusion that every coercive transaction is Pareto-superior, strictly parallel in this regard to every voluntary transaction (Kvasnicka 2008).

I can think of two points that might be made in response. First, it can be claimed that the coerced do demonstrate that they object to being subject to coercion. Their engagement in activities such as tax evasion, the use of tax havens, looking for loopholes in the tax law, joining black or grey markets, etc., seems to provide ample testimony to this assertion. However, an immediate counterargument here might be that as soon as we invoke the abovementioned activities, which can assume the form either of *ex ante* precautions or of *ex post* reactions, we

start to compare two systematic processes stretched over time – systematic coercion and systematic attempts to avoid that coercion – rather than two kinds of interactions undertaken at specific time points. The problem with the welfare analysis of processes is that it involves making intertemporal comparisons of utility, together with the attendant unwarranted assumption that the preference rankings of the involved parties are constant over time. The subjectivist, demonstrated-preference-based welfare theory expounded in this paper avoids making the said assumption precisely by focusing on specific time points at which specific voluntary or coerced interactions take place.

Thus, in order to defend the claim that coercive interactions are necessarily Pareto-inferior, we need to show that the coerced suffer a utility loss precisely at the moment in which they are coerced. One way of doing this could consist in making the critic realize the following: as long as the owner of the property title X does not trade X for something else or give it away, he demonstrates that he prefers keeping it. Hence, by coercively appropriating X, the coercer can be objectively shown to frustrate the original owner’s preferences. After all, if the original owner were willing to part with X on his own, there would be no need for coercion – the would-be coercer could obtain X by means of trade or as a gift. In other words, “that he [the original owner] is not demonstrating a preference for the transfer in the case of aggressive violence used against him is inferred from his initial property ownership and that aggressive violence is an implicit, non-consensual claim on his property” (Herbener 2008, p. 61). In sum, non-action with respect to one’s property implicitly presupposes that one prefers to keep the property in question, even if one does not actively use it at a given moment.

One might claim that the above argumentation applies only to the overt, explicit kinds of coercion such as assault or burglary, but not to the more implicit and imperceptible ones, such as taxation – after all, judging by the way in which most of the people submit their tax forms, it might be thought that they are doing so voluntarily as far as the observation of preferences expressed in actions goes. Such a contention, however, disregards the fact that a credible threat of violence is a type of violence in its own right. To think of a vivid analogy:

Suppose someone approaches you on the street, whips out a gun, and



demands your wallet. He might not have molested you physically during this encounter, but he has extracted money from you on the basis of a direct, overt threat that he *would* shoot you if you disobeyed his commands. He has used the threat of invasion to obtain your obedience to his commands, and this is equivalent to the invasion itself. (Rothbard 1998, p. 78)

Hence, insofar as the threat of imprisonment and even more intense expropriation in the event of disobedience constantly hovers above the taxpayers, their seemingly uncoerced payments cannot be truly considered as such.

Let us now move to another possible objection, which is the following: even though undertaking a certain action demonstrates that the agent prefers a given outcome to the available alternatives, it does not imply that as a result of achieving this outcome his utility increases overall. Think about the example of a few firms forming a voluntary cartel on the market and raising the prices of their products. Even if after the emergence of the cartel consumers continue to patronize it, thus demonstrating their preference for buying a certain good at a “natural monopoly” price over not buying it at all, it appears difficult to maintain that they are better off after the formation of the cartel than they were before it took place.

What this objection seems to overlook is that the welfare theory under consideration says only that every voluntary transaction is Pareto-superior within given momentary conditions, which are brought about by the preceding interpersonal transactions (voluntary or otherwise). It does not say, however, that those preceding (or subsequent) transactions cannot impose some sort of psychological disutility on a given person and alter his preference ranking. It cannot be guaranteed that, psychologically speaking, one will find the conditions prevailing at time  $t$  more favorable than the conditions prevailing at time  $t-1$ . The crucial point is that as long as one is permitted to act freely at  $t$  and  $t-1$ , each of those actions is going to be Pareto-superior, even though, holding other things constant, it is possible that one's action at  $t-1$  is going to be capable of bringing him greater subjectively perceived satisfaction than his action at  $t$ .

Next, let us consider an interesting criticism based on the claim that even assuming that any coercive regime is necessarily less conducive to the promotion of social utility than a fully voluntary regime (since the latter, unlike the former, consists exclusively of mutually beneficial and thus Pareto-superior transactions), the same assertion cannot be made with respect to comparisons between various regimes belonging to the continuum stretching from pure voluntarism to extreme coercivism. For example, both a minarchist system and a social democratic system represent a mix of voluntary and coercive transactions, i.e., a mix of Pareto-inferior and Pareto-superior transactions. The same can be said about, on the one hand, a regime in which attempts at aggression against legitimate property holdings are successfully fended off, which results in preserving the existing pattern of ownership, and, on the other hand, a regime in which such attempts are successful, thus changing the said pattern.

Now, even though it is clear which system in both of the abovementioned pairs involves more (successfully carried out) initiatory violence, it would seem that the ordinal character of utility and the non-comparability of individual utility rankings (Mises 1980; Herbener 1997; Rothbard 2004, pp. 18-20) do not allow us to say on purely economic grounds that either of the regimes in question generates more or less welfare than the other. This is because all these social arrangements are strictly symmetrical insofar as they result in mixes of individual gains and losses, and discounting the value of the aggressors' preference scales vis-à-vis the value of the non-aggressors' preference scales appears to be an arbitrary, logically unjustifiable move. Again, two points can be made in response. First, it may be suggested that social arrangements can be classified as better or worse with regard to utility maximization depending on the extent to which they approximate the ideal type of pure voluntarism - hence, according to this criterion, minarchism is better than social democracy, the system that successfully fends off the actions of aggressors is better than the one that does not, etc. However, this answer might appear to be somewhat evasive insofar as, given the characteristics of utility mentioned in the previous paragraph, such approximations could seem to be conceptually incoherent, or at least incomparable in any meaningful sense.

A more promising reply consists in claiming that if we accept the definition of society along the lines of that proposed by Mises, who describes it as “the total complex

of the mutual relations created by (...) concerted actions” aimed at “cooperation and coadjuvancy with others for the attainment of definite singular ends”, whose results are “division of labor and combination of labor” (Mises 1996, p. 143), we can define the relevant criterion of social welfare as the extent to which individuals within a given group are enabled to “evaluate and allocate the means at their disposal when pursuing their goals through social action, i.e., action that makes use of voluntary exchange and the social division of labor to realize its aims” (Salerno 1993, p. 130). This, in turn, allows us to “discount any gains, in terms of direct utility or exchangeable goods, that accrue to the [aggressive] interveners and their beneficiaries, while remaining safely within the bounds of strict *Wertfreiheit*” (ibid., p. 131), since the actions of the said interveners

necessarily distort or annul [the free market’s] intricate calculational nexus coordinating consumer preferences and entrepreneurial choices, *ipso facto* generat[ing] a less efficient allocation of resources, i.e., one that does not completely and exclusively reflect the anticipated preferences of the participants in the social division of labor. (ibid.)

In sum, on a definitional level we may effectively exclude aggressors from society and thus rank regimes vis-à-vis their conduciveness to the promotion of social utility based on the degree to which they are free of institutional coercion and unobstructive with respect to bringing about the conditions under which it is possible to fend off non-institutional coercion successfully.

Let us now move to the issue of whether feeling regret about acting on a given desire proves that in hindsight we identify it as irrational (which might be problematic for the welfare theory under consideration if we take irrationality of any given action to be an indication of its Pareto-inferiority). One could think that this is evidenced by the desirer saying something like “this is not what I really wanted” as he reflects on his past choice and subsequently undertakes some actions to rectify this state of affairs. Here, I believe, we need to insert a crucial qualification. As I already emphasized repeatedly, I am perfectly sympathetic to the claim that voluntary actions

reveal the agent’s preferences, but:

All we can say is that an action, at a specific point of time, reveals part of a man’s preference scale *at that time*. There is no warrant for assuming that it remains constant from one point of time to another. (Rothbard 1956, p. 6)

Thus, if the desirer says at  $t1$  “this is not what I really wanted” with reference to his choice made at  $t0$ , this statement is not strictly speaking correct. “This is not what I want right now, but this is what I wanted back then” would be a much more accurate description of his intertemporal preferential makeup. And if this description is to be taken as indicative of the agent’s irrationality, we have to make the assumption that rationality requires constancy of preferences over time. I see no reason to make such an assumption. As purposive and reflective beings, we can and often do change our goals and aims, both in response to continually accumulated new empirical data and their logical scrutiny, as well as in response to purely internal changes of heart, taste and evaluation. What matters for rationality is not constancy, but consistency, and the above mistaken identification of irrationality results from confusing the two:

(...) *Constancy* and *consistency* are two entirely different things. Consistency means that a person maintains a transitive order of rank on his preference scale (if A is preferred to B and B is preferred to C, then A is preferred to C). (...) *Constancy* [means] that an individual maintains the same value scale over time. While the former might be called irrational, there is certainly nothing irrational about someone’s value scales changing through time. (Rothbard 1956, p. 6)<sup>4</sup>

In sum, since rationality does not require constancy of preferences over time, feeling regret about one’s past actions cannot be construed as an indication of their irrationality – and, by extension, of their Pareto-

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4 On the distinction between constancy and consistency of preferences, see also Mises (1996), p. 103.

inferiority.

Finally, let us say a few words about the apparent asymmetry in the way in which the demonstrated-preference-based welfare theory treats the concepts of positive and negative externalities. As I repeatedly indicated earlier, according to the framework that underlies the theory in question, a positive externality is an economically unoperationalizable term, because, by definition, there can be no demonstrated market demand for the goods alleged to exhibit such externalities. However, at the same time the framework under discussion admits that there exists a perfectly meaningful economic definition of negative externalities - i.e., the effects of transactions between A and B which physically interfere with the property rights of C (Rothbard 1982; Cordato 1992). How can this conceptual asymmetry be explained?

To do so, it has to be noted that non-action with respect to someone else's assets that are alleged to create positive spillover effects can be given a number of equally plausible though mutually exclusive psychological interpretations (free-rider's enjoyment, indifference, dislike, etc.), but only one praxeological interpretation (a preference for non-payment over payment for the ostensible good under consideration). Likewise, non-action with respect to one's own assets can be psychologically interpreted in many different ways, but only one explanation makes praxeological sense in this context - namely, a preference for keeping the assets in question over trading them for something else, giving them away or disposing of them in any other manner.

Hence, it becomes visible that an action (payment or other form of voluntary acceptance) is required on the part of the putative beneficiary of a positive externality to prove that he is in fact one, but no action is required on the part of someone whose property is uninvitedly interfered with to classify any such interference as a negative externality. This, as I see it, is because the benefits derived from keeping one's property assets can be traced back to the preceding action of acquiring them (via the regression theorem of social interactions) (Herbener 2008, pp. 63-4), but the benefits of being affected by positive externalities can be traced back to none of the preceding actions of the

ostensible beneficiaries.

The above point can be further illustrated by reflecting on an argument often encountered in debates on full-reserve banking versus fractional-reserve banking. Many advocates of fractional-reserve banking argue that cash balances held in demand deposit accounts are idle and since depositors are not actively using them, banks are free to exercise control over them and lend them out for investment purposes. The advocates of full-reserve banking, on the other hand, take the view that these supposedly idle reserves indicate a conscious decision on the part of depositors, and that a bank that lends them out is making an erroneous assumption that the depositors' putative idleness stems from the fact that they do not currently need their deposits. However, holding money in a cash balance does, in fact, serve a concrete and important function, which is hedging against uncertainty through the accumulation of liquid assets (Hutt 1956; Hülsmann 1996, p. 12; Rothbard 2004, p. 265). This is yet another illustration of the fact that non-action with respect to one's assets has to be interpreted in light of one's previous decisions and that it cannot be taken as an indication that, at least for the time being, the assets in question dropped out of one's preference scale.

## 5. Conclusion

Having defused a number of objections and dealt with a number of conceptual tangles related to the subjectivist, demonstrated-preference-based welfare theory adopted and defended in this paper, as well as having explored in more detail some of the more general considerations dealing with entrepreneurial methods of solving the free rider problem, I have to conclude that the neoclassical theory of common goods suffers from a number of significant logical shortcomings. Furthermore, I contend that even if, for the sake of the argument, we were to put these aside, the effective provision of the ostensible common goods would not require the existence of a territorial monopoly of force, and could be satisfactorily delivered in a purely market-based system.

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## *Reviews of books about Ron Paul*

Walter E. Block<sup>1</sup>

Ron Paul, in addition to being a doctor, a politician, a leader of the libertarian movement, is also a heavily published author. He has written the following books: Paul (1981, 1983A, 1983B, 1984, 1987, 1990, 1991, 2000, 2002, 2007, 2008A, 2008B, 2009, 2010, 2011, 2012, 2013; Paul and Lehrman, 1982, 2012; Rangel and Paul, 2006). And when I say “written” I mean “written.” That is, he wrote them himself, in sharp contrast to the volumes authored by many famous people, which were really penned, so to speak, by professional writers and editors.<sup>2</sup>

However the present review will leave all of those volumes untouched. Instead, it is dedicated to a very different oeuvre: books *about* Ron Paul, written by other authors. To wit, I will discuss the following books<sup>3</sup> that

have been written not by, but about, Ron Paul: 1. Alford, 2013; 2. Block, 2012A; 3. Doherty, 2012; 4. Haddad and Marsh, 2008; 5. Hammond, 2012; 6. Richardson, 2008; 7. Rink, 2011; 8. Stevo, 2012.<sup>4</sup>

### **1. Alford, 2013**

I highly recommend this book, as I do all others on this list. However, to some extent, this really is not a book at all. If I had to characterize it, it would be almost as a picture post card; the photographs are that good. Not one telling friends and relatives about a wonderful vacation, but relating to all and sundry what a wonderful person Ron Paul is, and how important and wonderful was his candidacy of 2012. Alternatively, this book could

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<sup>4</sup> Note, too, that one of my own books, Block (2012A), is on this list. Thus, my plan is a somewhat curious one, in that it calls for an author to review his own book. But, as I say, I want this review of all books about Ron Paul so as to be as comprehensive as possible, and I rank that goal higher than adhering to the usual practice of authors not reviewing their own works. However, this “review” of mine of my own book shall be exceedingly modest, merely giving “name, rank and serial number” kinds of information about it. I shall do something quite similar for Doherty (2012), since I have already written a full bore review of that book (Block, 2012B)

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<sup>2</sup> In the Jewish tradition, if you want to say that the chicken soup is a bit thin you say, “They waved a chicken over some boiling water.” Adopting this metaphor, we can say of the volumes “written” by many famous people, but certainly not Ron Paul, that they waved the author over that book.

<sup>3</sup> If anyone knows of any other contributions in this regard, do let me know. I want my reviews of the books about Ron Paul to be as inclusive as possible.

take its place amongst coffee table books which specialize in photography.

The title of the book is *Swindled: How the GOP Cheated Ron Paul and Lost Themselves the Election*. I don't say this is a mis-labeling. But the actual book is a bit less angry than the title might indicate. Don't get me wrong. Alford is clearly upset with the injustice perpetrated on Dr. Paul and makes this case in masterfully compelling manner.<sup>5</sup> There is no question about that. But, there are so many pages in this book with a picture of a baby wearing a "T" shirt in support of Ron, or a photograph<sup>6</sup> of our hero giving a speech to a large audience and other events that will warm the cockles of a libertarian's heart. For example, on p. 39 we are treated to a view of the rear of Dr. Paul lecturing to people in what appears to be an ice rink, and the caption reads: "The next day, he rallied the troops, numbering over 3,000 in Houston."<sup>7</sup> On page 51 we see a photo of an enthusiastic rally of mostly young people for the Congressman in Louisiana. I know it is a cliché, but I cannot resist: these pictures alone are worth the entire price of admission, and there is practically one on every page. They are numerous, they are uplifting, they are inspirational, at least to me, and, I suspect, to all fellow admirers of Ron Paul as well.

Despite the niceness of this offering, there is quite a bit of justified anger in it as well. Let me give but one example. On p. 75 we see depicted one of the most outrageous reportorial events of the entire campaign: the Minnesota non-binding caucus of February 7, where the first and third place finishers were mentioned, but not the one in between. States Alford of this disgraceful scandal, "Anyone want to hazard a guess as to who won second place with 27% of the vote?" To ask this is to answer it.

## 2. Block, 2012A

True confession: I have a man crush on Ron Paul. I dearly love him. This book illustrates those feelings of mine. This volume is my love letter to Dr. Paul. How's that for a fast review?

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<sup>5</sup> It resembles the Richardson book, see below, in that regard.

<sup>6</sup> There are pictures on most of the pages of this publication. Lovely pictures. Wonderful pictures. Many of them brought tears to my eyes.

<sup>7</sup> I cannot say for sure that this is actually p. 39. The version of this publication I dealt with had no page numbers, so I filled them in for myself. Possibly, I miscounted the pages.

## 3. Doherty, 2012

I have already written a review of the Doherty book (Block, 2012B), so I shall be mercifully brief here also. All I want to say is that of all eight books about Ron Paul, this one has sold the most copies. Amazon Best Sellers Rank places this volume at #316,103 in books sold. It is my fervent hope that Doherty's effort, and my review of all these books, will help focus attention on some others of those on this list, since they are also very important. They all merit a wider audience, including my own, if you will forgive this bit of shameless self-promotion.<sup>8</sup>

## 4. Haddad and Marsh, 2008

This deserves, almost, to be considered a book *by* Ron Paul, not *about* him. It was edited, not authored by people other than himself (I was sorely tempted to capitalize this word, but have successfully resisted, as you can see, gentle reader). Thus, I count it, barely, as a book about and not by him. Why? It consists almost entirely of quotes, 166 in all, crammed into 318 magnificent pages, from Ron Paul. They are organized in alphabetical order, and range from abortion to bureaucrat to civil liberties to debt to economics to the fed at the outset, and on toward the end of the alphabet concluding with Viet Nam, War on drugs, and young people.

However, the 11- page introduction to the book constitutes a very, very good contribution to the bibliography of Ron Paul.

On the negative side, these editors are guilty of one small typographical error. They inform us (p. xii) that Congressman Paul was born in 1923. His actual year of birth was in 1936. Apart from this minor glitch this is a handy reference of a book. All Ron Paul admirers will want to have this volume on their bookshelves (that applies to all the books reviewed in this essay). If you want a short pithy statement from Ron Paul on any one of numerous topics, this is the place to find it. This publication contains no fewer than 656 footnotes. Haddad and Marsh have certainly done their homework, and I for one am grateful to them for it. So will you be.

## 5. Hammond, 2012

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<sup>8</sup> Doherty (2012) too. In the just world, one that had elected Ron Paul, this book would be on the best seller list.



The title of this excellent book (*Ron Paul vs. Paul Krugman: Austrian vs. Keynesian economics in the financial crisis*) is somewhat misleading. It implies that an actual debate is to take place between Ron Paul and Paul Krugman. If we can infer from this that an interaction of this sort is fair-minded or offers a roughly equally strong discussion of both sides, this demonstrates that the title does not accurately indicate the contents of this book. For instead of an even-handed explication of both sides, it is a veritable bashing of the latter based on the views of the former. And this is very welcome. For Krugman's views and contributions to public policy are incorrect, evil and malicious, while Paul's are the very opposite. Thus this volume is a very welcome addition to the literature. In it we see Krugman being hammered as he so richly deserves, and Paul takes on the role of the smiter, one he plays very well in the hands of Hammond. But I misspeak. What is written above makes it sound as if Hammond's contribution is limited to a mere marshaling of Paul's arguments. Not so, not so. It cannot be denied that there is a fair bit of precisely that in the small (104 page) volume. But our author contributes quite a bit more than that to the well-deserved intellectual evisceration of Krugman.

Paul's triumph over Krugman is a bit astounding, at least for those overly concerned with credentialism. For the Texas Congressman is "merely" a physician and a politician. He has no formal education in economics at all. In the other corner of this particular boxing ring stands a man replete with a B.A. in economics from the prestigious Yale University, a Ph.D. in economics from the equally prestigious MIT, who is a professor of economics at the equally prestigious Princeton University. In 2008 Krugman won the even more prestigious Nobel Prize in economics, and writes columns as an eminence grise for perhaps the leading newspaper in the world, the *New York Times*. Yet, when they meet in the middle of the ring, the former, with a little help from Hammond, scores a knockout blow against the latter, in perhaps the most unequal intellectual "debate" that ever took place. An evisceration is more like it.

Paul KO's Krugman on the Dot-Com bubble (chapter 1), the housing bubble (chapter 2), the Fed and interest rates (chapter 3), inflation (chapter 4). This book is a tour de force of the Austrian economics of Paul over the Keynesianism of Krugman. Hammond's volume demonstrates that Robert P. Murphy (2010) is no better than a(n intellectual) child molester. Krugman would not

stand a chance in the ring with Murphy, and the latter is a bully for even challenging him (<http://krugmandebate.com/>).

Other highlights of this book include the story of how Hammond himself came to adopt Austrian or praxeological economics. The usual suspects are indicted: Mises, Hazlitt, Rothbard, Woods. As well, his 137 notes at the back of the book offer invaluable links to this very one-sided "debate."

I have two quarrels with this magnificent book. One, Hammond (pp. 55-56) castigates "revisionist analysis." This is nothing more than a poor word choice. I think a better way to describe Krugman's "disingenuousness" might have been "pusillanimous" or, better yet, "downright lie." Revisionism has made such an important contribution to libertarian historical analysis as to make this statement of Hammond's almost an error. More seriously, this author relies too heavily on prediction, the *bête noir* of logical positivism. However, Hammond and I both very much appreciate that Austrians have been far better predictors than orthodox or Keynesian economists (Block, 2010A). However, this author should have made it clear that this was not due to Austrian praxeology per se, but rather thymology, or history (Mises, 1969, 1978).

I am grasping at straws here to find any shortcomings at all in this very important contribution to Austrian economics. (Hammond's appendix is reminiscent of Haddad and Marsh's entire book in that it contains a wealth of information in quotation format of Mr. Paul's warnings for the future, if the Fed maintains its pernicious policies.)

## 6. Rink, 2011

The full title of this book is "*Ron Paul: Father of the Tea Party*." Yes, this is true enough. But this is hardly what historians 500 years from now will remember Dr. Paul for. Instead, they will see him as one of the leading Austrian economists of his time, and perhaps the most successful libertarian proponent up until the early 21<sup>st</sup> century.<sup>9</sup>

That slight apart, this is an excellent biography of Ron Paul. I am tempted to repeat it word for word, right here and now, so compelling did I find it, but that

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<sup>9</sup> If the human race has not blown itself up by then by neglecting Congressman Paul's foreign policy analysis.

would never do of course. I might run afoul of copyright, and the editor of this journal has given me a strict word limit. Instead, just let me focus on but one element of this magnificent book: the election of Dr. Paul in 1996 for the 105<sup>th</sup> session of congress, which was covered in Rink's chapter 14. This really had me at the edge of my seat. Rink recounts the fascinating David and Goliath story of how Ron first beat out Democrat turned Republican Greg Laughlin for the GOP nomination and then sprinted past Democrat "Lefty" Morales in the general election. If you are not up on your feet cheering for Mr. Paul when you read this, you have a heart of stone, at least where liberty and sound economics are concerned. And this is only one of the many scintillatingly-told episodes in Ron's life.

I have some minor reservations about this book. While it features numerous quotes and a very good index, there are no citations. Historians and other biographers who want to dig deeper into this material<sup>10</sup> and use the present book as a launching pad, will be disappointed. Sometimes, it is difficult to determine who is saying precisely what. On other occasions the statements attributed to Dr. Paul do not sound to my ear as if he would ever had said any such thing. For example, on p. 125 Ron supposedly says of the drug war "I had never advocated legalization." Does that sound like Dr. No to you, gentle reader? Not to me. But without a cite, it is difficult to get to the bottom of this issue.<sup>11</sup> A very different statement of Rink's (p. 211) has far more of the ring of truth for me: "Pandering to the Party-base was not on Paul's agenda. As he had previously demonstrated in the Republican debates, he was willing to state his true beliefs no matter who was listening." This certainly undermines the oft-made claim of his bitter critics that the Congressman was "pandering" to anyone. "Pandering," and "Ron Paul," do not belong in the same sentence as far as I am concerned.

Here are some other attributions to Ron that do not ring true (p. 107): "After the speech, he (Ron Paul) was looking at me and shaking his head. He wasn't blaming me. He spoke to a huge crowd! But that didn't matter to him. The only thing that mattered to him was the television coverage..." this statement was made by Eric Dondero, as of 1998 Dr. Paul's "travel secretary and 'advance man,'" (p. 102) but later estranged from him. I would have liked to see Rink at least query the claim that

Ron cared only about television coverage.

Here is Rink (p. 121):

Paul reached out to DeLay to help him get in touch with Armeiy and the rest of the Republican delegation from Texas. Before announcing his candidacy, he hopped a jet to Washington, DC, with high hopes for a productive meeting. He assumed the Republicans would be interested in the possibility of using his candidacy to increase their number, perhaps offering him financial support and endorsements in his bid to defeat the Democrat.

"A court-ordered redistricting was coming up in Texas, and I told them, 'If you guys help protect my interests in this, I can gain this seat for you,'" he recalled.

This is Ron Paul? Talking about protecting *his* interests? Who, precisely, is making this latter statement? Dondero? Paul? I think the former, but I cannot be certain, based on the text. If Dr. Paul were really interested in protecting his own interests, methinks he would have more likely stayed in Lake Jackson practicing medicine, and writing books about the free market and investing in gold. I would have liked some reaction from Rink at this point at this seeming false note.

Another whine on my part; there is a typo on p. 117, "Reigns" should be reins."

But let me end this review on a positive note. I had to dig deep to find any flaws at all in this marvelous book. The picture on p. 102 (there are many, many other very good ones) is to die for. It features four of my all-time heroes. But I am not going to tell you who they are. Go get this book and see for yourself. That's an order! Ok, ok, I can't resist. They are Bert Blumert, Lew Rockwell, David Gordon and Murray Rothbard. What a fearsome foursome, at least to the bad guys.

## 7. Richardson

Want to get your dander up? Then read this book. Although her voice is cool, calm and collected,

<sup>10</sup> May there be a plethora of them I pray

<sup>11</sup> I am very open to the possibility that this is merely a typographical error.

Richardson's outrage at the unfair treatment accorded Ron Paul can be read practically between each and every line in the book.<sup>12</sup> Let me give you just a small taste of this (pp. 62-63):

"The Nashville *Tennessean* omitted Ron Paul from its Feb 3 voter's guide, but covered all the other candidates and their positions.

"*The Birmingham News*, one of Alabama's largest newspapers, omitted Ron Paul from its extensive voter's guide on Sunday, Feb. 3.

"The evening before Super Tuesday, the Associated Press ran an in-depth article detailing the candidates' final efforts before the big day. All the candidates except Ron Paul, that is."

Now, of course, I knew that the media had all along been mistreating Congressman Paul and his candidacy for president. But I was not as fully aware of each jot and tittle of this injustice until reading Richardson. Her chapters 9-10 alone are worth the full price of admission in this regard. There, she details even more the ill treatment accorded Dr. Paul by such worthies as the entrenched GOP, Fox News<sup>13</sup> and the neoconservatives.

Richardson sets several tasks for herself in this book and accomplishes them all, superlatively. First she asks (p. 1): "Who are these people?" She describes them as follows: "They came from the far reaches of the political spectrum, crossing age and cultural boundaries to surprise their fellow Americans and confound the media elite. They rocketed the 'Asterisk Candidate' to the top of straw polls across the country and campaign polls across the Internet. They all but took his promotion out of the hands of his presidential campaign staff, raising record-breaking millions of dollars in single days, renting the largest blimp in North American to tout his candidacy, and purchasing full-page ads in newspapers before the first primary was held... all independent of the official campaign."

She continues: "Who are these people? That's easy. They're collect students. Grandparents. Veterans.

Professionals. Retirees. Democrats. Republicans. Constitutionalists. Libertarians. Right-wing conservatives. Flaming liberals. Business owners. Doctors. Lawyers. Christians. Agnostics. Atheists. Whites, Blacks, Hispanics and Asians." All this is just from Richardson's first page. I'd quote the rest of the book, too, were the editor of this Journal not breathing down my neck not to do so, rotten kid that he is. In addition she later notes, these people put up yard signs of their own manufacture; they hung banners on highway overpasses; they stood in the rain to cheer on their man; they wrote letters to the editor protesting the unfair treatment accorded Ron. They did all this with little or no support<sup>14</sup> from the official Paul campaign. A high point of this book is Richardson's numerous interviews with several of these very people.

Second, she demonstrates in minute detail just how scurrilously the Congressman was treated. There is a continual litany of the media saying a given indication was important, e.g., straw polls, and then when Dr. Paul does well in them, such criteria are deemed irrelevant. These stories, and the outraged way Richardson tells them, make the blood boil of all red-blooded Ron Paul supporters.

But this book is by no means limited to litany of injustices perpetuated on our man. Her take on substantive issues is as sure-footed as any devoted libertarian would wish. Her renditions of Dr. Paul on war, taxes, economics, immigration, abortion, guns, education, health care, and many more, serve as a good introduction to the Ron Paul philosophy, as good as any ever written.

I have but one criticism of this excellent book. Richardson's contribution to it ends on p. 132. The volume ends on p. 191. Why the difference? From page 133 until the close of the book there are two appendices which reprint two of Congressman Paul's speeches. These of course were superlative. They are well worth intensive study. However, they are available electronically. I would have appreciated hearing more from this new important contributor to the freedom movement, Richardson. Or, if she had no more to say, the book should have ended on p. 132.

Let me end on a note that will prove to be controversial, but really should not be. First, I note that Richardson is a woman. That alone is somewhat surprising, given the disproportionate number of females in the libertarian movement. Notice of this fact will no doubt be seen as an indication of a denigration of females. Well,

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<sup>12</sup> Alright, I exaggerate, but only slightly.

<sup>13</sup> "Fair and balanced," indeed.

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<sup>14</sup> But with great appreciation

let those who object to this make the most of it. Here comes an even more politically incorrect insight. Based on the picture of her that appears on the back cover of her book, this lady is one of the most beautiful women not merely in our movement, nor only in the U.S., but on the entire planet. Does it deprecate women in general or their intellects to merely mention such a fact? Not at all. Facts are facts. Merely because a bunch of harridan feminists might object to this one being noted does not render it untrue or improper. Nor is it a put-down. Looks and talent; the one has nothing to do with the other. But, as a book reviewer, I feel obligated to report on anything of potential interest to the reader, and this certainly qualifies.

### 8. Stevo, 2012

The Stevo book is somewhat a departure from all the others in this review. It, virtually alone, is devoted not to biography, nor to libertarian principles, nor to the Ron Paul debates but rather solely to strategy.<sup>15</sup> And here, I confess, lies a bit of a weakness of mine. I feel on solid ground when it comes to Austrian economics or libertarian theory, but the best strategy for the Austro-libertarian movement has always been a bit of a mystery to me. If I have any views on this it is “different strokes for different folks.”<sup>16</sup> What will work for some people, will not work for others. Let us take two illustrative examples. Who are the two most successful leaders of the freedom movement in terms of converting massive numbers of people to our banner? Obviously, they are Ayn Rand and Ron Paul. They and only they were able to fill stadiums full of people for the cause of liberty.<sup>17</sup> And yet these two people had virtually the opposite personalities and characters, and thus their strategies were entirely different. Ayn Rand personified an attitude of “in your face,” while

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15 The only exception to this claim are chapters 14-18 of my own book (Block, 2012A) where I muse about how Ron can most effectively deal with “interviewers” who will not allow him to speak, who continuously interrupt him on those rare occasions he is allowed to get in a word or two (literally) in edgewise. As well, I look at other tactical and strategic issues in that section of my book.

16 I am not only a methodological individualist, in the scientific praxeological tradition, but also apply this to strategy.

17 Ludwig von Mises, Murray Rothbard and Friedrich Hayek may have made a stronger and more lasting intellectual case for laissez faire capitalism, who can say, but we are now discussing mass appeal, not that confined, mainly, to scholars. Here, Mr. Paul and Miss Rand reign supreme.

Ron Paul pursued a much more low key strategy. So, in my view, there is no one right viewpoint to take on this issue.

What is Stevo’s contribution to this matter? The first two words of the title of this book are “How to.” Well said. This is indeed a “how to” book. How to do what? To elect Ron Paul president of the U.S., of course. The volume is now a bit dated in that it offers a plan to win the 2012 election, and it is now 2013. It would have been equally “irrelevant” had it been aimed at 2008, or even 2016 or thereafter. That is, it is not irrelevant at all, nor is it merely of antiquarian interest. It is rather chock-full of crucial information for any election of any libertarian at any time or place. If I had to sum this book up in a short phrase it would be “applying common sense with the benefit of vast experience to the challenge of electing libertarians.”<sup>18</sup>

Yes, Stevo make the case in behalf of Ron Paul. He does so with verve and insight. But he spends very few pages on this labor of love. If that is your main interest, do not read this book. However, if you want to become a far more effective supporter of candidates like Ron Paul, if you want to use your time to this end more efficiently, then, again, don’t read it. Instead, *devour* it. Peruse it over and over again until you fully grasp its message.

What, then, is its message?

He states (pp. 10-11): “1. Ask pro-peace Democrats that you personally know to vote Republican in the primaries for Ron Paul and make sure that those who agree to vote for Ron Paul actually show up on election day. 2. Work the rest of your ‘social precinct.’<sup>19</sup> 3. Activate your own network of Ron Paul supporters.”

In this brief review I cannot fully convey the myriad of hints, suggestions, and advice Stevo gives. They all have the ring of truth. In sports, the key to success is to “keep your eye on the ball.” This author is asking all of us to keep our eyes on the political ball, so as to better promote the Ron Paul type candidacy. He does not allow himself, or us, to be deflected for even a moment from this one goal. In short, he is unswerving, intent, monomaniacal,

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18 Wenzel (2012) favors libertarian campaigns not so much to elect libertarians as to publicize liberty, without compromising principle. I am just a bit more optimistic than he, particularly for minor offices such as dog catcher, mayor of a town of only a few hundred people. However, it cannot be denied that Ron Paul is a libertarian, and was elected to a pretty high political office, for more than just a few times.

19 By this Stevo means family, friends, fellow club, church, team members, etc. What used to be called whoever you list on your rolodex. You youngsters out there, look this up.

bless him.<sup>20</sup>

I content myself with but a few examples of this marvelous work. He warns of the “neutralizer” (p. 180) someone who may well be a Paul supporter, but with enthusiasts like this we might well prefer actual enemies. Stevo mentions a man in a V for Vendetta mask who completely hijacked a libertarian event, and cost our movement valuable television coverage. Costumes like this are perfectly all right; at a Star Trek convention, the purpose of which is not to elect a president. But if that is the goal, we would be better of “being clean” for Ron,<sup>21</sup> dressing and acting much like Mormon missionaries.

Here is yet another gem (p. 122): “Just like anyone with ideas revolutionarily different from the status quo, Ron Paul generates his fair share of contempt. You don’t need to worry about convincing his haters to love him That’s futile and doesn’t matter in an election. In an election you want to focus on the people who are already sympathetic to his ideas. The one with the most votes wins, not the one with the fewest enemies.”

No book can be all bad that severely rebukes traitors to the libertarian cause such as David Boaz. Says Stevo of this imposter: “Ultimately, anyone who says ‘Ron Paul is the wrong messenger’ betrays his own lack of belief in personal choice.”<sup>22</sup> However, I think Stevo lets Boaz off too lightly when he implies the latter is merely a “defeatist” or “downer.” I know Boaz, personally, and he is none of these things. Instead, Boaz is upbeat and optimistic -- about the issues he supports. No, “traitor” is far more accurate (Block, 2010B). It is one thing for a Paul Krugman, or a Giuliani, or a Sean Hannity to attack Ron Paul. Such people are well known to be enemies of liberty. But Boaz has been long associated with the libertarian movement. He is the vice president of the Cato Institute, an organization linked in the public mind with free enterprise. Boaz (1997) has even had the effrontery to write a book with the “L” word in its title. For him to denigrate Ron Paul as the “wrong messenger” for liberty is an unforgiveable stab in the back. Ok, ok, not unforgiveable. Were Boaz to publicly apologize for this act of his and beg forgiveness, it would be granted by many libertarians, me certainly included. But, of course,

he has done no such thing.<sup>23</sup>

When I first read Stevo’s advice on Krugman, ignore him, it is a waste of time to attack him, his mind is already made up, set in stone, there is no chance of ever changing his mind, I disagreed with the author of this book. My thought was that it is good to take on the most famous, prestigious and articulate of the many enemies of human freedom. Even if Krugman himself remains obdurate, he can still be taken down a peg or two in the eyes of his followers, and potential ones too. Stevo’s point was rather problematic for me, as I am a professor accustomed to criticizing precisely scholars such as Krugman.

But then I remembered Stevo’s advice about narrowing our focus, keeping our eyes on the ball: Ron Paul for president, or, more generally, electing principled libertarians. Will refuting Krugman help do this? Not bloody likely. It would be the rare voter who would even understand such an intellectual battle. What of Hammond (2012) who offers us a “debate” between Krugman and Paul, and my very positive review of that book? Am I committing a logical contradiction? Not a bit of it. Not every book praising Ron Paul and his candidacy has to be narrowly focused on that one goal as does Stevo (2012). Hammond (2012), and my strong support for it, is thus not incompatible with Stevo’s far more limited goal, and my championing of that, too.

It is unusual for a book review such as this to even mention an acknowledgements section, let alone praise it. I shall risk all in breaking this tradition. Stevo mentions some four dozen people and organizations. I had never before even heard of most of them. Why do I mention this? This is because it is notable that a person such as me who has been deeply involved in libertarianism since about 1964 is ignorant of an entirely different strand of our movement. This could not be the case were we not growing by leaps and bounds, and these few pages at the very end of his book make this case in spades.

I end this review on a rather charming note. Stevo (p. 3) makes a reference to Murray N. Rothbard as a “historian.” I have never before seen such a description of my friend Murray. I am far more accustomed to seeing him referred to as an economist, ethicist, logician, strategist, even as “Mr. Libertarian.” I do not at all quarrel with this description. Lord knows, if Rothbard’s contribution was solely limited to history, he would well deserve such an appellation. It is only testimony to his

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20 An alternative aphorism employed by Stevo is “Grab up the low-hanging fruit, first.”

21 “Be clean for Gene” was the rallying cry for [Eugene McCarthy’s 1968 Presidential Campaign](#).

22 Stevo (2012, 126) cites Boaz saying precisely that.

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23 For a good critique of Boaz, see Tucker, 1997

gigantic contribution that this description would even be slightly remarkable.

### **Conclusion.**

These books, all of them put together, have been written, almost, as if by one very erudite person. Or, perhaps, a better way to put this is that they have seemingly been created as if by several co authors, planning out a major collaborative project. What I am getting at here is that there is very little substantive overlap amongst them. For the most part, they cover different aspects of the Ron Paul phenomenon. Of course, there is but one exception to this rule: the love for Dr. Paul and what he stands for exudes from almost every page of each of these publications. One would have to be very hard-hearted not to appreciate the admiration and respect that each of these authors has for

the Congressman's rEVOLution.

There is of course some incompatibility. One author inveighs against even mentioning Krugman. But virtually the entirety of another's book concerns that particular fraudulent economist. However, this is the only bit of contrariness I was able to discern in my perusal of this entire oeuvre; perhaps the exception proves the rule.

It is my fervent opinion that this is an important set of books.<sup>24</sup> If what Ron Paul stands for is to be promoted, it cannot be done, only, via his own publications. It is important that those of us who are his students, his admirers, also make a contribution to his efforts. Writing books about Mr. Paul and his philosophy is certainly one way to do just that.

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<sup>24</sup> Please excuse my blatant self-promotion, in that I am one of the authors in this compilation.

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## ***David Stockman, The Great Deformation: The Corruption of Capitalism in America (Philadelphia: Public Affairs, 2013)***

George Bragues<sup>1</sup>

To those who remember the various political dramas that enveloped the Reagan presidency, David Stockman will immediately come to mind as the person who served as that administration's budget director from 1981 to 1985. Afterwards, Stockman embarked upon a career in high finance that ended when America's prosecutorial state bore down upon him with allegations of civil fraud. Eventually settling the charges, Stockman has gone on to apply his business experience, illumined by a decent grounding in Austrian economics, to explaining the ills of contemporary American political and economic life. He locates the ultimate cause of these in the evolution of the country's financial and monetary system in *The Great Deformation: The Corruption of Capitalism in America*. Stockman could certainly have improved his mode of presentation in this book, but his thesis is basically right that America's commercial republican order has become almost fatally corrupted by the abandonment of a sturdy monetary anchor.

To claim that the politico-economic status quo is

corrupt presupposes an ideal state from which the current situation deviates. For Stockman, that ideal reasonably consists in a government that restricts its military forces to the defense of the nation against foreign attacks; that limits the provision of welfare and social insurance to those in demonstrable need; that keeps its spending in line with the revenues it is able to collect via taxes; and that neutrally enforces the rules of the game in a free market based on private property and sound money. Instead, as Stockman details, the U.S. military is regularly summoned to intervene abroad for ostensibly realpolitik and moral purposes. The American welfare state is a gargantuan cash cow fed by high taxes and milked by the less needy. Special interest groups systematically extract legislative and regulatory privileges from the state. Not only that, the government engages in macroeconomic stabilization policies with a combination of ad hoc tax and spending maneuvers and the discretionary management of a fiat money. The result of all this is a progressively debilitated economy ever more prone to boom and bust sequences as well as a government addicted to deficits and saddled with an accelerating debt. Going forward, as Stockman rightly notes, the high debt portends an ominous rise in social discord, as every interest group fights to defend their

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perquisites and tries to pass on the costs of debt reduction to others.

How did we arrive at this sorry state? According to Stockman, the key lies in President Richard Nixon's move in 1971 to close the gold window. Keeping this open was a *sine qua non* of the Bretton Woods regime of fixed exchange rates that had prevailed since the end of World War II, a system in which the U.S. committed itself to exchanging gold for dollars at a \$35 per ounce rate with central banks around the world. Once the U.S. reneged on this commitment, Bretton Woods was doomed, a system of floating currencies manipulated by governments took over, and politicians became empowered to more effectively pressure central bankers to fund their vote-getting projects with money printed on demand.

So long as money was backed by gold, this could not be so easily accomplished. Politicians had to finance government expenditures by taking on the challenging tasks of convincing voters to pay higher taxes. Granted, there was always the option of issuing government bonds to make up for a shortfall, but the central bank could not be so readily marshaled to monetize the debt. With gold taken out of the money equation, a crucial budgetary restraint on political decision making was removed. Washington became an uninhibited feeding ground for corporate and industry lobbyists, while the Fed acquired the habit of stoking unsustainable booms by frequently maintaining interest rates below market levels, with the financial crisis of 2008, and the associated bailouts, being the latest, and most detrimental, consequence of Nixon's fateful decision.

To Austrian economists, this story definitely has a familiar ring to it. Yet in an intellectual and political milieu dominated by the notion that our problems lie in too little government regulation, it is a story that bears retelling. Inasmuch as Stockman acquired a reputation

during his time in the Reagan administration as someone who speaks truth to power, his telling is apt to obtain a receptive audience across the ideological spectrum than an Austrian economist would have difficulty eliciting. More importantly, Stockman enriches the story with an impressive attentiveness to historical and institutional details as well as a solid grasp of the complexities of modern financial markets. This allows readers to follow each step along the path that all the new money created since 1971 has taken – that is, from its original injection by the Fed into the banks of Wall Street, where the funds would be used in carry trades to finance ever more complex investment and speculative positions, and from there eventually reverberating to Main Street, disproportionately benefiting financial elites and the wealthy along the way. Stockman also knows his way around a set of financial statements. He uses this mastery to convincingly demonstrate that there never was any danger that letting AIG fail in 2008 would unleash a contagion that would have brought the entire financial system crashing down. This proof alone that the bailout of Wall Street had no rational basis is worth the price of the book.

All this being said, one wishes that Stockman, or at the very least his editor, would have pruned this large book. There is much repetition here that tests even a sympathetic reader's patience. More than just occasionally, too, Stockman is too acerbic. Finally, Stockman missed the chance to go deeper in his analysis. The question is left hanging as to why the U.S. abandoned gold in the first place. Stockman endeavors to provide an explanation, but it depends too much on the individual proclivities of those who happened to be calling the shots within the Nixon administration at the time. Might the decision to give up on gold been the result instead of larger social forces, perhaps related to the exigencies of democracy?



