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VOLUME 8

THE DYNAMICS OF INTERVENTION: REGULATION AND REDISTRIBUTION IN THE MIXED ECONOMY

P. KURRILD-KLITGAARD

Editor

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EDITOR'S NOTE

Advances in Austrian Economics maintains a strict policy of double-blind refereeing. The current volume, however, contains contributions unusual for this series, such as underground classics previously available only as *samizdat* manuscripts and an article appearing earlier in a refereed scholarly journal. It was therefore decided that not all contributions would be subjected to the normal refereeing process.

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EDITOR'S INTRODUCTION

This volume of *Advances in Austrian Economics* brings together a number of studies, but split along two fields of concentrations. The primary, which makes up the vast majority of the pages of the volume, is dedicated to an examination and re-appreciation of the insight of the Austrian School of Economics usually referred to as the theory of interventionism and closely associated with the research of the Austrian School giants Ludwig von Mises and F.A. Hayek (e.g. Mises [1929] 1996 [1940] 1998; Hayek, [1944] 1976). Together they formulated and applied an innovative theory of how government intervention may come to have a dynamic character, where intervention in one area will tend to generate still more and still farther-reaching interventions. The second is a small section with a debate between on one hand, Walter Block and William Barnett and on the other, Gordon Tullock, which is part of a long on-going debate on Austrian business cycle theory, which initially began elsewhere (Tullock, 1987, 1989; Salerno, 1989; Wagner, 2001; Block, 2001).

The purpose of this volume has been to continue the editorial ambition set out in the first editorial preface of the present editorial staff: That is, to encourage and publish research from a perspective that sees Austrian economics less a particular doctrine or method with a fixed set of principles and more as a rich and living tradition of research in the social sciences broadly conceived – and one whose potential has not been exhausted (Koppl, Birner, & Kurrild-Klitgaard, 2003). A second aspiration outlined on the same occasion was to explore the potential of engaging other scholarly traditions, and to include these even if they are not strictly Austrians (however narrowly or broadly that tradition might be defined). We believe that both these aims are expressed in the type of analysis and dialogue exhibited in this volume.

We are grateful to the contributors, in particular to Walter E. Grinder and John Hagel III for letting us include two previously unpublished papers, which long have been known to a small group of scholars, but which should be shared with others. We also are grateful to Vibeke Pierson who provided valuable editorial assistance on three manuscripts, and to Stefan Voigt who made useful suggestions.

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PART I:
THE DYNAMICS
OF INTERVENTION

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THE POLITICAL ECONOMY OF THE DYNAMIC NATURE OF GOVERNMENT INTERVENTION: AN INTRODUCTION TO POTENTIALS AND PROBLEMS

Peter Kurrild-Klitgaard

1. INTRODUCTION

In almost all aspects of social life government intervention seems much more pervasive and intrusive today than ever before – at least in many of the Western countries. Governments seem year by year to consume still more resources and to regulate the details of the actions and interactions of their citizens still further.

As such the development might easily be seen as an expression of the dangers, which the Nobel Prize winning giant of the Austrian School of Economics, F.A. Hayek (1899–1992), warned against in his famous classic, *The Road to Serfdom* (Hayek [1944] 1976; cf. Hayek [1973] 1982, vol. II, p. 120). Here Hayek in essence argued that intervention in one area may lead to intervention in more areas, and intervention beyond a certain point may lead to total planning of everything:

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> It is sometimes said … that there is no reason why the planner should determine the incomes of individuals. The social and political difficulties involved in deciding the shares of different people in the national income are so obvious that even the most inveterate planner may well hesitate before he charges any authority with this task. …
>
> [But we] have already seen that the close interdependence of all economic phenomena makes it difficult to stop planning just where we wish and that, once the free working of the market is impeded beyond a certain degree, the planner will be forced to extend his controls until they become all comprehensive. These economic considerations, which explain why it is impossible to stop deliberate control just where we should wish, are strongly reinforced by certain social or political tendencies whose strength makes itself increasingly felt as planning extends.
>
> Once it becomes increasingly true, and is generally recognized, that the position of the individual is determined not by impersonal forces, not as a result of the competitive effort of many, but by the deliberate decision of authority, the attitude of the people toward their position in the social order necessarily changes. There will always exist inequalities which will appear unjust to those who suffer from them, disappointments which will appear unmerited, and strokes of misfortune which those hit have not deserved. But when these things occur in a society which is consciously directed, the way in which people will react will be very different from what it is when they are nobody's conscious choice. …
>
> While people will submit to suffering which may hit anyone, they will not so easily submit to suffering which is the result of the decision of authority. It may be bad to be just a cog in an impersonal machine; but it is infinitely worse if we can no longer leave it, if we are tied to our place and to the superiors who have been chosen for us. Dissatisfaction of everybody with his lot will inevitably grow with the consciousness that it is the result of deliberate human decision.
>
> Once government has embarked upon planning for the sake of justice, it cannot refuse responsibility for anybody's fate or position. In a planned society we shall all know that we are better or worse off than others, not because of circumstances which nobody controls, and which it is impossible to foresee with certainty, but because some authority wills it.
>
> And all our efforts directed toward improving our position will have to aim, not at foreseeing and preparing as well as we can for the circumstances over which we have no control, but at influencing in our favor the authority which has all the power. The nightmare of English nineteenth-century political thinkers, the state in which ''no avenue to wealth and honor would exist save through the government,'' would be realized in a completeness which they never imagined – though familiar enough in some countries which have since passed to totalitarianism. …
>
> There will be no economic or social questions that would not be political questions in the sense that their solution will depend exclusively on who wields the coercive power, on whose are the views that will prevail on all occasions (Hayek [1944] 1976, p. 105ff).

While Hayek's exposition of this analysis was path-breaking and eye-opening to many people, he was in reality only making an application of a logic, he had been taught by his mentor, fellow Austrian School giant, Ludwig von Mises (1881–1973), in the 1920s. Mises' analysis was begun as early as in 1912 with *Theory of Money and Credit* (Mises [1912] 1971), it was later developed in his critiques of socialist planning (e.g., Mises [1922] 1981), and is set out in detail in a number of shorter works (Mises [1929] 1996, [1940] 1998, [1950] 1991), and in his magnum opus, *Human Action*, Mises explicitly and systematically integrated his analysis of the dynamic character of government intervention with his more fundamental logic of human action, the socialist calculation problem, property rights, etc. (Mises [1949] 1966, ch. XXXVI).[1] This research paradigm, its promises, problems and potential – is the topic of the present collection of essays.

2. THE MISES–HAYEK POLITICAL ECONOMY ANALYSIS OF INTERVENTION

The essence of the insights making up the core of the analysis of interventionism formulated by Mises and Hayek may be summarized as the view that every government activity necessarily constitutes an intervention, i.e., an act whereby resources (in the broadest possible sense) through the coercive intervention of the government are reallocated relative to what would have been the outcome if human beings had been allowed to interact freely, and where this intervention results in welfare losses for at least some of the parties involved and potentially for all.[2]

However, what makes this process dynamic is the further insight that when such an intervention takes place the disturbance in the forces of supply and demand will lead to problems, which the decision-makers will subsequently have to address. In essence, they are then confronted with a new choice: to repeal the original intervention or to introduce further interventions. If they repeal the original intervention, they may recreate the market solution, but if they instead decide to intervene still further, it will only be a question of time before new, negative consequences of the new intervention manifest themselves – at which point they will be facing a replay of the previous choice.

Yet, if the decision-makers consistently choose to intervene still further rather than to repeal the interventions creating the welfare losses in the first place, they will produce a still more government-controlled society – a *Zwangswirtschaft*. To paraphrase Adam Smith's description of the beneficial outcomes of the market process – but here with a quite different conclusion – decision-makers are now led as if by an invisible hand to an end that might not itself have been part of their intention, i.e., they are led down the road to serfdom.

Any attempt at creating a "middle of the road" between a pure free market economy and a completely planned economy must, according to Mises and Hayek, ultimately fail, because such a condition cannot itself remain stable. The problems created by the original interventions will continuously create disturbances in the markets and necessitate still new decisions on what to do and will tend to generate still more intervention (Mises [1929] 1996, p. 54, [1949] 1966, p. 858f, [1950] 1991; cf. Burton, 1984; Kurrild-Klitgaard, 1990). The interventions made by the government simply cannot achieve the goals set; quite on the contrary they will worsen the situation, which will lead to further interventions, etc., and eventually these choices will lead to a totally government run economy – or alternatively have to be abandoned. Mises took this perspective to its ultimate conclusion: "There is *no* other choice: government either *abstains* from limited interference with the market forces, *or* it assumes *total control* over production and distribution. Either capitalism or socialism; there is no middle of the road" (Mises [1929] 1996, p. 9; emphasis added).

As such any attempt at a system of middle-of-the-road interventionism will not be a very successful one:

> [The] universal struggle against competition promises to produce in the first instance something in many respects even worse, a state of affairs which can satisfy neither planners nor liberals … By destroying competition in industry after industry, this policy puts the consumer at the mercy of the joint monopolist action of capitalists and workers in the best organized industries. Yet, although this is a state of affairs which in wide fields has already existed for some time, and although much of the muddled (and most of the interested) agitation for planning aims at it, *it is not a state which is likely to persist* or *can be rationally justified.* Such independent planning by industrial monopolies would, in fact, produce effects opposite to those at which the argument for planning aims. Once this stage is reached, the only alternative to a return to competition is the control of the monopolies by the state – a control which, if it is to be made effective, must become progressively more complete and more detailed. It is this stage we are rapidly approaching. … if we are … rapidly moving toward such a state [of centralized planning], this is largely because most people still believe that it is [sic] must be possible to find some middle way between 'atomistic' competition and central direction. Nothing, indeed, seems at first more plausible, or is more likely to appeal to reasonable people, than the idea that our goal must be neither the extreme decentralization of free competition not the complete centralization of a single plan but some judicious mixture of the two methods. Yet mere common sense proves a treacherous guide in this field. Although competition can bear some mixture of regulation, it cannot be combined with planning to any extent we like without ceasing to operate as an effective guide to production. … Both competition and central direction become poor and inefficient tools if they are incomplete; *they are alternative principles used to solve the same problem, and a mixture of the two means that neither will really work and that the result will be worse than if either system had been consistently relied upon* (Hayek [1944] 1976, p. 41f; emphasis added).

3. THREE CHALLENGES FOR THE MISES–HAYEK ANALYSIS

So, given the Mises–Hayek analysis, are we on the way to Leviathan? And are societies and economies therefore going to pieces? Or are we, quite on the contrary – and as some critics of ''globalization'' and ''neo-liberalism'' might claim – solidly on the way to a capitalist economy and a minimal state?

The latter would certainly seem not to be the case. But neither would it seem to be altogether clear that the former is the case. For a while the scope of government intervention in terms of potential interference has been extended in many countries, not all of them have experienced a steady de facto expansion of government in all areas – and some not in very many areas. Some countries, most notably the former socialist states in Eastern Europe, have indeed even witnessed dramatic declines in government intervention since 1989 – and yet not really realized completely free markets. In fact, for many Western countries the overall picture of recent decades would seem to be one of increasing regulation in some areas, some decrease in regulation in other areas, and with total taxes more or less stabilizing, albeit perhaps at relatively higher levels than in previous decades.

To illustrate this we may consider the changes in actual government intervention in the economies of the world in recent decades as measured by the extent of economic freedom, analyzed by the Fraser Institute and its collaborators in the Economic Freedom of the World Index (Gwartney, Lawson, & Gartzke, 2005). Fig. 1 exhibits the development in overall economic freedom in the countries rated in the index since 1970 on a scale from 0 to 10. The figure, which gives graphs for both the average index values for all rated countries and for only OECD countries, shows an overall decrease in economic freedom (and hence increase in government intervention) in the 1970s and early 1980s, after which the average index values for the rated countries have risen and stabilized.

However, these average index values cover quite different countries, which may have experienced quite different changes over the period. So, alternatively we may consider just a single country, such as done in Fig. 2, which displays the index values over time of the seven main areas covered by the Economic Freedom of the World Index as well as the overall index value, but here only for the case of one country (Denmark). As is evident, the individual policies have changed significantly over the period: In some areas government intervention has become more pervasive (public sector size and regulation of businesses); in other areas, it has become much less so

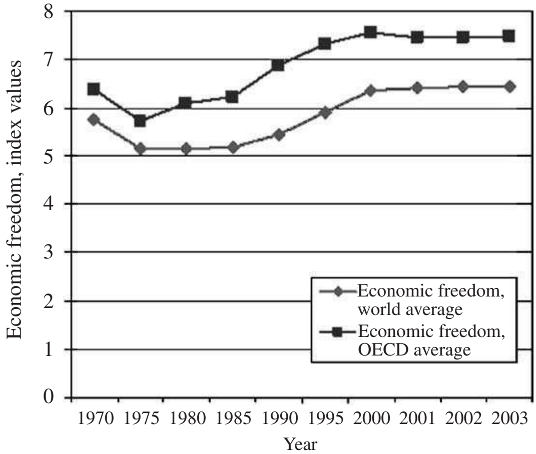

Fig. 1. Changes in Averages, Economic Freedom of the World Index, all Countries and OECD Countries, 1970–2003.

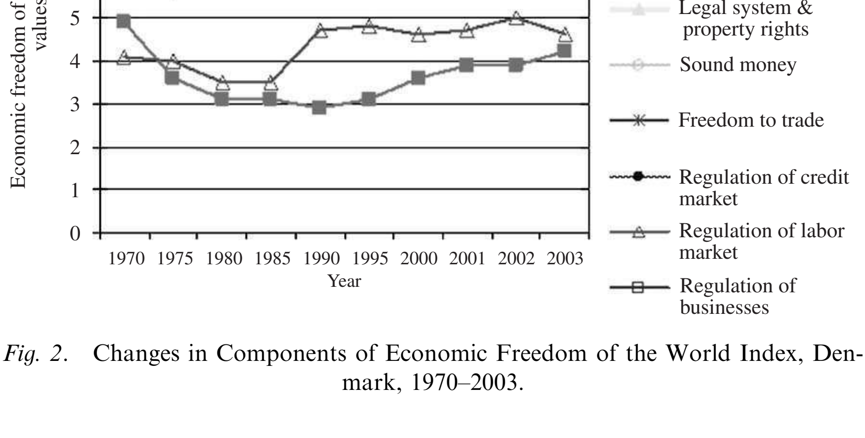

Fig. 2. Changes in Components of Economic Freedom of the World Index, Denmark, 1970–2003.

(monetary and trade policies, etc.), and in yet other areas there have been minor changes during the period but with no overall changes (e.g., regulation of labor markets). The overall picture is one of increasing overall economic freedom, even if, e.g., the tax burden has increased.[3]

Either way, the general picture seems to be that both individual countries and a large number of countries on average may display the same pattern: interventionist economies, where governments often intervenes, some times more and some times less, depending on the areas. There is no consistent march toward either serfdom or freedom, at least not over the last 30–35 years.

Now, disregarding the possible issue that the index may be fundamentally flawed, these two figures alone suggest that there are issues which the analysis of interventionism needs to address. Why have there been changes up and down in the overall extent of economic freedom (rather than uniform tendencies)? That is, what drives such changes, and why have the countries of the world not gone either all the way down the road to serfdom or all the way up the road to freedom?

As for the second part of the Mises–Hayek claim – that the consequences of such an interventionist regime will be unattractive – it is less obvious that the interventionist regimes necessarily do extremely poor. While the consequences of government intervention are far from as positive as envisioned by the most optimistic champions of such policies, and while government intervention indeed seems empirically overall to be hurtful to growth and prosperity (cf., e.g., Scully, 2001; Holcombe, 2001; Berggren, 2003; Kurrild-Klitgaard & Berggren, 2004), we should simultaneously acknowledge that the problems facing many modern societies, even the more regulated and taxed ones, are not necessarily as obviously frightening as what Mises and Hayek feared. A lot of countries could be doing much better in terms of the living standards of their citizens, but quite clearly many could also be doing much worse. Yet Mises, for example, spoke of how

> The interventionist policies as practiced for many decades by all governments of the capitalistic West have brought about all those effects which the economists predicted. There are wars and civil wars, ruthless oppression of the masses by clusters of self-appointed dictators, economic depressions, mass unemployment, capital consumption, famines (Mises [1949] 1966, p. 855).

Such phenomena have indeed occasionally occurred, not least in Mises' own time, but they are not the general picture of, e.g., those many Western countries, which have regimes that in almost every way are considerably more interventionist than they were, when Mises and Hayek warned that the middle-of-the-road was untenable and that these states were on the road to serfdom. So, while there is a well-established association between economic freedom and economic growth and prosperity, we should at least be somewhat puzzled when we observe that many interventionist countries seem to be doing comparatively fine. Even the most obvious of all types of government activity – i.e., the size of the public sector as such – does not seem to have significant, visible harmful (or beneficial) consequences with regard to economic growth (cf. Gordon & Wang, 2004). In other words, a little intervention here and there, while harmful, may not necessarily kill the goose that lays the eggs.

On the other hand, if the consequences indeed occasionally or for longer periods seem to be too negative, then we have, what Ikeda has called the "Misesian paradox", e.g., in his contribution to this volume: if "interventionism is, as Mises describes it, illogical, unworkable, unsuitable, self-defeating, and contradictory ..., why is it the most widespread and persistent politico-economic system in the world? (cf. Ikeda, 1997, p. 46).

There are, arguably, three problems confronting the application of the Mises–Hayek insights. The first is that there seems to be an aspect of almost determinism to it – or at least a sort of binary quasi-determinism. In certain passages of Mises and Hayek it seems specifically to sound as if there really are two and only two possibilities at each "decision node" – to intervene or not to intervene – and two and only two possible final outcomes – either a completely free market economy or a completely regulated, planned economy. Hayek, for example – in the previously quoted passage – seems to suggest that there is a "point of no return", after which interventions necessarily will lead to a total planned economy (Hayek [1944] 1976, p. 105).[4] Mises almost simultaneously suggested in an even more deterministic tone exactly the opposite conclusion – that the level of interventionism as it was after World War II had reached an unsustainable level and would have to disappear altogether: "Yet the age of interventionism is reaching its end. Interventionism has exhausted all its potentialities and must disappear. ... The interventionist interlude must come to an end because interventionism cannot lead to a permanent system of social organization" (Mises [1949] 1966, pp. 855–858). Obviously, both cannot simultaneously and equally be true.

Even if we accept these supposedly mutually exclusive final outcomes as ideal-typical characterizations that may be possibilities, it should be obvious that these are not the only logical or empirical possibilities. A middle-of-the-road system of relatively widespread intervention may perhaps lack a solid, consistent normative justification of its own,[5] and it may seem difficult to define conceptually in a way which simultaneously is logical, comprehensive and empirically applicable, but obviously it is not something that a priori simply cannot exist in practice – not for longer periods and perhaps not even without obviously catastrophic consequences.

But maybe there is no necessity in a steadfast march either one way or another. There would seem to be two main arguments for this, a predominantly theoretical and an empirical observation combined with theoretical insights. The theoretical argument is that these simply are not the only necessary alternatives in any meaningful sense. If we consider the logic of the decision-making situation as it would look like if we displayed it in an extensive form of a game-theoretical analysis, then there is simply no necessity for the outcome to be either a totally free market economy or a *Zwangswirtschaft*, where everything is regulated and redistributed; there are numerous other options and several other scenarios. Most fundamentally the political decision-makers may consider not simply either intervening or not-intervening: rather, they may consider a broad range of policies, ranging from total Marxist-style intervention and all the way to a total Rothbardian-style extinction of government activities in that particular area (or all areas), as well as – between these poles – an infinite number of other possible policy alternatives, including minor increases or decreases in existing interventions – and even not doing anything at all. At the next node in this decision-tree – to borrow a metaphor from game theory – "nature" will be responding to whatever the decisions of the political decision makers were, but since we have no exact knowledge of the preferences and resources of the agents in the market place (or in the political market), we cannot a priori determine, beyond the extremely general, what the negative consequences will be – including whether or not they will be so considerable as to necessitate a further, future decision on whether to de-intervene or re-intervene – or not do anything at all. This would indeed also seem to mirror real-world empirical experience fairly well. Even when deregulation takes place, it rarely results in all government activities being completely abolished in that particular area, but rather in the creation of some new regulations simultaneous with the abolition of others.

There is another reason why the logic may not be as straightforward as suggested by Mises and Hayek, namely that there conceivably may be inherent "equilibrating" tendencies also in the process of intervention, whereby there – so to speak – are upper limits to how much may be intervened before the problems become so big that the decision-makers decide to loosen a bit, albeit without doing so more than what is necessary to keep the economy from collapsing. This line of reasoning was perhaps first suggested by the British political scientist Norman P. Barry (1984b; cf. 1984a) and subsequently criticized (Gray, 1984; Burton, 1984). What Barry suggested was, in essence, that there may be an "optimal rate of exploitation", where interest groups with interests different from those demanding more intervention may counteract the activities of the latter through the state itself, thus producing a consequence different from the Hayekian "Serfdom".[6] Barry's specific analysis invoked the fact that none of the western, liberal democratic market economies (whom Hayek was warning in 1944) have actually experienced the hyperinflation, which Hayek argued would be the automatic and necessary consequence of the policies he was criticizing.

To this we might add the example of the Laffer curve: the argument put forward by many free market economists from the 1970s and onwards that government revenues might actually be increased by lowering taxes and thereby stimulating the incentives for the market participants to engage even more in productive and mutually advantageous relationships – from which governments might then skim the cream, so to speak (Laffer, 2004). If indeed governments reacted to such analyses then that behavior would be consistent with Barry's hypothesis – thereby suggesting that there are variations of the "middle-of-the-road" – interventionism and that these may actually occasionally learn from mistakes, but only fiddle with the possibilities rather than fundamentally change the system.

The bottom-line thus becomes that portraying the choices of the decision-makers as simple binary choices is simply not very realistic (in any sense of that word), and hence that the portrayal as one between complete capitalism or socialism simply does not make sense. Furthermore, such a portrayal of the choice of the decision-makers almost of necessity leaves the analysis somewhat impotent when it comes to interpreting and explaining the events of the somewhat more complex empirical reality. However, there are obvious issues, which the analysis should seek to address. Why is it that sometimes decision-makers choose to extend intervention and other times to repeal it (or some-times to do nothing at all)? What is the role of "culture" or ideology in either supporting or restricting interventionist decisions? Austrian economic analysis, as it currently stands, has very little to say on this issue. In contrast, academics outside the tradition – often in ignorance of the Mises–Hayek analysis – have highlighted some factors, which might easily be integrated into the analysis, most notably the asymmetric nature of the relative dispersion of costs and benefits among decision-makers, interest groups, etc. (Olson [1965] 1971; Buchanan, 1979; Wilson, 1980; Arnold, 1990). Together the observations should necessitate some second thoughts among those fond of the Mises–Hayek type analysis. In particular, it would seem that social scientists working in the Austrian tradition need to focus more specifically and less abstractly on how particular versions of interventionism may work in practice.

The second problem is that there seems to be a rather poor application of the insights to cases of theory building or empirical applications. Many Austrian School economists seem to have been quite satisfied to repeat the general points made by Mises and Hayek, but not really to elaborate the theoretical framework. There are some notable exceptions, e.g., attempts at taking the purely theoretical analysis of interventionism further (Rothbard [1970] 1977; Ikeda, 1997), at bridging into new theoretical insights (e.g., Higgs, 1987) and to conduct empirical applications (e.g., Rothbard, 1963; Thornton, 1991), but such attempts have generally been relatively few. If the Mises–Hayek analysis of interventionism is to be a vibrant, challenging research program, it needs not only to re-tell its theoretical foundation but also to develop and extend its theoretical analysis and apply this to highlighting actual processes of intervention.

The third problem is perhaps an outgrowth of these two first problems: there seems to be an almost nonexistent interest in the Austrian theory of interventionism outside the rather narrow circles of self-conscious Austrian School economists. This is all the more striking since there are strands of social science research which should seem to be naturally aligned with the Austrian analysis, first and foremost the application of so-called rational choice models, inspired by economic theories and game theory, to the field of politics. Such analysis comes in many forms (Mitchell, 1988), but especially the types of inquiry initiated by the "public choice" scholars of the "Virginia school" would seem to be potential allies (cf. the classic works by Buchanan & Tullock [1962] 1999; Olson [1965] 1971).[7] Many public choice scholars also focus on the essentially interventionist character of every single government activity (e.g. Aranson & Ordeshook, 1981) and on the redistributive and welfare loss producing nature of such, most notably the analysis of "rent-seeking" spearheaded by the works of Gordon Tullock (Tullock [1967] 2004, cf. 2005). Some attempts at combining insights from both the Mises–Hayek analysis and the public choice school have been made, but again the examples are relatively few and sporadic (e.g., Higgs, 1987; DiLorenzo, 1988; Thornton, 1991; Anderson & Boettke, 1993; Boettke, 1995; Ikeda, 2003), or confined to a single special issue of the *Review of Austrian Economics* (15:2/3, cf. Boettke & López, 2002). The end result is that – with the exception of Hayek's more popular publication on the road to serfdom (Hayek [1944] 1976) – the Mises–Hayek analysis of interventionism is largely unknown outside Austrian circles – even if it actually might have much to teach others, and perhaps even be integrated with the thinking of other schools of thought.

4. THE CONTRIBUTIONS

Raising such questions are in the line of the editorial ambitions of this series (cf. Koppl, Birner, & Kurrild-Klitgaard, 2003; and the Editors' Introduction to the present volume), and these are, generally speaking, the types of issues that have motivated the editors to try to collect studies such as those included here.

The contributions of this volume span wide, both in chronology, perspectives, applications and conclusions, and – as in almost all edited volumes – this creates a certain unevenness in the collection as a whole, but roughly speaking the contributions to this collection of studies may be roughly divided into three parts: theoretical themes; attempts at conceptual extensions or discussions of related subjects; empirical applications and perspectives.

The collection begins with an introductory essay by a scholar, who is no doubt his generation's leading scholar on the Austrian theory of interventionism, the U.S. economist *Sanford Ikeda*, whose pioneering work in the field has brought back wider attention to the entire Mises–Hayek theory of interventionism (Ikeda, 1997). In his essay, Ikeda seeks to introduce the historical evolution of the Mises–Hayek tradition of political economy and to show that it indeed is a useful framework for understanding the operation of the mixed economy, and specifically that with updating and revision in light of more recent theoretical innovations it can be made even more useful still. This – Ikeda argues – is particularly the case when it comes to incorporating concepts and insights from the public choice tradition; he sees the identities of the two research programs as distinct but complementary.

Two contributions to this collection stand out in terms of their historical role and character, i.e., the two essays authored by *Walter E. Grinder* and *John Hagel III*. These were two elements of a much larger research project envisioned by Grinder and Hagel in the mid-1970s, which resulted in a number of papers presented at academic conferences – these two papers at the June 22–28, 1975 Institute for Humane Studies conference on Austrian economics at the University of Hartford, which was one of the conferences that is widely credited with having been instrumental in stimulating U.S. interest in the Austrian School in the 1970s.[8] However, only one of the papers from this project was ever published (Grinder & Hagel, 1977), and the planned book never saw publication – and it is all the more relevant that these two papers finally are published. In the first of these – presented by Hagel in 1975 and with him as the main author – Hagel and Grinder give a basic introduction to the Austrian theory of the dynamics of interventionism, especially as seen the Rothbardian integration and systematization of the Mises–Hayek analysis of interventionism with the insights from other Austrians (Kizner, Lachmann, et al.) as well as classical liberal economists and sociologists such as Albert Jay Nock. This allows Hagel and Grinder to address such questions as the comparative differences between, e.g., a system of interventionism, socialism and fascism, as well as the role of ideology.

The article by the two American Austrian economists *Walter Block* and *William Barnett II* is a contribution along the same general line of analysis. But they turn their attention to the methodological underpinnings of the Austrian analysis and focus on how this makes the Austrian analysis different from that of neo-classical, positivist economists – including, as they see it, public choice theory and neo-classical welfare economics, just as they try to distinguish the Austrian political economy from aspects of Marxist analysis.

In his paper, the U.S. economist *Bruce L. Benson* focuses more narrowly on trying to elaborate on the analysis of interventionism, and he finds that both Austrian political economy and public choice theory have flaws. But as distinct from both Ikeda (who thinks that Austrian political economy and public choice are distinct but compatible), Block and Barnett (who think that they are different and should remain so) and Hagel and Grinder (who for various reasons did not address the issue directly) he does so by explicitly calling for dropping the distinctions between the traditions and instead formulating an integrated Austrian-public-choice and neo-institutional model that may include assumptions about the relationships between regulations, property rights security, and both market and political behavior. He attempts to show this by applying the insights to the process of regulation in a context of rent-seeking special interest groups.

The next group of papers try to apply Austrian insights derived from or related to the theory of interventionism to selected areas within economics and politics. In the second of the two 1975-papers by Hagel and Grinder – here with Grinder as the primary author – the authors seek to show how the Austrian theory of interventionism and the Austrian theory of business cycles not only have a common origin in the works of Mises and Hayek in the 1920s but also may provide insights to each other. The U.S. public choice economist *Roger D. Congleton* in his paper raises the highly acute question of how governments manage (or mismanages) crises. The paper does not utilize the Austrian theory of interventionism directly, but rather seeks to introduce Hayek's analysis of the use and subjective character of knowledge into a public choice model of the political economy of political decision-making in times of crisis – an area of research, which so far has been neglected by public -choice theorists. Swedish political scientist *Erik Moberg* considers the Misesian question of whether the middle-of-the-road really is stable and situates his answers in terms of a dialogue between the Austrian School and public choice theory and specifically in a comparison of the latter's analysis of the so-called median voter theorem.

But what is the role of "culture" in generating particular responses to particular issues of public policy? Hayek touched upon it briefly in *The Road to Serfdom*, but it is a question largely left out of consideration in the Mises–Hayek theoretical inquiry into the dynamics of intervention – but should it be? These are indeed some of the themes originally investigated by the U.S. economist *Daniel B. Klein* in an article in *Economics and Philosophy* (Klein, 1994); that essay has been republished here, but in a revised version and with a new postscript written in 2004. Klein's answer to the question is that politicians are honest – and rent seeking; his paper may in some ways seem as a support for the call of some of the contributors to try to integrate Austrian intervention analysis and public-choice theory. In my own essay, I try to add a different perspective to the problem of getting the right solutions – and reforms – to institutional arrangements. Specifically, the essay tries to address issues which really originate in the public choice analysis of constitutional arrangements, often known as "constitutional political economy" or "constitutional economics" (cf. Buchanan, 1987; Gwartney & Wagner, 1988; Voigt, 1997). Much of this type of analysis relies on a type of analysis, where a problematic collective action situation is identified and subsequently a "contractarian" solution is posited. The Mises–Hayek analysis enters the picture in the sense that it may be used to highlight why constitutions often are not very good at limiting government in practice: government activities have a tendency to create demands for further such, and this will gradually erode constitutional constraints. As such his analysis fits well as support for Ikeda's conclusion that even a minimal state will be a victim to the dynamic tendencies of interventionism.

The third group of papers all deal with more specific empirical aspects of the dynamics of interventionism – or even with very specific case studies. U.S. economist *Robert Higgs*, who in his modern classic, *Crisis and Leviathan* (Higgs, 1987), drew on both Austrian and public choice insights in order to analyze the growth of government in the 20th century, here takes up a related theme, namely how to explain the changes in the growth of government in the late 20th century. He examines this in a critical dialogue with the Austrian School and simultaneously demonstrates how many measures of government size fail to capture the real extent of government intervention; part of this analysis concludes that societies are most likely to remain on the middle-of-the-road. The U.S. economist *Robert J. Bradley, Jr.* considers the dynamics of interventionism in the U.S. energy industry, while the British economist, *Mark Pennington*, examines land use regulation in the U.K. The U.S. economist *Mark Thornton* applies the logic to the attempts by governments to use "sin taxes" to prevent individuals from harming themselves, e.g., with drugs or alcohol, and the Swedish political scientist *Rolf Höijer* considers two related empirical examples from the paradigmatic case of the welfare state of Sweden: the governments' sterilization campaigns and seat-belt campaigns. It is shown that the initial introduction of government "insurance" schemes is frequently followed by interventions that either exclude individuals or limit how they may behave. The German economic historian *Oliver Volckart* analyzes the interventionist character and structure of the Nazi state 1933–1939, partly as a criticism of the public choice economist, Ronald Wintrobe's analysis of bureau competition in *Hitler's Third Reich*. The collection finishes with a short note by Swedish political scientist *Jan-Erik Lane*, who raises questions relating to the Austrians' concept of "spontaneous order" as an explanatory element in the analysis of the development of the European Union.

These contributions, in each of their individual ways, do indicate that the Austrian analysis of the dynamics of interventionism is a promising research program, and one which may both contribute to the perspectives of other traditions as well as gain from the insights produced by these.

NOTES

1. Cf. Ikeda (1997) and Ikeda's contribution to this volume.

2. Cf. also Rothbard (1956); for a typology of the forms of intervention, see Rothbard [1970] 1977.

3. For an analysis of this particular case, see Kurrild-Klitgaard (2005).

4. Hayek, of course, did not embrace determinism, but merely one focusing on structural constraints, cf. Hayek [1944] 1976, pp. 1–2. However, his analysis of the seeming inevitability of interventionism seems to almost suggest it.

5. Even this is somewhat debatable. While one may disagree with every one of them (as at least the present author does), there is certainly nothing plainly absurd in the welfare state ideological recommendations of, say, a John Rawls or an Alan Gewirth (cf. Rawls, 1971; Gewirth, 1978).

6. Cf. Gray, 1984, p. 37f. The argument seems to be potentially compatible with the Chicago School view of interest groups such as espoused by, e.g., Gary Becker and Donald Wittman.

7. As so many others (e.g., Boettke & López, 2002), I shall follow Dennis C. Mueller's by now classic definition of "public choice" as simply meaning the economic study of non-market decision-making or the application of economics to political science, cf. Mueller (1976); Mueller (2003). With this definition it would indeed seem easy to see the Austrian theory of interventionism as a part of public choice, even if it is not a theory developed by or usually elaborated on by members of the Virginia School.

8. For a detailed eyewitness account of this somewhat historic and star-studded conference, including words about the positive reception of the Hagel and Grinder papers, see Ebeling (1975).

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THE DYNAMICS OF INTERVENTIONISM

Sanford Ikeda

1. INTRODUCTION

The term "dynamics of interventionism" refers to a social process, i.e., a sequence of adjustments to change over time, among a great many individuals, who largely share a common set of rules of interaction.[1] It is constituted by the unintended consequences at the interface between the governmental and market processes, when the scope of government is either expanding or contracting in relation to the market. *Interventionism* is the doctrine or system based on the limited use of political means (i.e., legitimized violent aggression (Oppenheimer, 1975[1914])) to address problems identified with laissez-faire capitalism. Thus, an *intervention* refers to the use of, or the threat of using, political means to influence non-violent actions and exchanges. Supporters of interventionism do not completely reject the institutions of capitalism, such as private property and the price system, but do favor using piecemeal interventions that extend beyond so-called minimal-state capitalism[2] in order to combat suspected failures or abuses they associate with the unhampered market. Examples of this would include, but are not limited to, market power, externality, asymmetric information, income inequality, racial and sexual discrimination, and the business cycle.

The collapse of really existing socialism, and the consequent discrediting of the intellectual case for collectivist central planning, has intensified the

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focus of policy makers and academics on the operation of the so-called "mixed economy." At the same time, prominent scholars have questioned whether the theoretical arguments that have done so much to discredit the economics of collectivism have any relevance at all for a critique of the mixed economy. Richard Posner, for example, has recently remarked:

> The endeavor of Hayek's successors that I am concerned with has foundered on his failure to bequeath to them any guidance on how to extend his approach to problems other than the problem of central planning. [...] I do not regard as distinctive, except in vocabulary, efforts to extend the Austrian critique of central planning to regulation in general ... an extension that very largely merges [the] Hayekian critique into the neo-classicists' public-choice theory (Posner, 2003).

This essay will draw on recent work in the political economy of interventionism to argue that contrary to these sentiments the same insights that have served to reveal fundamental flaws in the economic case for central planning in a purely collectivist system play a similar role with respect to the more limited forms of governmental planning that characterize the mixed economy. The deep problems that undermine extreme collectivism also afflict its more moderate manifestations to the extent that political relations substitute for economic relations.[3] Moreover, it will show that the legacy of the Austrian critique of central planning is not a political economy indistinguishable from public-choice theory, but one that is at the same time quite distinct from though complementary to it. The end of the essay will identify some puzzles and problems as possible areas for further research in Austrian political economy (APE).

2. THE HISTORICAL DEVELOPMENT OF THE THEORY OF INTERVENTIONISM

This section sketches the historical background to the modern theory interventionist dynamics. It is neither comprehensive in listing all of the works germane to the theory of interventionism nor does it attempt to fully summarize those works that are cited.[4] Instead, only those works are discussed that deal explicitly with the characteristic features of interventionism as they are identified here.[5] Mises, Hayek, Kirzner, and others have all provided additional concepts and insights that have proven useful for updating and revising our understanding of the dynamics of interventionism, but they are not specific to the study of interventionism. These I will introduce as they become relevant to the discussion later.

The dynamics of interventionism is an essential element in a larger enterprise that might be termed ''Austrian political economy.'' The defining features of APE can be traced to Mises's 1912 *Theory of Money and Credit*, not only in the relatively short passages addressing the unintended consequences of regulatory price distortions (Mises, 1971[1912], pp. 245–249), important as these are, but even more in the very theory of business cycles presented therein. In broad outline, Mises argues that the monetary authority's attempt to manipulate market rates of interest, in order to overcome trade slumps that are thought to be an inevitable consequence of unhampered capitalist production, creates a macroeconomic outcome that tends to induce further destabilizing, and ultimately futile, interventions. The authority's efforts to stimulate borrowing and investment by using its political control over the central bank to lower interest rates when the rate of real saving has not increased, ignores savers' actual time preferences and produces disastrous consequences. In the short term, interest rates are indeed lower than they would have been in the absence of credit expansion and the policy will have its intended effect, but savers' actual time preferences will eventually manifest themselves in the form of a shortage of loanable funds. When this happens interest rates will rise, choking off further net investment, placing in jeopardy all those investment projects, completed or otherwise, that were begun when interest rates were artificially lowered. A corrective bust must then follow the artificially induced boom. Moreover, any attempt by the authority to forestall the downturn, via ever-increasing rates of credit expansion, will be met with failure as savers, their underlying time preferences having had no reason to change, continue their real savings at pre-interventionist levels and disappointed borrowers continue to bid-up market interest rates. While initially ignorant of the conditions that created the boom, then, the lack of sufficient real savings to meet the increased demand for credit must eventually reveal the error of the underlying policy to borrowers and lenders.[6]

While Mises's business-cycle theory does not illustrate every feature of modern interventionist dynamics, it does capture most of the important ones: the unintended consequences of a well-intentioned intervention generates an unsustainable cumulative process that initially depends on the ignorance of individual agents, but results eventually in a crisis as those agents become aware of the untenable situation.

In his seminal article of 1920, ''Economic calculation in the socialist commonwealth,'' Mises (1920) and later in his book of 1922, *Socialism*, Mises (1981[1922]) both of which originally targeted purely collectivist forms of central planning, Mises contributed what would later become a crucial element in the theory of interventionism. In those works Mises demonstrated that private property and free exchange are indispensable in a world of scarcity, if an individual planner wishes to rank multiple alternatives and choose from among them in a non-arbitrary fashion. Central to his argument is the role of prices stated in terms of money, which emerges in more developed market orders. The uncoerced exchange of private property – in particular money for goods and services – gives rise to money prices that provide a relatively simple way for individuals in a complex economy to form ex ante expectations regarding potentially profitable or loss-making courses of action and to evaluate ex post whether those expectations were correct. Money prices enable planners to tell whether the means they use are, from their own perspective, appropriate for the ends they have chosen. Under pure collectivist central planning, in which all property belongs to the state, stable and well-defined private-property rights are absent, and so the money prices that depend on the free exchange of these property rights do not emerge. Thus, the collectivist central planner, much as anyone else in a purely collectivist economy, has no meaningful way to judge whether means have been suitably matched to ends. It is in this sense that, according to Mises, rational economic calculation is impossible under socialism. I maintain that this argument is robust in that calculation problems of this sort will tend to emerge to the degree that interventionism compromises any given individual's claim to private-property rights.

In several articles beginning in the 1930s, but especially in his "The use of knowledge in society," Friedrich A. Hayek, whose theoretical and policy outlook in economics was inspired chiefly by Mises, elaborates upon Mises's analysis of the role of property rights and the price system, and the consequences of its absence under pure collectivism, by pointing out that in the market order relative prices serve as indices of scarcity. Here Hayek formulates what has come to be known as "the knowledge problem." There are two aspects to this problem. The first is that knowledge relevant for any given individual's plan, in a complex order consisting of a multitude of such plans, is dispersed among an unknown number of anonymous individuals throughout society. The second concerns how to get this knowledge into the minds of those for whom it would be useful. Knowledge here refers to "the knowledge of the particular circumstances of time and place" (Hayek, 1948, p. 80) that is local and contextual knowledge, and that "by its very nature cannot enter into statistics and therefore cannot be conveyed to any central authority in statistical form" (*ibid.*, p. 83). It is thus in contrast to explicit and fully articulable information or technical data. In a market order of private property and free exchange, as local conditions change the supply of or demand for a given commodity, its price relative to substitutes and complements (in consumption or production) will rise or fall depending on whether it has become more or less scarce. In a sense, the market process sidesteps the knowledge problem faced by a collectivist economic dictator, even a benevolent one, because there is no need for each agent to be fully informed of all relevant knowledge in order to enjoy a high likelihood of completing his plans. The benevolent dictator would be stymied by the knowledge problem owing to the dispersed and contextual nature of local knowledge. I maintain that similar problems affect planning in the mixed economy to the extent that interventions interfere with the price mechanism, either directly in the form of price controls or indirectly through nonprice interventions and (as argued earlier) the erosion of property rights.

In several later works, Mises took on the topic of interventionism directly, most notably in *Critique of Interventionism* (1926) and in *Interventionism: An Economic Analysis*, Mises (1998) which was published in 1998 from a manuscript completed in 1940.[7] The latter is a more coherent and systematic treatment than the former, which is a collection of essays written at different times and for different audiences, but was until recently perhaps the best independent treatment (i.e., notwithstanding the comprehensive discussion on interventionism in Mises's (1966[1949]) *Human Action*) available. This can be seen in the flow of the chapters listed in *Interventionism*'s table of contents: Interference by Restriction, Interference by Price Control, Inflation and Credit Expansion, Confiscation and Subsidies, Corporativism and Syndicalism, War Economy, and The Economic, Social, and Political Consequences of Interventionism. Here Mises lays out a nearly complete statement of his argument against interventionism as a tenable doctrine and coherent politico-economic system. The following has become a paradigm in this critique.

Suppose public authorities, sincerely believing that milk prices are too high for the poor, impose a price ceiling in order to make it more affordable to them. Here Mises, following what is by now fairly standard textbook economics, explains how a shortage will develop once the existing stock of milk is consumed. At this point, the authorities face a choice of either removing the price control or attempting to address the artificially caused shortage with further intervention. If they choose the latter, the same or similar results will occur elsewhere in the system. If they choose to impose a price ceiling on the input prices of dairy farmers,[8] shortages will eventually emerge in those markets, confronting them with the same choice of either abandoning their interventionist policies or continuing to pursue them with renewed vigor. Should they consistently pursue an interventionist policy, in time what began as laissez-faire capitalism will be transformed, through piecemeal interventions and ever-magnifying crises, into a system that approaches collectivist central planning. As the scope of intervention increases, the choice that policy makers face at each decision or "nodal" point is the same but with ever more severe consequences. Eventually, the internal contradictions of interventionism will become so significant, reaching a crisis at the systemic level, that they will be forced to abandon it in favor of more radical alternatives. Mises's fundamental point is that the forces of demand and supply that create order in free markets are radically at odds with the conscious direction of even limited government central planning. Note that in his emphasis on the role of relative money prices that emerge from demand and supply (and, as we will see later, the importance of the integrity of the underlying property rights), Mises's critique of interventionism is a logical extension of his earlier arguments against rational planning under pure collectivism. In his estimation, then, interventionism is untenable as a doctrine and "contradictory" and "unworkable" in practice (Mises, 1977[1929]). It does not represent a coherent alternative to either capitalism or collectivism, each of which is at least internally consistent.

In *The Road to Serfdom* (1976), F.A. Hayek again, using Mises's analysis as a starting point, offers an explanation of how interventionism tends to systematically alter the norms of public choosers (i.e., those who decide public policy) so as to favor ever-increasing levels intervention. First, he explains how the attempt to grant what he calls "absolute security" to one privileged group over others only serves to increase the insecurity felt by those in non-privileged groups. The latter then have a greater incentive to demand similar kinds of protections for themselves, the result of which is to increase the insecurity of those still remaining outside the state's protection, while reducing the level of economic freedom overall, as political relations displace economic ones. In the redistributive policies of welfare-state capitalism, for example, public policy can attempt to reduce the income insecurity felt by members of a particular group only by shifting that insecurity onto members of other groups, since it now becomes these other groups' responsibility to shelter the privileged group from the normal uncertainties of life, in addition to their own. Forced redistribution creates winners who gain at the expense of losers. The net effect of interventionist transfers is to exacerbate rather than reduce the overall level of uncertainty and insecurity experienced by all members of a community, because a person will tend to be a member of more than one group at any given time (e.g., an ethnic minority as well as upper-income), and because the increasingly arbitrary use of political power itself introduces growing insecurity into social relations. The ever-rising demand for intervention that this process sets into motion, what might be termed "transfer dynamics," thus occurs endogenously as an unintended consequence of prior interventions. In this way, the popular support for greater expansion of political power into the market tends to increase directly with the amount of intervention already permitted (Hayek, 1976[1944], pp. 119–130). Elsewhere, I have termed this phenomenon the "dynamic trade-off thesis."

In a second argument, independent of though related to the first, Hayek maintains that such terms as "social injustice" have no meaning in the context of the impersonal market process because overall production and distribution therein are the unintended result of the interactions of a myriad of individuals, or groups that are small relative to the overall market order, no one of whom can meaningfully be identified as responsible for any particular gain or loss. Such concepts can nevertheless serve to rally the demand to redistribute wealth. The irony is that once the redistributive intervention takes place, those who lose as a result now have a legitimate and identifiable target, i.e., the central authority and its supporters, to blame. Social injustice now becomes meaningful, but only as the unintended consequence of the very attempt to achieve a mythical social justice via forced transfers (*ibid*., p. 69). I have termed this the "self-fulfillment thesis."

Among the explanations of how interventionism alters politico-economic *norms*, it is important to mention another line of thought that runs parallel to the two just mentioned, examples of which can be found in the works of the sociologists Nathan Glazer (1988) and Charles Murray (1988). They offer a kind of endogenous explanation that I have called the "gradual acceptance thesis," in which any given intervention makes successive interventions seem less onerous to public choosers. As interventions accumulate, the propensity of the general public to accept, and of public authorities to offer, additional interventions grow proportionally. I have termed this the "gradual-acceptance thesis."

In *Power and Market* (1977) Murray Rothbard continues the Misesian tradition of interventionism analysis. He critiques various forms of intervention, from price and product controls to antitrust and taxation, and provides a taxonomy within which to place each of them. This taxonomy consists of three categories: "autistic interventions" (i.e., state interference with private, non-exchange activities), which include regulations regarding speech and religious observances; "binary intervention" (i.e., forced exchange between private individuals and the state), for example, taxation and publicly provided goods and services; and "triangular intervention" (i.e., state-mandated exchange among private individuals), such as income-transfers, price and production controls, and environmental, health, safety, and civil-rights regulations.[9]

Perhaps the best historical treatment of the consequences of interventionism is Robert Higgs's (1987) *Crisis and Leviathan*, which examines the growth of government in the United States after the Civil War. He argues that the size of government tends to expand secularly over time, punctuated by sudden episodes of rapid expansion that are typically the result of systemic crises of one sort or another. These crises are responsible for a "ratcheting-up" effect with respect to the secular course of government expansion, in which the size of government after each crisis falls but never quite to the pre-crisis level. In addition, Higgs argues that "ideology becomes most prominent during social crisis" (Higgs, 1987, p. 47), and that available evidence substantiates his thesis that each period of dramatic political and economic change in recent American history "altered the ideological climate" in such a manner that it made a larger role for government more acceptable than it would have been otherwise (*ibid*., p. 59). This point is the same as the gradual-acceptance thesis. In this book, however, Higgs does not attempt either to explain the reasons for the secular growth of government between crises or to discover any consistent relations among the various crises themselves.[10]

In accord with the main thesis of this essay, that the socialist-calculation debate is highly relevant for the study of the interventionist mixed economy, Israel M. Kirzner argues in "The perils of regulation" (1985) that

> Just as the attempt to seek social efficiency through central planning rather than through the spontaneous market process, in the Mises–Hayek view, must necessarily fail, so too, *for essentially similar reasons*, must attempts to control the outcomes of the spontaneous market by deliberate, extra-market, regulatory action necessarily tend to generate unexpected and wholly undesired consequences (Kirzner, 1985, p. 123; emphasis added).

In so arguing, Kirzner sheds new light on the nature of these "unexpected and wholly undesired consequences." Employing the framework of entrepreneurial discovery (which I will discuss in greater detail later), and taking the Mises–Hayek approach to the problems of collectivist central planning as his point of departure, Kirzner observes that

> to announce that one can improve on the performance of the market, one must also claim to know in advance what the market will reveal. This knowledge is clearly impossible in all circumstances. Indeed, where the market process has been thwarted, in general it will not be possible to point with certainty to what *might* have been discovered that has now been lost (*ibid*., p. 131; emphasis original).

With this in mind, Kirzner offers four novel ways to view the issue of regulatory interventions into the market process.

The first is what he terms "the undiscovered discovery process," which relates to the absence of awareness, on the part of the supporters of an intervention, of the market's error-correction capacity. According to Kirzner, it arises either because of their lack of confidence in the market process to systematically equilibrate inefficient markets; or because of their belief that, in spite of the ability of markets to achieve a state of equilibrium very rapidly, the equilibria so achieved tend nevertheless to be inefficient, as in the case of public goods or externalities (*ibid.*, pp. 137–139). Either perspective would grant that an intervention, at least in principle, could improve upon the outcome of the unhampered market process. Second, "the unsimulated discovery process" refers to the lack of an effective, systematic discovery process in the public sector, owing to the absence there of a price-system-like mechanism that would enable entrepreneurial profit-seeking within the regulatory bureaucracy by which "regulators might come to discover what they have not known … (*ibid.*, p. 140). The third is what Kirzner calls "the stifled discovery process," in which an intervention, such as a price ceiling, obscures detection of currently existing and possible future profit opportunities, perhaps permanently. Like the first two phenomena, the consequences of the stifled discovery process are intrinsically unmeasurable because of their counter-factual nature. This is also the case with the fourth, "the wholly superfluous discovery process," in which an intervention can "set in motion a series of entrepreneurial actions that have *not* been anticipated and, therefore, that may well lead to wholly unexpected and even undesirable final outcomes" including the bribery and corruption of regulators (*ibid.*, p. 145; emphasis original).[11]

3. TWO PARADOXES

Two paradoxes present themselves in Mises's critique of interventionism. The first may be termed the "Misesian paradox." As the example of price control illustrates, the result of consistently following a policy of interventionism is either collectivist central planning or laissez-faire capitalism. In this sense interventionism as a policy appears to be highly unstable. Thus, if interventionism is, as Mises describes it, illogical, unworkable, unsuitable, self-defeating, and contradictory (Mises, 1977[1929], p. 37), why is it the most widespread and persistent politico-economic system in the world?

The second paradox might be called the "paradox of benevolence" or the "paradox of policy myopia." If public choosers are, as Mises typically assumes, public spirited in the sense that they try to pursue only policies that promote the general welfare, and if interventionism consistently generates negative consequences that frustrate their good intentions, why do they remain committed to it in the face of these negative consequences and frustrated intentions? Why do they commit the same kind of error again and again?

There are at least two other important gaps in Mises's framework.[12] These include, first, the absence of an explicit link between the "transfer dynamics" of welfare-state capitalism and the "regulatory dynamics" of regulatory-state capitalism. For Mises the dynamics of interventionism proper are driven primarily by distortions in the structure of relative prices. Clearly, price controls and regulations that create shortages and surpluses generate this kind of dynamic. It is less clear, however, whether or the extent to which a similar kind of dynamic prevails in a mixed economy characterized primarily by income redistribution through forced transfers. The second gap concerns the nature of ideological change in the dynamics of interventionism. For Mises, ideology enters exogenously in the sense that he does not explain the reasons for the propensity, or lack thereof, of public choosers to remain committed to interventionism. Mises emphasizes that public choosers have, at each decision node in the process, the choice of either continuing along the interventionist path or reversing course by dismantling prior policies, but does not analyze the causes and conditions that might go into their decision-making process. The discussions in Hayek and Higgs of how interventionism itself can systematically alter the underlying norms (as well as knowledge) and ideology of public choosers are relevant here.

The explanation of the dynamics of interventionism that follows will address these paradoxes and gaps. Indeed, it was the desire to resolve these issues in the Misesian critique of interventionism that prompted me to employ the more recent insights into the nature of the market process and regulation to revise and update the theory of interventionism.

4. THE ESSENTIALS OF AUSTRIAN POLITICAL ECONOMY

4.1. The Market Process

APE takes Kirzner's theory of the market process as its main analytical framework (Kirzner, 1973). This process can be best understood as the market's response to the presence of ignorance and error. Kirznerian sheer or *radical ignorance* is present when the possibility exists for ex post regret. It occurs when an agent remains utterly unaware of knowledge that would, from his point of view, result in a more successful attainment of his ends, even when that knowledge is available at zero cost. Ignorance of this kind is radical in the sense that it consists of "not knowing that you don't know, that you don't know, that you don't know, *ad infinitum* … something." It contrasts with the more standard concept of optimal or *rational ignorance*, in which an agent's ignorance is the result of a deliberate, optimizing choice based on expected marginal benefits and costs. Thus, a rationally ignorant person may not know something, but he knows that he does not know it. In the case of radical ignorance, at least some knowledge, probabilistic or otherwise, of the relevant expected benefits and costs is completely absent.

This is important for how one conceives of markets, because it introduces the possibility of error and discovery, of regret and surprise, of loss and profit. A world in which all agents are rationally ignorant is perforce a world in which their level of knowledge and ignorance is optimal. Genuine error is impossible in such a world because any outcome produced is the result of a calculus that has taken into account all relevant benefits and costs. Where agents are subject to radical ignorance, however, at least some relevant benefits and costs are utterly unknown. Human action takes place in a world where genuine error is a fact of life.

Note that Kirzner has added an important new dimension to the Hayekian knowledge problem. The knowledge problem can now be seen as the result not only of the dispersed and contextual nature of relevant knowledge in society, but also of the fact that agents may be radically ignorant of this situation. That is, agents not only have limited knowledge, but the knowledge they do possess can be wrong and they may be entirely unaware of this. The Hayekian formulation is consistent with the neoclassical approach in which local contextual knowledge may remain dispersed and under-utilized simply because the expected cost of search is too high relative to the expected benefit. Kirzner's contribution is to point out that local contextual knowledge may also remain dispersed and underutilized because agents attaching higher value to it (either because they will use it directly themselves or because they can sell it to those who are closer to directly using it themselves) may be utterly unaware of its very existence.

According to Kirzner, what keeps markets from collapsing under the weight of accumulated error is the capacity of human actors to discover error and the incentive to do so that the market order offers. In other words, where market institutions are well established, especially private property and the price system, error elimination (i.e., the discovery of radical ignorance) tends to present agents the reward of profit, and error creation the penalty of loss. While the presence of agents subject to radical ignorance carries with it the potential for errors to be generated persistently, alertness to profit opportunities, which Kirzner calls *entrepreneurship*, acts as a counter-force constraining the scope of those errors.

For Kirzner, entrepreneurship is an aspect of the category of human action, itself, rather than a characteristic or talent that only a few possess. Once a profit opportunity has been discovered it is possible for others to find a profitable way to compete against and possibly displace the first entrepreneurial agent. It is this *process* of rivalry that constitutes competition in Kirzner's sense. Thus, the *market process* is an entrepreneurial-competitive one. It is the competitive market process that serves as the error-correction "mechanism."

The market process describes an *order*, i.e., "a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct" (Hayek, 1973, p. 36). This is so in the sense that within the market process any given agent who possesses limited knowledge concerning local, contextual interpretations of facts, say, the anticipated future demand for his products or prices for inputs, is able to form reasonable expectations about prices and quantities in the future. Errors in local, contextual knowledge of this sort are then subject to the corrective forces set into motion by profit-seeking entrepreneurial competitors.

Although particular parts of the order certainly have been consciously put into place, such as the decision of parents to invest in the education of their children, the overall social order of which that investment decision is only a fractional part (in this case perhaps the market for loanable funds) is in no way the outcome of a deliberate plan on the part of any of the agents or subgroup of the agents in the system. It is what Hayek has termed a *spontaneous order*, i.e., the result of human action but not of human design (Hayek, 1967). Spontaneous orders have at least three features. First, they are adaptive and largely self-regulating in the sense that the principal source of order within them is endogenous. In the market process the ordering principle is the price system, the relevant properties of which have already been discussed. Second, they are largely self-sustaining, in that the ordering process also generates the impetus that drives the system. In the case of the market process this is the profit-driven, entrepreneurial discovery of error.

Third, they are open systems in the sense that their futures are, to use Shackle's famous phrase, unknowable but imaginable.

Thus, the peaceful interaction of purposeful agents in a world of scarcity and imperfect knowledge can generate a spontaneous market order – in which radical ignorance and error give rise to exploitable profit opportunities and competitive rivalry – so long as the institutions of private property and voluntary exchange, as well as norms of reciprocity and trust, are present.

4.2. The Governmental Process[13]

According to Mises, there are fundamentally two forms of management: profit management and bureaucratic management. Under profit management, which is the management principle that guides decision-making in private firms operating in the market process, agents organize and administer their firms to achieve the highest economic profit they are able to earn. The measure of success is the level of economic profit that they actually earn (Mises, 1969[1944]).

Bureaucracy is the administrative apparatus of the state. Under bureaucratic management, the management principle that guides decision-making in governmental agencies, agents cannot follow the profit principle because their primary source of revenue does not come from the sale of priceable units of output, but rather from political means used to appropriate wealth from the private sector in the form of taxation or credit expansion. Because the nature of political power is zero-sum, the central authority's principal aim is to retain control the use of political power by its subordinates through decrees and codes. The objective of bureaucratic management, which is charged with the task of administering political power, is therefore rule following, and the measure of success of a bureaucracy is the degree to which agents effectively execute bureaucratic rules and commands (Mises, 1969[1944]).

Of course, agents in private firms also follow rules and policies set forth by their organizational superiors, but these are always subject to the feedback of the "street-level" operators whose sales or failure to sell to their customers determines not only their own rewards but also the overall profitability of the firm. Not rule-following or the retention of power, but profit seeking is the underlying objective of the private firm. In contrast, because the lower-level operators of bureaucracies who are in direct contact with the public are not rewarded primarily on the basis of how well they serve this public, as long as they stay within the rules, they have much less reason than their private-sector counterparts to offer feedback on their service to their superiors. Moreover, the tools of interpretation and adjustment at their disposal are more sluggish and less finely tuned than the price system – mainly exit and voice, and to a lesser extent voting – so that the feedback that could be offered would in any case be of more problematic value to their citizen "customers."[14] In the private sector the profit motive tends to limit the rule-imposing and rule-following tendencies of management hierarchies. Under bureaucratic management, however, agents are less likely to strike an efficient balance between command and entrepreneurship that would promote spontaneous adjustment to changing conditions in a manner that would best address the interests of those they serve.

In contrast to the principle of spontaneous order, the principle of conscious direction makes for simpler, more mechanical, and less subtle adjustments in the governmental process. Government is essentially a constructed or planned order the various parts of which are coordinated predominantly by deliberate commands. Its formal methods of adjusting to changing circumstances within the public sector include legislative voting, budgetary reviews, and oversight. There are also the less formal methods of exit and voice. These can generate a social process that is similar to the spontaneous market process, but without a close analog to the price system they are severely limited in the type, quantity, and timeliness of the information they can process. The predominance of deliberate central planning, and the absence of the profit motive, allows the governmental process much less scope for local entrepreneurial adjustment to plan discoordination. It is often the case that the same government will at any given time conduct contradictory policies, such as instituting cost-raising safety inspections at airports and campaigning to reduce automobile-related fatalities, a significant part of which are direct consequence of the safety inspections.[15]

Where the profit-motive does prevail, such as when the government owns businesses that compete with private firms or where bribery and corruption are permitted, the governmental process may operate more spontaneously but still less so than the market, owing to the constraints of the overall bureaucratic hierarchy. Moreover, the governmental process generates little wealth of its own (except insofar as a minimal state is necessary to foster the wealth-creating capacity of the market process or that it operates profit-making businesses in open competition with private businesses) and is thus not self-sustaining. With few exceptions it relies on its taxing or monetary powers to acquire the wealth it needs to function.

With the essential features of the market process and the governmental process outlined, we can view the dynamics of interventionism as emerging from the interaction between the market process and the governmental process – i.e., the result of the piecemeal attempt to impose the principle of bureaucratic management onto the spontaneous market order.[16]

4.3. The Interventionist Process[17]

The unique perspective of APE, in contrast to public choice (PC), derives from two assumptions that have already been mentioned. The first, and less crucial of the two, is that public choosers are benevolent and public spirited in the sense that they seek to promote the general welfare. This is in stark contrast to PC, which, according to Gordon Tullock in an early contribution to the literature, gives "*special emphasis to the behavior of an intelligent, ambitious, and somewhat unscrupulous man in an organizational hierarchy*" (Tullock, 1965, p. 26; emphasis original). While the Austrian approach appears in this respect to be in accord with the "public-interest view" of conventional public policy, Mises and Hayek (the latter who in good faith dedicated his *Road to Serfdom* to "Socialists of all parties") merely wanted to eschew questioning the motives of their opponents, the practitioners and theorists of collectivism, by allowing that they were men and women of goodwill, so as to place their argument in the best light. It also implies that in evaluating the performance of an intervention one should adopt the stated perspective of those who support it. Thus, if proponents of rent control argue that it will increase the supply of affordable housing at reasonable prices, APE adopts this as the standard by which to judge its success or failure. Policy evaluation thus takes the form of using economic analysis to compare actual outcomes with announced intentions and of evaluating whether the means proposed will be effective in achieving the ends chosen.

However, maintaining the benevolence assumption, which is admittedly often empirically false, has the added *methodological* benefit of isolating the impact of the knowledge problem on interventionism from that of narrow political self-interest. The existence of the knowledge problem – of dispersed, contextual knowledge and radical ignorance – is the second and indeed far more important of the two assumptions. As radical ignorance is the starting point of the market process, so it is also the starting point of the theory of interventionism.

4.3.1. The Sources of Policy Myopia

Indeed, the policy myopia of public choosers can now be seen as a direct implication of the existence of radical ignorance in the following sense.

First, if the governmental process, guided by bureaucratic management, adjusts sluggishly to changing conditions, then where profit management and bureaucratic management undertake the same task[18] profit management should outperform bureaucratic management in more consistently discovering pockets of error owing to radical ignorance.[19] We would expect therefore that the discovery and correction of policy failure, defined in accordance with APE as a deviation of actual outcomes from announced intentions, would grow less likely as bureaucratic management displaces profit management and stifles the process of discovery.[20]

Second, entrepreneurs in the market process have an incentive to innovate around interventions (e.g., tax accountants who quickly find loopholes in each revision of the tax code) in ways that produce unexpected and undesirable consequences (again, from the perspective of its supporters). Given their lack of incentives and knowledge, well-meaning public choosers may simply be unable to keep pace with entrepreneurs who generate a ''wholly superfluous discovery processes'' by exploiting opportunities that each new policy creates.

In addition, the growth in the relative size of government undermines the effectiveness of the market process as an error-correction device. The substitution of political means for economic means erodes the private property rights that are the very foundation of the market order. The price system performs its function less effectively, the less secure owners are in the rights to property that they trade. The erosion property rights thus undermines the ability of the price system to reflect the relative scarcities of privately owned resources and the attempt to estimate profit and loss ex ante and to record profit and loss ex post.

In each of these considerations one of Kirzner's ''perils of regulation'' comes into play, stifling entrepreneurship or channeling it into areas that are at variance with actual intentions. The combination of the relative inability of bureaucracy to discover errors, entrepreneurs generating unintended consequences by innovating around each new intervention, and a reduction in the reliability of market signals owing to the breakdown in the error-correction capacity of the market process, makes it increasingly difficult for benevolent public choosers to see the accumulating surfeit of error or to correctly identify its source. The result in other words is policy myopia.

This helps us to better understand the dynamics of the interventionist process itself, since we can at least now partly understand why public-spirited government officials would continue to pursue unworkable policies. But if errors are so difficult to perceive, what is it that public choosers are responding to at each decision node?

4.3.2. The Sources of Frustrated Intentions[21]

Here it is important to point out that certain kinds of interventions produce repercussions that are more visible to public choosers, and more susceptible to entrepreneurial discovery, than others. This is especially true of such unintended consequences as surpluses and shortages, while outcomes such as inefficiency and waste are harder to detect. (Note that from an Austrian perspective, both of these are disequilibrium phenomena.) The former may result from price controls, trade and production restrictions, and monetary manipulation (recall the Mises–Hayek theory of the trade cycle) that in turn produce "errors of over-optimism" and discoordinated plans. The frustrated intentions of public choosers derive in part from this visible discoordination. For example, those who expect rent control to create more plentiful and cheaper housing may be harshly confronted by chronic shortages and higher real rents that demand either a further interventionist response or a retrenchment of existing housing policies.

This can perhaps be best discussed by distinguishing knowledge problems from incentive problems. While incentive problems are the central concern of politico-economic analyses that are based on standard microeconomics, such as PC, they can be nonetheless an important part of APE (with certain modifications we will examine later). The relative-price distortions that are central to Misesian interventionist dynamics are essentially incentive problems, as are also the sources of the dynamics of the Mises–Hayek business cycle theory. Incentive-based, unintended consequences are the primary impetus for the interventionist process because they are what public choosers respond to.

The undiscovered inefficiencies owing to "errors of overpessimism," are a form of radical ignorance that requires more dynamic entrepreneurship to discover. These are knowledge problems. As we have seen, their unintended consequences are initially less obvious and harder to detect and "under the radar" of public choosers. They grow in significance as the politico-economic system moves closer to the collectivist end of the spectrum where their cumulative burden finally becomes a more visible hindrance to plan coordination.

4.3.3. Ideological Change

Thus, two forces emerge as the relative size of the state increases. The first is the breakdown of the institutions of the market (property rights, the price system, norms of reciprocity) that undermines the error-correction capacity of the market process. The result of this first force is to progressively discoordinate the market order, further weakening the ability of agents to learn.[22] The second is the accumulating burden of errors of over-pessimism, discoordination, and inefficiency. Together they constitute the purely economic aspect of the dynamics of interventionism.

A third factor is ideological change, or more precisely the attitudes of public choosers toward interventionism, itself.[23] Our earlier look at the historical background of the theory of interventionism introduced three theses regarding ideological change. The virtue of these theses, from the viewpoint of a theory of interventionism, is that they each *to some degree* endogenize ideological change such that the propensity of public choosers to favor interventionism tends to increase with the use of political means (and to decrease as reliance on political means is reduced). The *gradual-acceptance thesis* does this by arguing that each intervention unintentionally weakens the aversion or psychological resistance citizens might have to intervention, making further interventions marginally more acceptable or less onerous. The *self-fulfillment thesis* states that an unintended consequence of an intervention that is based on a spurious rationale could be to render that rationale conceptually coherent, and in doing so provide a stronger basis for further intervention. And the *dynamic trade-off thesis*, which perhaps most effectively endogenizes ideological change, states that an intervention intended to reduce insecurity may produce greater insecurity among some or all public choosers, which in turn stimulates a further demand for government to reduce the added insecurity.

These considerations, however, should not be understood to completely endogenize ideological change. A fully deterministic theory of interventionism would in fact contradict the spontaneous-order nature of the process it is trying to describe, in particular its open-endedness. Rather, at each nodal point, i.e., at each point in the interventionist process where there is an opportunity to radically alter the course of public policy, public choosers have the option of abandoning interventionism (during the expansionary phase) or re-embracing it (during the contractionary phase). The endogenous forces of ideological change are thus strong empirical tendencies rather than unyielding obstacles to free choice.

These forces for ideological change operate in concert with the purely economic forces (i.e., the erosion of the error-correction function of the market process and the cumulative burden of discoordination and inefficiency). If we can say that price distortions *drive* the dynamics of interventionism, then ideological change *directs* it. As we will later see, which one of these predominates will depend on whether the mixed economy is mostly regulatory or redistributive in nature.

4.3.4. Nodal Points: Micro- and Macro-Crises

According to Mises, the consistent pursuit of interventionist policies will ultimately produce a major systemic crisis that will finally reveal the unworkable and contradictory nature of interventionism. Policy myopia, combined with an ideological propensity to favor further intervention at each nodal point, keeps the interventionist process moving in the direction of pure collectivism, against the wishes of the interventionists themselves. These nodal points constitute micro-crises of increasing magnitude that can take the form either of severe instability within a particular industry or a geographic region (e.g., U.S. airlines or New York City in the 1970s) or of macro-economic disruptions that fall short of major systemic crises (e.g., garden-variety recessions). While any one of these lesser-crises can in principle induce a radical reconsideration of interventionist policies as a whole, it is a widespread systemic crisis, such as the former Soviet Union experienced just prior to its collapse, that historically has been the critical turning point in the interventionist process.

Is it possible to say at what stage in the process such turning points are most likely to occur? In systems that are close to laissez-faire capitalism, the levels of distortion in market signals owing to interventions and the erosion of private-property rights are relatively low. Also, negative unintended consequences, seen and unseen, are bound to be similarly inconsequential. As economic and ideological forces push the system further from laissez-faire capitalism, the harder-to-see inefficiencies and obstacles to entrepreneurial discovery mount. At the same time, increasing controls on adjustment, restrictions on property usage, and erosion of informal norms of reciprocity undermines the effectiveness of the price system and drives the market order ever farther, in principle, from full plan coordination. Planning and the accurate perception of error, in the private and public sectors, become increasingly difficult. Thus, while the inherent contradictions of interventionism accumulate, it becomes harder for public choosers to rationally evaluate the sources of their problems and to formulate a viable alternative. As the level of exploitable private wealth diminishes owing to inefficiency and the disguising of income, and as the breakdown of the market process continues, the interventionist process eventually reaches a point at which the inner contradictions and instabilities of the mixed economy finally become unmistakable and intolerable, heralding the systemic crisis. This all suggests that the turning point at which public choosers must abandon interventionism in favor of either capitalism or collectivism should tend to occur toward the collectivist end of the politico-economic spectrum.[24]

4.4. The Process of Disintervention

It is possible to roughly characterize the expansionary phase of the interventionist process as the incentive-driven movement of resources away from areas of the market order where investment returns have fallen owing to burdensome regulatory or redistributive interventions, and toward areas that have been relatively free of intervention where returns would tend to be higher. We might take a similar view of the contractionary phase of the process, during which a process of "disintervention"[25] takes place. At the point of systemic crisis there are likely to be few attractive investment opportunities. The sudden and dramatic reversal from expansionary intervention to contractionary disintervention means that many fewer sectors will be prone to superfluous or stifled discovery processes. These become potentially gainful areas in which to invest. Unless large proportions of the system are freed from interventionist policies, bottlenecks may occur that prevent a higher degree of plan coordination and inefficiency reduction than might otherwise be possible. These bottlenecks could be enough to jeopardize radical reform by weakening public choosers' ideological commitment to disinterventionism and threaten recidivism. In general, then, the more radical and far-reaching the reversal from interventionism is, the fewer and less important such bottlenecks there will be, and the better the prospects for successful reform.

As did the public choosers in Czarist Russia, Weimar Germany, and Great Britain in the early 20th century, the regime may embrace a very different alternative than did the USSR, New Zealand, and the PRC later in the century.

5. KINDS OF INTERVENTIONIST DYNAMICS

The exposition up to now has not asked whether any important differences exist between the interventionist dynamics that result from (price and non-price) regulations on the one hand and income redistribution policies on the other. Indeed, Mises is not explicit on how these two forms of interventionism are related with respect to the character of the dynamics they produce. As we will see, while all the elements of the dynamics of interventionism that we have so far discussed are present in both, the importance of some compared to others does depend on which kind of interventionist dynamic we are talking about.

5.1. The Regulatory Dynamics of Regulatory-State Capitalism

Regulatory dynamics are the result of interventions that most directly create relative-price distortions in the market order.

This calls for a brief explanation of the meaning of price distortion as used here.[26] It is a common notion that price controls create surpluses or shortages. Following the strict logic of standard microeconomics, however, a price control produces neither a shortage nor a surplus in any but the shortest of short runs. Instead, price controls merely generate a new equilibrium in which output and price may be different. That is, under the assumption of perfect knowledge, agents adjust instantaneously to the new set of circumstances created by the intervention. It is also common to argue that, normatively, the price control generates a deadweight loss. This is again not the case, since, again strictly speaking, the new equilibrium is optimal *given* the price control.[27]

It is otherwise in market-process theory, which takes the existence of radical ignorance as its starting point. If the market is at any moment outside of equilibrium, which happens when there is radical ignorance, then the effect of a price control would not be to create a shortage or surplus in the sense of bringing something into existence that did not exist before. Rather, from a market-process perspective shortages and surpluses are the norm and prices are rarely if ever at their equilibrium levels (nor is it likely that a single nonequilibrium price prevails). Entrepreneurial discovery of profitable arbitrage opportunities tends to keep disequilibrium prices close enough to their equilibrium levels that they are able to both roughly reflect relative scarcities and enable meaningful economic calculation. Thus, entrepreneurial alertness is responsible for establishing the overall order of the market, but this does not mean that all plans perfectly dovetail. In this context, what a price control does is hamper the ability of entrepreneurs to discover these arbitrage opportunities, making chronic a situation that may otherwise have been at least partially removed.[28] *This is the sense in which price controls distort relative prices: they stifle entrepreneurial discovery by reducing the possibility of adjustment.*

It is also possible to see that the standard distinction between price and nonprice regulations in conventional microeconomics, insofar as the former do and the latter do not create surpluses and shortages, does not exist in market-process theory. Nonprice regulations are interventions usually aimed at addressing economic inefficiencies owing to "market failure," in the standard microeconomic sense. Analyzing them from a static viewpoint, they simply raise the cost of an activity (e.g., regulations regarding market power, externality, asymmetric information, occupational safety, or racial discrimination), and standard microeconomics does view this as merely moving the firm or market to a new equilibrium, possibly at a higher price. From a market-process viewpoint, however, these regulations are, aside from whatever good they may do for those who directly benefit from them, obstacles in the way of entrepreneurial discoveries, some of which might have perhaps removed the undesirable element in a way that was even more satisfactory to the regulations' supporters (i.e., Kirzner's "undiscovered discovery process"). At the least, they reduce the effectiveness of relative prices in aiding the entrepreneurial discovery of error. They create price distortions in the same way that price controls do and exacerbate existing surpluses or shortages. Thus, both price and nonprice regulations foster "errors of over-optimism" the visible consequences of which (surpluses and shortages) feed the interventionist process.

In a mixed economy in which regulatory interventions predominate, i.e., "regulatory-state capitalism," the unintended consequences of relative-price distortions are central to the resulting dynamics. However, regulations also redistribute wealth – indeed this is one of the central tenets of PC and has been pointed out by Austrians, as well (Rothbard, 1977[1970]) – which they accomplish by forcibly seizing property rights from some to give to others. For example, rent controls increase the wealth of tenants at the expense of some portion of landlords' claims to wealth. In banning certain religious practices, public authorities are benefiting those who do not tolerate those practices at the expense of the rights of those who do; and since these practices must take place somewhere, i.e., on someone's property, then the ban effectively infringes on property rights. Such interventions erode property rights in the same way, though perhaps not initially to the same extent, that direct appropriation of assets do, and their effects on the market process are also the same. That is, the unintended consequence of this wealth/property transfer is to undermine the ability of the price system to coordinate plans. *Thus, any given regulation has two effects on the interventionist process. One is the direct distortionary effect on relative prices, the other the effect on property rights, which indirectly distorts relative prices.*

Finally, ideological change tends to support the expansionary phase of interventionism in the manner described earlier.

5.2. The Transfer Dynamics of Welfare-State Capitalism

Transfer dynamics are the result of interventions designed primarily to redistribute wealth. Let us term the mixed economy in which these redistributive policies predominate "welfare-state capitalism."

We have seen how regulations redistribute wealth as well as distort relative prices. By the same token, wealth redistribution also distorts relative prices by altering the structure of property rights in the manner just described. Viewed from this framework, then, each kind of intervention affects both relative prices and property rights.

Nevertheless, redistributive policies will tend to produce relative-price distortions that are weaker than those of regulatory intervention, since the latter includes policies that impinge directly on prices. At the same time their redistributive effects will naturally tend to be stronger. This implies that the kind of distortions found in the pure regulatory state will tend to be less evident under pure welfare-state capitalism. Insofar as this means that the surpluses and shortages owing to relative-price distortions do not appear, then pure welfare-state capitalism may experience fewer micro- and macro-crises than pure regulatory-state capitalism. This comparative stability does not mean, however, that welfare-state capitalism can escape the major crisis of interventionism altogether. Inefficiencies would still accumulate, and the market process and the reliability of price signals would still break down as private property and other market institutions lose their integrity. Nevertheless, *the contradictions of welfare-state capitalism may manifest themselves less frequently, and interventionism persist somewhat longer, than in the regulatory state.*

In addition, ideology may be a more important factor when it comes to wealth redistribution, to the extent that the desire to rectify social injustices of various kinds plays a larger role in initiating and sustaining support for the large-scale transfers of the welfare state than it does in garnering support for the regulations aimed at rectifying market inefficiencies. In the regulatory state, ideological change serves more to reinforce the tendencies unleashed by relative-price distortions. In the welfare state, the various ideological tendencies described in one or all three theses – gradual acceptance, self-fulfillment, and dynamic trade-off – may be the major forces in transfer dynamics. Ideological change could then play a larger role in the dynamics of interventionism in the welfare state than it does in the regulatory state, and relative-price distortions a smaller role.

6. THE INSTABILITY OF THE MINIMAL STATE

When Mises claims that "measures that are taken for the purpose of preserving the private-property order are not interventions" (Mises, 1977[1929], p. 17), he is implicitly assuming that capitalism under a minimal state is immune from his criticism of interventionism – that it is coherent and stable in a way that an interventionist mixed economy is not. Interventionism, for Mises, thus involves the *improper* use of political power in the market order, and it is only then that the dynamics of the mixed economy are set in motion.

From the viewpoint of the present analysis, however, in the presence of a government wielding political means, even one that conforms to the minimal or ‘‘night-watchman’’ state, it is arbitrary where one draws the line demarcating interventionism from non-interventionism. The taxes, subsidies, and regulations required to maintain the minimal state, minimal though they may be, interfere with the entrepreneurial competitive process in the same way, though certainly to a lesser degree, as the taxes, subsidies, and regulations of the welfare state or the regulatory state. Defining interventionism as the use of political means in areas beyond those strictly required by the minimal state does not in any way alter the effect that political means will have on the market process within the bounds of the minimal state.[29] Thus, as long as knowledge is not perfect, errors are likely to occur in the bureaucratic administration of the limited number of governmental activities. It is conceivable that on some occasions, in response to these kinds of errors (e.g., tax-prices that are set too high or benefits set too low), agents more favorably disposed than others will seek political solutions to their problems (e.g., protections or subsidies). The economic and ideological dynamics of interventionism would at this point be under way.[30]

Naturally, owing to the relatively low level of politically induced discoordination and inefficiency within minimal-state capitalism, as well as a stronger aversion there among public choosers to political action compared to more interventionist systems, we should expect this proclivity to be relatively weak. There nevertheless exists a real tendency for minimal-state capitalism to become unstable.

7. IMPLICATIONS AND PATTERN PREDICTIONS

APE thus begins with three general propositions. The first and foremost is the impossibility of rational economic calculation and coherent planning under pure collectivism. Next is the dynamic instability of the mixed economy owing to the internal contradictions of interventionism. Finally, there is the inherent instability of the minimal state.[31] These may also be regarded as first-level implications of Austrian comparative-systems analysis. Our examination of each, here and elsewhere (Ikeda, 1997), has revealed more specific inferences or that, when combined, generate at least eight "pattern predictions." Presented in order of decreasing generality and increasing empirical content they are as follows:[32]

1. At any given time, nearly all economic systems will be mixed economies.
2. Nearly all existing systems will be in flux, cycling somewhere between the extremes of laissez-faire capitalism and complete collectivism. Of these, the majority will tend to be moving secularly toward collectivism.

   Note that in drawing these first two implications, APE has resolved the "Misesian paradox" of why, if interventionism is unworkable and unstable, it is nevertheless such a popular and enduring doctrine and policy. *Instability does not imply transience any more than survival implies success.*
3. A mixed economy in the expansionary phase will be characterized by a series of micro- and lower-level macro-crises that ultimately culminate in a major macro-crisis encompassing the entire politico-economic system.
4. If there is a "turning point" at which public choosers reject the interventionist ideology and take radical steps toward either pure collectivism or the minimal state, it will occur at a systemic macro-crisis.
5. Turning points will occur on the politico-economic spectrum closer to pure collectivism than to the minimal state.
6. State expansion will tend to take place more continuously than state contraction or disinterventionism, which, especially in its initial stages, will display change of a more rapid, radical, and sweeping nature.
7. The pure welfare state will be less prone to severe macro-crises and endure longer than the pure regulatory state, although it is still subject to the same underlying instability and systemic failure.
8. The more strongly committed public choosers are to the principles of the minimal state, the less likely it will be that changes in endogeneous ideological preferences, in response to governmental error, will generate the "critical mass" among the public that is needed to initiate the dynamics of interventionism.

8. COMPARISON WITH PUBLIC CHOICE

APE and PC have a great deal in common. Both seek to understand governmental institutions and political processes from the viewpoint of purposeful human agents, and both are skeptical of the effectiveness of political means to address perceived social problems. Along with these shared sentiments, however, there are also significant differences. By removing some of those differences it may be possible to integrate APE and PC into a unified framework of political economy. Such an undertaking may be worthwhile.

8.1. The Meaning of Government Failure

The conventional, or "public interest," view of political economy can be said to have two versions. There is a "naïve version" that argues that intervention is justified whenever the unhampered market fails to achieve optimal efficiency, so that market power, free riding, asymmetric information, and the business cycle may be effectively counter-acted by the appropriate public policy. A more sophisticated version favors intervention only when the cost of doing so is less than the benefit of removing the failure. Both versions assume that public choosers seek to promote the general welfare and that they possess perfect information. The consequences of imperfect private actions are reparable by perfect public policy.

APE and PC argue that the governmental institutions and policies proposed to correct perceived failures of the unhampered market will not necessarily improve the general welfare. They turn the tables on the public-interest approach by demonstrating that very often these institutions and policies are themselves prone to failure. The differences between them lie in what each means by "failure" and in the role accorded, if any, to the assumptions of public interest and perfect information.

In PC, as in standard microeconomics, government failure is defined in terms of whether the equilibrium that political action achieves generates a deadweight loss.[33] The equilibrium orientation of PC is significant because it implies that the failure of government does not lie in public choosers failing to attain their intended objective. PC (especially its "Chicago" but to a large extent also its "Virginia" variant)[34] employs the same knowledge assumption as standard microeconomics, namely, that agents possess perfect information. And because they possess perfect information, utility-maximizing public choosers will always achieve the ends they seek. That is why George Stigler has said about regulation, "the truly intended effects should be deduced from the actual effects,"[35] or, as Richard Wagner has put it, "public choice theory is a proposition about inferring intentions from observations ... " (Wagner, 1989, pp. 46–47). *The starting point of public choice is thus the observation of a divergence between announced and actual intentions.* In public, for example, a politician may oppose an unpopular transfer of wealth from taxpayers to a special-interest group, while privately lending it support because of the political benefits it brings him. Or, he may actually favor a new a crackdown on illegal immigration because it ensures him the support of labor unions, but publicly announce that it is a precaution against domestic terrorism. There is deception or hypocrisy involved here, as the larger public interest is covertly sacrificed for more narrowly personal political gain. This orientation, combined with its microeconomic foundation, means that *public choice recognizes a governmental failure when hypocrisy produces deadweight losses in equilibrium.*

Notice also that there is a built-in propensity to view these hypocritical and deceptive public choosers as narrowly self-interested. A benevolent public servant in contrast would never dream of behaving this way. Instead, these agents possess ''self-interest with guile'' and engage in ''politics without romance'' (Buchanan, 1984, p. 11).

For Austrian political economy, the initial fact-to-be-explained is a divergence between intended and actual outcomes. The presence of radical ignorance makes this divergence possible, as public choosers select inappropriate means to achieve a well-intentioned end. If the public chooser is unable to correctly foresee all of the ramifications of a given policy, owing both to the dispersed and contextual nature of relevant information and to a lack of entrepreneurial alertness, i.e., the knowledge problem, then there is bound to be at least some discrepancy between his expectations and the actual consequences of his choice of means. As noted, this is especially true in a mixed economy, where the governmental and market processes clash and adjustment is exceptionally problematic. The chances of achieving an equilibrium in the mixed economy, with or without deadweight losses, are as slim as they are in the unhampered market process, only more so. A suboptimal equilibrium would obviously be an inappropriate benchmark in this case. *For APE, then, government failure occurs when an intervention does not produce the outcome sought by its proponents.* The burden of APE is thus to explain why this happens and whether one should ever expect otherwise.

Earlier, we saw that in addition to the knowledge problem, the traditional critique of interventionism typically assumed that public choosers are benevolent. Unlike the assumption of radical ignorance, however, the assumption of public spiritedness is not an indispensable or even a defining component of APE (although it does have the methodological benefits mentioned). This is because the objective sought by the proponents of an intervention may not be a benevolent one, but rather a narrowly selfish one. The APE concept of market failure is broad enough, however, to easily accommodate the case of a public-choice-style hypocrite whose deceptions do not necessarily produce the desired outcome, and who is subject to frustrated intentions. The great "master builder," Robert Moses, may have undertaken vast urban-renewal projects in the 1950s and 1960s in order to maintain political power over construction in New York City, and though his announced intention was to provide better housing for the poor, the unintended consequence of much of this was to destroy informal neighborhood networks that were responsible for keeping streets and other public spaces safe. Poor but civil slums were transformed into breeding grounds of incivility and violence, an outcome that Moses himself disapproved of (Jacobs, 1961; Caro, 1975).[36] For APE, the unintended consequences that arise from radical ignorance, and not public spiritedness per se, are the key to understanding discrepancies between (open or concealed) intentions and actual outcomes.

8.2. Toward a Unified Framework of Political Economy

I have recently analyzed the relation among the conventional public-interest approach, PC, and APE on the basis of the assumptions made in each case with respect to motive and knowledge (Ikeda, 2003). Regarding motives, the alternatives are confined to "narrow political interests" versus "benevolence." Regarding knowledge, the alternatives are "perfect knowledge" versus "partial radical ignorance."[37] The conventional public-interest approach to policy analysis (naïve and sophisticated) thus assumes public choosers tackle social issues with a combination of benevolence and perfect knowledge. APE has tended to combine the assumption of benevolent public choosers with that of partial radical ignorance.

So far we have characterized public-choice theory as combining narrow political interests with perfect information. However, this is not always the case in the practice of PC. That is, with few exceptions[38] I believe public-choice scholars would not claim that all of the possible consequences of a political decision can be perfectly foreseen. For instance, there is evidence to suggest that the policies of the United States federal government concerning illegal drugs and welfare transfers together have played a large role in causing failure of inner-city public schools and in rising urban violence (Murray, 1984), but it is highly unlikely that they are the intended consequences of these policies' supporters. An entirely consistent neoclassical microeconomist, however, would have to conclude that public choosers must have been able to foresee all the possible states of the world that would be created from these interventions, as they subtly interacted with the various other gradients of the interventionist process, and attach precise probabilities to each and every one of them. Whether public choosers do choose to pay attention to these ramifications, of course, depends entirely on whether the expected benefit of doing so exceeds the expected cost. Methodological consistency, however, would demand that violence and failing schools were indeed a foreseeable *and* intended outcome of their narcotics and redistribution policies, even if they decide that it is better to ignore them. Rational ignorance, ignorance by deliberate choice, can explain all and there is no such thing as a truly unintended consequence.

Again, I do not think that most practitioners of PC would see it this way, especially those in the tradition of Virginia PC (VPC). In theory, however, they remain committed to the neoclassical utility-maximization framework – ''we commence with individuals as utility maximizers'' (Buchanan, 1984, p. 14) – with all its attendant equilibrium baggage. In practice, their work sometimes falls into a fourth category characterized by public choosers who suffer from partial radical ignorance as well as narrow self-interest. And as I have argued (Ikeda, 2003), this is precisely where a more unified APE/PC theory can go. It would require that APE relax the benevolence assumption, which would entail little or no loss of methodological integrity, and that PC take the more significant step of abandoning the utility-maximization/equilibrium framework at the level of theory. Even in recent publications, however, leading VPC scholars continue to characterize the ''knowledge problem'' (the term ''information problem'' is often used instead, perhaps to distinguish it from the APE interpretation) as the result of high information costs rather than radical ignorance (Tullock, Arthur, & Brady, 2002). This has to change if, for the sake of methodological coherence, practice and theory are to be made consistent.

9. AREAS FOR FUTURE RESEARCH

Clearly, an important agenda item is to find a useful way to integrate APE and PC into an internally consistent framework along the lines indicated.[39] Some might respond by arguing that APE and PC appear to be doing this already in practice, spontaneously if you will. Even if true, however, at some point, as these paradigms drift closer together, a more careful unification in theory will become more desirable if not absolutely necessary. But unification does not mean sameness. Differences in subject matter and in the way in which questions are framed would undoubtedly remain, so that rather than competing paradigms APE and PC may continue to offer valuable complementarities.

Within the domain of APE occupied by the dynamics of interventionism, many theoretical and empirical questions remain. An obvious empirical issue would be to examine whether the various pattern predictions mentioned in this essay, conform to observable data. Examining the so-called explanatory power of pattern predictions five and seven – regarding where on the politico-economic spectrum turning points are most likely to occur and the relative stability of pure welfare states – may be particularly interesting. Using the various published indexes of economic freedom as a proxy for the level of interventionism in a given system, one might correlate these levels with historical instances of systemic crisis, using perhaps frequency and severity of economic downturns as a proxy. In an essay appearing in this volume, Robert Higgs proposes that the cycling behavior described in pattern prediction two takes place within a much narrower range than I had initially suggested. It would be interesting to see whether this is right. The curious investigator might also tease out further implications of the framework and attempt to corroborate them empirically.

Theoretical issues worth investigating might include the relation between micro-crises and macro-crises, and the extent to which a particular target area of intervention, such as a city or industry, is able to maintain its politico-economic stability by relying on market signals generated in less interventionistic regions of the system, much as Mises argued that a small socialist economy can utilize international prices to assist it in its planning. This is an area in which I am currently engaged: the political economy of urban interventionism. In addition to its impact on ideology, I have found it useful to ask whether interventionism has a systematic effect on local norms of reciprocity and the so-called social capital. Here the writings of Robert Putnam (2000), as well as Jacobs (1961) and Nathan Glazer (1988) among others, have been especially helpful.

It may be worthwhile exploring the different effects that an intervention might have depending on whether the market in question is assumed to be in or outside of equilibrium. For instance, is there an important difference between price and nonprice regulations outside of equilibrium? I have suggested that there is, but much more can be done. Also, very little has been done from an APE perspective on the dynamics of disinterventionism, which is especially important as countries around the world have attempted, with varying success, to move away from planned economies. How likely and under what conditions will either recidivism or successful reform occur?

Aside from the dynamics of interventionism, another part of APE that has remained relatively unexplored has been the dynamics of the governmental process. This encompasses questions of the nature and implications of the knowledge problem within the public sector, itself. A related area is the economics of bureaucracy, along the lines pioneered by Mises (1969[1944]) and developed by Tullock (1965) early in his career.[40] I have found the insights of Charles Wolf (1990) and James Q. Wilson (1989) on the nature of governmental problems and bureaucratic behavior very suggestive for future research in this area, as they both directly address the question of what a bureaucracy can and cannot know and why.

10. CONCLUDING THOUGHTS

APE offers a coherent framework for understanding the mixed economy, as does PC. In its own way each undermines the case for the mixed economy. The Frankfurt School of Habermas and Offe likewise offers a critique of the mixed economy that parallels APE. In a similar fashion, the traditional Marxian analysis of capitalism sees little long-term hope in short-term efforts to shore up its inner contradictions. Is there an alternative to these critiques of the mixed economy that offers a coherent framework in which limited forms of central planning coexist harmoniously with the market process?

The current microeconomic theories of market failure have been shown to be woefully inadequate to the task, especially as they postulate imperfections in the private sphere, which can be successfully repaired by assuming perfection in the public sector. In any event, that approach is far from a satisfactory *theory* of the mixed economy in the sense of, say, Marx or even Keynes. It is true that the traditional macroeconomics of J.M. Keynes does postulate a systemic problem of laissez-faire capitalism that the trained intelligence of men and women of goodwill can solve. Nevertheless, it is a coherent framework, warts and all. The problem is that those who still take it seriously are largely confined to policy makers. No self-respecting economic theorist does any more, and rightly so.

What, then, besides their hopes and prayers, are policy makers basing their policies on? What informs their choices, their views on the long-term impact their policies will have on society as a whole (rather than on a particular interest group)? If there is a theory behind all this, where is it? Indeed, there appears to be no complete theory of the mixed economy that demonstrates how systematic government intervention will produce an outcome that is viable in the long term. APE and PC have been attacking a set of largely incoherent policies and not a system; at best an attitude about what works that is based on ad hoceries. Bohm-Bawerk and Mises at least had Marxism and socialism to sink their teeth into – respectable doctrinal opponents against whom great care and logic had to be taken. What do we have today? Keynesianism, among theorists, is long dead. Our opponents are who, exactly? What *system* are we critiquing?

The subtitle of my 1997 book is ''toward a theory of interventionism,'' but I am coming around to the conclusion that Mises was, not surprisingly, more astute in titling his 1927 book *Kritik des Interventionismus* (*A Critique of Interventionism*). The inescapable conclusion of an APE/PC analysis is that interventionism is an unworkable and incoherent system because in the strict sense of the word it is not a system at all. Strictly speaking there can be no such thing as a theory of the mixed economy – only a theory of why it systematically fails.

NOTES

1. Later we will see how these rules (e.g., norms of action, prices, property rights) tend to change in response to government interventions themselves as the process continues over time.
2. For elaborations on the various meanings of capitalism and collectivism as they are used here, see Ikeda (1997, pp. 32–38).
3. This essay draws extensively on Ikeda (1997).
4. For a fuller treatment see Ikeda (1997). While the burden of this essay is to show that the tradition of political economy begun by Mises and developed by Hayek and others is a useful framework for understanding the operation of the mixed economy, and that with updating and revision in light of more recent theoretical innovations it can be made more useful still, the relatively small number of works canvassed in this section is less a reflection of extreme selectivity on the part of the present author than of the relative paucity of the literature that shares this perspective on interventionism. Compared to a literature review of PC, which would (and has) required a book-length treatment (see e.g., Mueller, 1989), a relatively short essay would seem to suffice for a political economy based on the dynamics of interventionism. For another treatment of the history of the critique of interventionism, see Don Lavoie's (1982) essay.
5. It is perhaps appropriate to mention at this point the work of Claus Offe (1984). While, with its Marx-inspired starting point, it is certainly outside the tradition of Mises and his followers, it nevertheless reflects a sensitivity to the dynamics of intervention that is quite congenial to the views presented here.
6. This is an instance of a phenomenon that Kirzner (1963) first identified and has more recently termed an ''error of over-optimism,'' whose detection is inevitable.
7. Other works in this vein are *Planning for Freedom* Mises(1996[1952]), another anthology, and *Planned Chaos* Mises(1961), which is closer in execution to *Interventionism*, but more discursive.

8. Mises does not treat of alternative policy responses, such as a subsidy to producers or consumers or milk, but as I will explain later, a similar dynamic operates.

9. While Don Lavoie argues that Rothbard has thus extended "the scope of the concept of interventionism to an increasing variety of categories of government policy to which [Mises's] original form of argument was applicable" (Lavoie, 1982, p. 169), I have concluded that these categories add little to our understanding of the interventionist process, itself. For example, how does it deepen our knowledge of the consequences of taxation, which is a binary intervention, by calling it a binary intervention? For an extended argument see Ikeda (1997, Appendix C).

10. But see Higgs's contribution to the present volume.

11. Mark Thornton (1991) has successfully applied this Kirznerian framework to the case of prohibition. Robert Bradley (2000) has also recently employed parts of this framework in his comprehensive treatise on the government regulation of the oil industry.

12. There is also Mises's unsatisfactory treatment of subsidies and nationalization. For a discussion of this see Lavoie (1982) and Ikeda (1997, Appendix B), which offers a possible explanation.

13. Ikeda (1997, Chapter 3), deals extensively with the ideas discussed in this section.

14. PC tends to view the political process as a kind of market and identifies the customers of bureaucratic agencies as not the citizens they serve but the governmental bodies responsible for their funding.

15. McKenzie and Lee (1990) offer a similar argument relating airline safety to traffic deaths.

16. If these processes do not "clash," then the dynamics of interventionism will not emerge. However, the present argument is that some degree of clashing is inevitable.

17. Ikeda (1997, Chapters 4 and 5), deal at length with the topics covered here.

18. To the extent that there are no alternatives to bureaucratic management, the case of national defense is often used, and then perhaps one would not expect profit management to perform better.

19. The latter include in particular what Kirzner has referred to as "errors of over-pessimism" (e.g., a seller who sets his price lower than he could get), which, because they do not inevitably create outcomes that are obviously at variance with expectations, require a more dynamic form of entrepreneurship to reveal. Economic inefficiencies typically fall into this category. This is in contrast to "errors of over-optimism" (e.g., a seller who sets his price higher than he could get), which the agent is in some sense bound to discover, such as when shortages or surpluses occur. These concepts play an important role later in this essay.

20. For recent evidence tending to support this conclusion, see Megginson and Netter (2001).

21. Ikeda (1997, pp. 110–112) actually defines three versions of "frustrated intentions." The conclusions of this essay pertain to all three.

22. In Ikeda (1999) I argue, using the analysis of Rizzo (1990), that to the extent that the interventionist process can be seen as tending to drive the system ever further from a fully coordinated state, learning becomes increasingly difficult.

23. In more recent work I have explored the effect of interventions on local norms of reciprocity and social capital. See Ikeda (2002). The mechanisms involved, however, appear to be similar to those operating on ideology as it is defined here.

24. It also implies Fabian-style "creeping socialism" is extremely unlikely, since systemic failure would likely occur far short of pure collectivism.

25. Since in the next section I will distinguish between regulatory and transfer dynamics, the term deregulation might produce some confusion were I to use it to refer the dismantling of both regulatory and redistributive interventions.

26. See also the discussion in Ikeda (1997, pp. 157–159). Again, Mises does not attempt to explain the respective dynamic consequences of price versus nonprice regulations.

27. On the Panglossian nature of modern welfare economics see Kirzner (1992).

28. For a more extensive explanation of the effect of price controls in disequilibrium, see Ikeda (1998).

29. It does not serve my current purpose to try to present and justify the proper duties of the minimal state. This would seem, however, to be a matter that anyone must resolve who wishes to define interventionism as Mises does.

30. This argument is presented more rigorously and extensively in Ikeda (1997, Chapter 6).

31. The three other important parts of APE concern (1) the nature of bureaucracy and the governmental process, (2) the modified elements of PC, discussed in the next section, and (3) the analysis of violent conflict and war. For the purposes of the present analysis, the first two play supporting roles, while the last does not enter at all. In Higgs's (1987) analysis, however, war and conflict is central.

32. These are each more fully derived and explained in Ikeda (1997, Chapter 7).

33. See for example the normative perspective of the various public-choice models summarized in Mueller (1989, pp. 373–465). Also, according to Buchanan: "government or political organization is shown to 'fail' in certain respects when tested for satisfaction of idealized criteria for efficiency and equity" (Buchanan, 1984, pp. 11–12).

34. See Charles Rowley (1994, p. 288) for the distinction between Chicago and Virginia branches of PC.

35. Quoted in Wagner (1989, p. 56; emphasis omitted).

36. Incidentally, this is a manifestation of the dynamics of ideological change extended to rules of civility, trust, and norms of reciprocity. In addition to Jacobs (1961), the work of Nathan Glazer (1988) is relevant here, in particular, his discussion of how the deadening formality and red tape of governmental programs displaces the public spiritedness arising in the context of the informal relations that constitute what he calls the "fine structure of society."

37. Assuming total radical ignorance would leave the system hopelessly far from plan coordination for the market process to function at all. See again Rizzo (1990) and Ikeda (1998).

38. For examples of what these exceptions might look like, see Donald Wittman (1995), who, though not a follower of PC, interprets the perfect-knowledge assumption of standard theory as leading inexorably to the conclusion that existing politico-economic conditions are necessarily optimal. Stephen Shmanske (1994) does not endorse Wittman's policy conclusions, but he also interprets the world entirely through the lens of an equilibrium always, information-cost-only perspective.

39. A recent issue of *The Review of Austrian Economics* is devoted to Austrian economics and PC, and explores parts of this agenda. I have found that the articles by Boettke and Lopez (2002), Randall G. Holcombe (2002), and Daniel Sutter (2002) interesting in this regard. As already noted, Ikeda (2003) also compares and contrasts APE with PC.

40. See Ikeda (1997, pp. 77–89, 147–148, 209–211).

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FROM LAISSEZ-FAIRE TO *ZWANGSWIRTSCHAFT*: THE DYNAMICS OF INTERVENTIONISM☆

John Hagel, III and Walter E. Grinder

1. PREFACE

This paper will develop some of the social and political implications of the Austrian theory of interventionism originally presented by Ludwig von Mises and Friedrich A. Hayek.[1] Specifically, it stresses the inherently destabilizing and retrogressive characteristics of the interventionist dynamic

☆Prepared for Symposium on Austrian Economics, University of Hartford, June 22–28, 1975. It has been published here without changes other than with regard to references. This paper represents merely one phase of an extended collaborative effort between Walter Grinder and myself (i.e. John Hagel) Our ultimate objective is to present a detailed and comprehensive analytical model of the structure and dynamics of the state capitalist system as it has evolved historically in the U.S. This model will synthesize the theoretical insights of Austrian economics with concrete historical and sociological analysis. Since this particular paper addresses merely one dimension of a broader analytical mode, the reader is advised to see as well Walter Grinder and John Hagel, "Towards a Theory of State Capitalism: Ultimate Decision-Making and Class Structure", a paper presented at the second Libertarian Scholars Conference in October 1974. A revised version of this paper will appear in the first issue of the forthcoming *Journal of Libertarian Studies.*

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within a market system and argues that the dislocations produced by political intervention in the market system ultimately require the replacement of the price mechanism by a completely different system for the allocation of resources based on arbitrary political decision-making (the *Zwangswirtschaft* type of social organization discussed by von Mises). These points will be developed within the framework of an analytical model of the structure and dynamics of political capitalism as it has evolved historically in the U.S.

2. THE MARKET PROCESS

For an audience such as this, it will presumably not be necessary to develop in great detail the arguments on behalf of the efficiency and desirability of the unhampered market process for the allocation of scarce resources.[2] Nevertheless, it is important to stress certain fundamental characteristics of the market process which are essential for an understanding of the full consequences of political intervention.

Pure market systems are characterized by a constant equilibrating process, which adjusts to the dynamic of change in a manner designed to achieve an optimum allocation of economic resources. Austrian economists in particular have stressed the fact that the operation of the market system can only be understood as the process of information dissemination occurring over time and that it is highly misleading to conceptualize the market system as a static structure. Static structural approaches to economic analysis and the related tendency to focus exclusively on aggregate constructs rather than on the purposive action of individuals have been major factors underlying the prevalent misunderstanding of the dynamics of market economies.[3]

The market process is essentially a learning process designed to provide an optimum information flow to market participants, ensuring that existing misallocations of resources are perceived and remedied. As a learning process, the market ensures both an optimum amount of malinvestment and an optimum amount of resource idleness.[4] Professor Israel Kirzner's recent study on entrepreneurial decision-making within the market process has focused attention on the strategic role of the entrepreneur's alertness to price discrepancies in the dissemination of information.[5]

In advanced technological societies, the process of change (the "forces of divergence", to use Ludwig Lachmann's phrase) tends to accelerate and increase in complexity. As a consequence, the entrepreneurial process of adjustment becomes more refined and highly specialized in a constant effort to maximize the speed and flexibility of response and even the slightest interference with this entrepreneurial activity will seriously weaken the "forces of convergence" within the market system. In the absence of such interference, a pure market system is a dynamic and yet self-contained system lacking any endogenous tendencies to depart from the competitive market process.

Perhaps one of the most serious misconceptions concerning market economies is that they should conform to an idealized, structural model of perfect competition. As a consequence, it has become common wisdom that market systems cannot persist over time because of an "inherent" tendency to deviate from the ideal of perfect competition and to encourage the unhampered growth of monopolies which critically distort the market process. The concept of a market process is meant to describe a "real world" phenomenon and, since the real world is constantly changing, static models of perfect competition inevitably distort our understanding of market economies. As Hayek argued in his critique of such models, "competition is by its nature a dynamic process whose essential characteristics are assumed away by the assumptions underlying static analysis."[6] The model of perfect competition is irrelevant as a standard for measuring the effectiveness of the competitive market process since, at any point in time, a situation considered to be monopolistic by such a standard may represent an optimal allocation of resources within the market system. The theoretical analysis of economies of scale within individual firms confirms that these firms attain an optimal size on the unhampered market within the context of an on-going process of change and not necessarily in relation to some abstract, normative concept of perfect competition.[7]

Moreover, there are compelling theoretical reasons to insist that cartels and other attempts to insulate market participants from competitive pressures through voluntary agreements will ultimately be frustrated by the market process itself.[8] While cartels and other agreements strive to preserve uniform prices as a means of curbing competitive activity, the widely divergent cost structures of each firm participating in the agreement constitute a strong incentive for the more efficient producers to withdraw in an effort to capture a wider share of the market. Usually, the final breakdown of such cartel arrangements is preceded by a period of growing, covert non-price competition among the cartel participants.

In fact, the concept of monopoly acquires a meaningful sense only if it is restricted to situations in which a market participant has relied on the non-market device of political intervention to insulate himself from the process of competition on the market, thereby permitting him to enjoy a rate of return which deviates substantially over time from the return which would have been possible on an unhampered market. The inherent instability of voluntary cartel arrangements and the essential role of political intervention in preserving monopoly positions on the market is not only theoretically demonstrable, but has also been amply confirmed by American historical experience.[9]

3. THE ECONOMIC MEANS AND THE POLITICAL MEANS

To understand the full implications of the interventionist dynamic within market systems, it is necessary to make a preliminary distinction between two fundamentally incompatible means for the acquisition of wealth in society: the economic means and the political means. As originally formulated by the German sociologist, Franz Oppenheimer, the economic means refers to the acquisition of wealth through production and voluntary exchange within a market system.[10] The political means, in contrast, involves the use of coercion to confiscate and appropriate wealth accumulated through the economic means. By its very nature, the political means benefits one group only at the expense of another and the institutionalization of the political means within the state precipitates a process of class conflict, which pervades the entire society and profoundly influences the subsequent evolution of both the political and economic system.

In an earlier paper, we presented a schematic outline of the class structures characteristic of a system of political capitalism and, while a detailed presentation of this outline is neither possible nor appropriate here, it is necessary to identify two prominent elements of this class structure before proceeding with the present analysis.[11] First, the term "political class" represents a broad category encompassing all those individuals and groups in society who are net beneficiaries of the political means. Within the political class, a numerically much smaller group may be isolated and identified as "ultimate decision-makers" within the political capitalist system in the sense that they are largely responsible for defining the parameters within which policy formulation and debate occurs. This group, as technically defined, constitutes a ruling class. For reasons discussed in the earlier paper, we believe that the fusion between state and "private" interests which occurs in the banking sector will lead to the emergence of a ruling class drawn in large part from this area of the economy.

The introduction of the political means within a market system generates an interventionist dynamic that is inherently destabilizing and retrogressive.[12] The economic means and the political means are incapable of coexisting in a stable relationship within a single social system since there is an expansionist tendency inherent in the latter which will cause it to occupy an increasingly dominant position within the social system. Von Mises characterized the tension between the market process and political intervention in the following manner:

> The conflict of the two principles is irreconcilable and does not allow of any compromise. Control is indivisible. Either the consumers' demand as manifested on the market decides for what purposes and how the factors of production should be employed or the government takes care of these matters. There is nothing that could mitigate the opposition between these two contradictory principles. They preclude each other.[13]

The inevitable antagonism between these two means for the acquisition of wealth in society stems from the fact that political intervention within the market system does not simply achieve a transfer of wealth, it also necessarily produces distortions and disturbances within the pricing mechanism which regulates the flow of information within the economy. These dislocations are internalized within the market system, producing an "objective" misallocation of resources that generates demands for further political intervention. The Austrian theory of interventionism is an ecological theory which stresses the inter-related and interdependent nature of the market system such that a discrete intervention in one part of the system has far-reaching, and often unforeseen, consequences in other parts of the system. The evolution of political capitalism, therefore, is ultimately determined by the deepening contradictions between the economic means and the political means within the social system.

4. SPECIFIC EXAMPLES OF DISLOCATIONS PRODUCED BY INTERVENTIONISM

In his essay "Middle-of-the-Road Policy Leads to Socialism", von Mises illustrated the expansionist character of interventionism by using the example of price regulation for milk products. Presumably, such a policy originates in the determination that milk is an "essential" commodity and that consumers should be able to obtain this commodity at a "reasonable" price. Yet, assuming that the price ceiling is set at some point below the prevailing market price for milk, this intervention in the price mechanism will have a variety of unintended consequences. Since the production and distribution of milk will no longer be as profitable as it once was, the resources involved in these activities will begin to shift over time to other, more profitable, activities and the supply of milk will begin to decrease relative to demand (which will be stimulated by the artificially low price of milk). Government planners who had originally sought to assure the availability of milk to consumers will thus be confronted with the option of either repealing the original price regulation or extending the scope of price regulation to cover the various factors of production necessary for the production of milk in an effort to increase the profitability of marginal producers. If the latter option is chosen, it is possible that it will be accompanied by a system of rationing to ensure that "needy" consumers will have access to the dwindling supplies of milk.

The latter option, however, merely raises the identical dilemma for planners on another level as the supply of each of the factors of production subject to the new price controls begins to decline as well. If pursued to its conclusion, the eventual result of a relatively innocuous policy designed to ensure the availability of milk at a "reasonable" price will be to expand the scope of price regulation until it encompasses the entire economy.[14] As von Mises indicated:

> Price control is contrary to purpose if it is limited to some commodities only. It cannot work satisfactorily within a market economy. The endeavors to make it work must needs enlarge the sphere of commodities subject to price control until the prices of all commodities and services are regulated by authoritarian decree and the market ceases to work.[15]

Certainly, if anyone needed further proof of this principle, our most recent experiment with wage and price controls should have settled all doubts.[16]

Another example of the disastrous consequences of price regulation may be seen in the policy of regulating the price of natural gas.[17] Not only has such a policy resulted in steady decreases in the supply of natural gas, it has also precipitated widespread dislocations within the entire energy sector and reinforced our growing dependence on foreign energy imports. These developments in turn have been a major factor in proposals for mandatory "conservation" regulations, massive state subsidies for alternative energy R&D projects and creation of a state-owned corporation to undertake exploration for additional natural gas supplies. While much of this paper will focus on the role of political intervention in "protecting" and "strengthening" private corporations, natural gas price regulation illustrates another dimension of the process – the utilization of the political means by one private economic interest group against another prominent interest group.[18] In this case, electric utility companies and other large industrial consumers of natural gas were instrumental supporters of natural gas price regulation as a means of substantially lowering their own production costs.

While price controls offer a particularly convenient illustration of the unfolding of the interventionist dynamic, a similar process is precipitated by any form of political intervention in the market system: tariffs, subsidies, inflationary monetary expansion, etc. The complexity of the market process and the necessarily imperfect information of political actors assures that as long as the market process continues to function, in however limited form, each intervention will tend to bring about a state of affairs which, even from the point of view of the people who sponsored the intervention, is "worse" than the state of affairs prevailing ex ante. However, the consequences of each intervention may require considerable time before they become apparent and, even then, it is not always immediately apparent that the initial intervention was the cause of the subsequent distortions in the market system.

5. THE EXPANSIONIST TENDENCIES OF INTERVENTIONISM

Political intervention in the market system thus introduces an inherent element of instability, persistently confronting policy-makers with the option of either expanding or contracting the scope of intervention. As von Mises suggested, "interventionism cannot be considered as an economic system destined to stay"[19] – it is necessarily a transitional system, unable to remain at any one stage for a prolonged period of time. Furthermore, there is a crucial distinction between the "instability" characteristic of market systems and the instability generated by political intervention. Market instability is a manifestation of its equilibrating mechanisms adapting to the inexorable process of change and striving to fulfill the changing expectations of market participants. Political intervention, in contrast, substantially increases the degree to which the expectations of the market participants remain unrealized as the learning function of the price mechanism is progressively short-circuited and the misallocation of economic resources grows more pervasive. The instability associated with political intervention thus indicates that the imbalance between the "forces of divergence" and the "forces of convergence" is steadily increasing within the market system, resulting in a corresponding decline in consumer welfare.

While political intervention in market systems is not inevitable, certain sociological factors suggest that, in the absence of a broadly held individualist, market-oriented ideology, there will be a strong temptation to rely on the political means instead of the economic means in attaining specific goals. A basic corollary of the praxeological "action axiom" holds that human action will be undertaken only if it is anticipated by the actor that he will be able to substitute a more satisfactory state of affairs for his present less satisfactory condition. This "action axiom" corollary acquires considerable significance when considered in association with "Epstean's Law" as cited by Albert Jay Nock: man tends to satisfy his needs and desires with the least exertion.[20] Since expropriation usually requires less exertion than production, the political means will represent an attractive alternative to the economic means for a broad range of individuals – particularly those who lack the ability to produce efficiently on the unhampered market. This conclusion is further reinforced by the observation that individuals relying on the political means characteristically hold a relatively high time preference and, even if they had the understanding necessary to realize the ultimate consequences of political intervention, they would probably prefer to maximize short-term returns.

Similar arguments may be advanced to support the contention that there will be a tendency to expand the scope of political intervention once it is initiated rather than to abandon the original interventionist measures and remove the cause of the market distortions. Moreover, a democratic political system tends to reinforce this tendency. As the misallocation of resources resulting from a particular interventionist measure becomes apparent, political pressure will be generated to remedy its adverse consequences. Since the cause and effect relationship between political intervention and the subsequent distortions in the market system are usually not readily apparent and since politicians will generally prove extremely reluctant to admit that the earlier measures were mistakes, they will not surprisingly prefer to expand the scope of intervention by proposing additional measures to cope with the new problems.

This tendency is strengthened by the fact that the beneficiaries of the political means who can clearly perceive the prospect of large, and relatively short-term, financial gains will usually appear more vocal and better organized than the fragmented non-beneficiaries who are often unaware of the long-term adverse consequences of interventionist measures. The members of the ruling class, representing the leading economic interests under political capitalism, retain their essential role as ultimate decision-makers by defining the parameters within which policy-making occurs.[21] The thrust and shape of interventionist policies in a political democracy, therefore, results from the centralization and manipulation of democratic demands for the purposes of the economic/political elite. Historically, the leading interventionist measures in the American economy have been proposed and actively supported by prominent leaders in business and finance to promote their own interests.[22] The myth of the "businessman as a persecuted minority" has performed a major role in obscuring this historical reality and, to be able to identify the acting individuals who have promoted the steady expansion of political interventionism, it is first necessary to penetrate this myth.[23]

It is important to stress, however, that the underlying interventionist dynamic in state capitalist systems is characterized by inherent tendencies which are independent of, and do not require, conscious intrigue within the economic/political elite. Of course, each interventionist act requires a conscious choice among its initiators – the point here is that the over-all pattern of a rapid expansion of the scope of intervention within the market economy need not have been foreseen, or intended, by the economic/political elite at the time that the initial interventionist measures were introduced.

There is one significant exception to the pattern of expanding political intervention, which arises in certain "crisis" situations where the alternative to abandoning particular interventionist programs would require a fundamental and sudden transformation of economic, social and political relationships. At such points, the economic/political elite will probably attempt to contract the scope of intervention even in the face of widespread public sentiment favoring additional expansion. However, these rare reversals are not sufficient to halt the interventionist trend since it is inconceivable that the economic/political elite will ever fully abandon political intervention in the market and the remaining intervention will lead to ever-intensifying dislocations requiring further intervention.

Prominent historical examples of such "crisis" situations were the establishment of the National Recovery Administration during the New Deal and the more recent experiments with systematic wage/price controls during the Nixon administration. On a more limited scale, the critical housing shortages resulting from the adoption of rent control legislation in large urban areas have generated popular demands for massive public housing projects and the economic/political elite, confronted with the prospect of socialization of the housing market, has been forced to reconsider the desirability of the original rent control legislation.

6. *ZWANGSWIRTSCHAFT*: THE CULMINATION OF INTERVENTIONISM

The dislocations produced by political intervention in the market system lead to a continued deterioration of the integrative and coordinative function of the price mechanism. Both Carl Menger and Ludwig Lachmann have analyzed the role of the price mechanism in regulating the information flow through a series of input/output prices between the higher and lower orders of production in the capital structure and distortions in these prices have particularly serious consequences for the market system as a whole.[24] The resulting dislocations and continued expansion of political intervention culminates in the emergence of a fundamentally different social system that replaces the price mechanism as a device for the allocation of resources by an intricate network of arbitrary political decision-making.

This movement from a market to a non-market system of centralized and arbitrary decision-making results in the crystallization of a socialist or, more appropriately, fascist set of economic relationships. Such a system has been alternatively labeled *Zwangswirtschaft* by von Mises and *Ordnungswirtschaft* by Robert Brady. As von Mises has indicated, the labels and outward appearances of a market system are preserved in a system of *Zwangswirtschaft*, but the task of allocating economic resources has decisively shifted from the market to the political system.[25] Thus, on a more concrete level, ultimate decision-making within the social system is transferred from Wall Street to Washington. Von Mises noted that prices, wages and interest rates in this new system are no longer what they appear to be, instead "they are merely quantity relations in the government's orders."[26]

As all economic issues begin to acquire political meaning – a necessary result of the departure from the price mechanism as a means of allocating economic resources – the role and size of the state apparatus begins to expand at an accelerating rate. The significance of the shift in the locus of ultimate decision-making is not that different people would be making the decisions since, in fact, in most cases the same people will be involved as personnel transfers between corporate offices and government offices become increasingly common. The real importance of the shift involves the abandonment of the price mechanism and its replacement by a system of decision-making operating within a completely different set of parameters and constraints. This transition process is a lengthy one since the full consequence of interventionism emerge only gradually over time and may be either accelerated or prolonged through various measures.

7. WAR AND INFLATION: CATALYSTS OF INTERVENTIONISM

Before outlining the major stages of the interventionist dynamic, attention should be focused on the role of two categories of interventionist measures, which are instrumental in defining the length and specific shape of the transitional process. First, the institutionalization of the political means in the form of the state necessarily requires regularized channels for financing the activities of the state apparatus. The very existence of the state thus presupposes systematic intervention in the market process and it is futile to pretend that this form of intervention, unlike other forms, is somehow compatible with the unhampered market system.[27]

While direct taxation is the most dramatic method of financing state activity, it is progressively supplemented by more indirect forms of deficit financing that are far less conspicuous among the public. Specifically, a growing reliance on borrowing through the sale of government bonds provides the basis for an intimate cooperation between the state and the banking institutions, which become heavily involved as intermediaries in the sale of these bonds. This mutually supportive relationship that develops between the state and banks is further enhanced by measures which authorize the monetization of the state debt, permitting banks to issue notes by using government bonds as part of their asset base. These arrangements for the financing of state activity reinforce the strategic position of the banking sector within the state capitalist system and are an important element in the explanation of the fact that the earliest and most systematic forms of state intervention often occur in the banking sector.[28]

In analyzing the interventionist dynamic in various historical contexts, the conclusion becomes inescapable that wars and war preparations have performed an essential role in accelerating the process of interventionism within the market system.[29] This insight is hardly a novel one; both the Manchester School of Richard Cobden and John Bright and the doctrinaire laissez-faire adherents in the Anti-Imperialist League in the U.S. at the turn of the century explicitly perceived the necessary correlation between war and domestic interventionism and, as a result, became actively involved in the peace movements of their day.[30] Unfortunately, it is an insight which the contemporary conservative movement tended to forget in the aftermath of World War II. While war-related intervention in the market system has far-reaching consequences, it is particularly important to note that the vast increase in the revenue needs of the state apparatus which inevitably occurs during war serves to consolidate further the intimate relationship that is forged between the state apparatus and the banking sector in state capitalist systems.

The traditional maxim that "war is the health of the state" should be amended to read that "war and inflation are the health of the state."[31] The close inter-relationship between these two dimensions of statist health becomes apparent in the often explicit reliance on war preparations as an inflationary pump-priming mechanism either to accelerate recovery from a depression or to postpone the downturn of the business cycle.[32] Single project expenditures by the state apparatus generally assume growing importance in the demand management policies adopted during the latter stages of the inflationary upswing. In this type of expenditure, characteristic of both the military and space programs, funds are directed into clearly focused, long-term projects in which cost considerations assume only secondary importance. The expenditures may thus be manipulated to reach individual firms or specific industries which are encountering financial problems. In this manner, they are useful instruments in sustaining the demand for the products of the higher orders of production, which have become over-extended as a consequence of the inflationary monetary expansion policies adopted by the state.

War-related expenditures represent a prominent form of single project expenditures since they prove far more acceptable to the economic/political elite than equivalent levels of expenditures in social welfare programs. While defense expenditure programs continue to represent a relatively minor share of total GNP, such aggregative comparisons are characteristically misleading for they entirely overlook the qualitative role of military contracts in assuring the profitability of individual firms in defense-oriented industries.

Perhaps the greatest impact of military expenditures occurs in the sphere of research and development (R&D) activity. According to one source, 80% of the R&D work conducted in the United States since World War II has been financed by defense, space and Atomic Energy Commission expenditures.[33] The consequence of this pattern of financing has been summarized by Seymour Melman in his recent book *The Permanent War Economy*:

> For example, as research in electronics was channeled into military and related applications a few industries, notably computers, gained from the government sponsored research in their fields, but a host of consumer electronics industries like radio and television manufacturing, left to their own devices, have suffered massive depletion, closing of factories, transfer of work abroad and loss of employment opportunity in the United States ... This effect on technical research is an important part of a larger process: a minority portion of the national product often shows decisive impact on the

> economy as a whole. A succession of major industries have been undermined for want of fresh technology [and] capital ... [34]

This channeling of R&D activity thus inevitably has a profound impact in determining the future shape and evolution of the structure of production by subsidizing technological research in certain areas and neglecting others.

8. STAGES IN THE EVOLUTION OF THE INTERVENTIONIST DYNAMIC

The transition from pure market systems to *Zwangswirtschaft* which results from the interventionist dynamic may be conveniently subdivided into three stages – pure market systems, political capitalism and fascism (as specifically understood by the concept of *Zwangswirtschaft*). The two latter stages in fact represent variants of the broader category of state capitalism that encompasses any social system in which the economic means and institutionalized forms of the political means coexist. While certain parameters define each stage, it must be emphasized that each stage is an ideal model and that no social system has existed which belonged entirely to one of these stages without any elements of the others also present. Hence, considerable variations are possible in the historical manifestations of each stage. The stages outlined in this ideal model nevertheless serve a highly useful analytic function in isolating and identifying the trends underlying the expansion of political interventionism.

The characteristics of pure market systems have already been briefly discussed in this paper and it is necessary here only to point out that this stage, in its ideal form, has never existed historically.[35] The institutionalization of the political means in the state is a pervasive theme in the history of mankind and, by its very existence, the state precipitates an interventionist dynamic in market systems which then progressively depart from the ideal model. A rigorous understanding of the requirements of the pure market system indicates that the institutionalization of the political means is fundamentally incompatible with the economic means essential to the market process.[36]

Once the institutionalization of the political means has occurred, the social system enters into a lengthy transitional phase known as political capitalism. This period in fact represents an aggregation of three overlapping sub-stages which reflect an evolving level of sophistication in the utilization of the political means. The first sub-stage involves the use of political intervention by individual corporate leaders for their own narrowly defined benefit. The political means may be employed either to acquire or to protect an economic position within the market system which would be insulated from competitive pressures. Examples of political intervention characteristic of this period include direct subsidies, state contracts and charters to monopolize a specific commercial activity.

The second sub-stage serves as the focus of Gabriel Kolko's illuminating historical study, *The Triumph of Conservatism*.[37] In this sub-stage, the political means is employed on a more systematic level to achieve the "rationalization" and "stabilization" of specific industries. "Rationalization", which emerges as a predominant consideration of the economic/political elite during this and subsequent periods, acquires a rather specific meaning defined by Kolko as "the organization of the economy and the larger political and social spheres in a manner which will allow corporations to function in a predictable and secure environment permitting reasonable profits over the long run."[38] Specific examples of political intervention in this sub-stage include the establishment of a broad array of regulatory commissions and the cartelization of the banking sector through such institutions as the Federal Reserve System.

The third sub-stage in the evolution of political capitalism is attained as the scope of political intervention expands to encompass the entire social system. This represents the "highest" form of political capitalism and it reflects the emergence of a cohesive ruling class capable of defining its own interests within the context of a broader system of political intervention. In other words, it presupposes a "systems" or "class" consciousness on the part of the leading representatives of the economic/political elite which permits them to adopt a long-range perspective in pursuing their interests. For example, during this period the scope of political intervention is considerably broadened to encompass an extensive system of social welfare legislation formulated and implemented by prominent representatives of the economic/political elite in an attempt to promote social stability and co-opt the potentially troublesome labor movement into the governing coalition.[39] James Weinstein's book, *The Corporate Ideal in the Liberal State*, concentrates on this phase of the historical evolution of political capitalism in the U.S., stressing the critical role of corporate leaders in the National Civic Federation in mobilizing support for social welfare legislation.[40]

Despite the expanding scope of political intervention within the transitional stage of political capitalism, the market mechanism, even though greatly hampered and distorted, remains the essential means for transmitting the information necessary for the allocation of economic resources.

However, one of the central assumptions of the corporate liberal consensus forged during the evolution of political capitalism is that the state has a duty to ensure full employment within the economic system and this duty in turn requires a progressive socialization of costs for "private" economic activity. As a consequence, an intricate network of legislation and government agencies emerges to perform this task. One of the fundamental contradictions in the political capitalist system is that the interventionist measures designed to assure full employment of economic resources are precisely those which render it impossible for the market process to attain even the more limited objective of optimal resource allocation.

9. THE SYSTEM OF *ZWANGSWIRTSCHAFT*

The socialization of private costs represents an essential element in the transition from political capitalism to the next, culminating stage of the interventionist process. By socializing costs and refusing to allow inefficient enterprises to fold, political capitalism denies market participants the ability to act on the basis of information transmitted through the price mechanism and thus make necessary adjustments in the allocation of economic resources. The price mechanism is therefore rendered increasingly ineffective as more and more allocational decisions are assumed by the state apparatus. In John T. Flynn's description of this process, the government "will insert itself in the structure of business, not merely as a policeman, but as partner, collaborator and banker."[41]

As one of the consequences of the progressive abandonment of the price mechanism, the state increasingly relies on corporativist forms of social organization to provide control mechanisms for coordinating the social system. Robert Brady, in his study of fascist social systems, has designated the industrial and professional groups which provide the organizational infrastructure for the economic system as *Spitzenverbände* or "peak associations."[42] These peak associations constitute the organizational embodiment of the fusion between state and private economic activity that culminates in the *Zwangswirtschaft* system. On a somewhat different level, Robert Caro's recent biography of Robert Moses, *The Power Broker*, provides an analysis of the system of "authority capitalism" which Moses actively promoted in the New York metropolitan area.[43] This system is based on a complex network of semi-"independent" authorities and commissions that provide another organizational model for the fusion of public and private spheres that might be extended to the national level. In addition to isolated urban experiments in "authority capitalism", other examples of an advanced stage of integration between the state apparatus and "private" corporations may be pinpointed in the banking sector, the sprawling "military-industrial complex" and the atomic energy industry.

A thin line separates the frontier between advanced political capitalism and *Zwangswirtschaft* and only the detached historian with the perspective of time will be able to determine when the line is eventually crossed. At several points in recent American historical experience – under the National Recovery Administration in the 1930s and, more recently, under Nixon's wage/price controls – the system of political capitalism appears to have approached the dividing line but then the economic/political elite, perhaps in recognition of the profound social transformations which would be precipitated by such measures, has withdrawn them and shifted to other policies to deal with the same problems.

Once this frontier has been crossed, and the institutions of *Zwangswirtschaft* have been consolidated in the social system, political planners will encounter the identical allocational dilemma which von Mises and Hayek, in their critique of socialist economic systems, argued must ultimately defeat any attempt to replace the price mechanism by central planning as a means for the allocation of economic resources.[44] A system of economic fascism, representing the culmination of a lengthy process of interventionism, is just as unstable a social configuration as any of the transitional phases of political capitalism. The transition to this new social system may be cushioned somewhat by the presence of a capital structure accumulated over time but, as this begins to disintegrate and social welfare begins to decline rather precipitously, popular dissatisfaction may be expected to increase, necessitating even harsher repressive measures. It is also likely that reform movements will arise within the ranks of the planners, resembling similar movements in the Communist bloc countries and hesitantly seeking to re-establish some sort of price mechanism. Whatever the specific outcome, it is clear that *Zwangswirtschaft*, like the interventionist systems that preceded it, cannot offer a permanent solution to the contradictions inherent in interventionism.

10. THE EVOLUTION OF IDEOLOGY: THE SUBJECTIVE DIMENSION OF INTERVENTIONISM

In tracing the evolution of political capitalism, it is instructive to note that it is characterized by frequent lags in subjective perceptions of changing objective economic conditions among members of the coalescing ruling class and that these lags are often the source of considerable political tension. During the initial stages of political capitalism, the predominant ideology remains essentially a variant of conventional laissez-faire doctrines. Beneficiaries of interventionist measures continue to support the market system as the most desirable form of economic organization moderated, however, by occasional and strictly limited political intervention. The necessity for specific interventionist measures is rationalized with often dazzling ingenuity by demonstrating the "special" circumstances that render the market process inadequate to secure the desired end (always stated in terms of a vaguely defined "public interest").

As the range of exceptions broadens and, in particular, as the highly disruptive consequences of sporadic interventionist measures in the capital market become apparent, the dominant ideology undergoes a fundamental transformation. The business cycle precipitated by expansionary monetary policies becomes associated with the "laissez-faire" economic system and prominent economic interests adversely affected by the dislocations accompanying the business cycle begin to support more comprehensive controls on the market process. Seeking to rationalize and stabilize, first, individual industries and then the economic system as a whole, a consensus eventually emerges concerning the necessity, and the desirability, of a more sophisticated and systematic form of political intervention. This consensus emerges only with difficulty and proponents of systematic political intervention inevitably encounter considerable opposition from increasingly isolated segments of the economic/political elite.[45]

In the Anglo-American historical experience, perhaps one of the most important factors in the shift from traditional laissez-faire economic doctrines to more explicit interventionist ideologies occurred during the 1930s when leading proponents of Austrian business cycle theory appeared unable, from within their theoretical framework, to explain the causes of the secondary depression which then gripped both the U.S. and England.[46] These expressions of uncertainty and the failure to present a systematic explanation of the causes underlying the secondary depression tended to discredit the entire theory and paved the way for more enthusiastic support for theoretical systems which professed not only to understand the causes of the business cycle but also insisted that instruments were available to moderate, if not eliminate, the adverse consequences of the business cycle and simultaneously attain the elusive goal of full employment.

The more sophisticated systems approach to political intervention reached its highest ideological expression in Keynesian theoretical economic doctrines, which offered both an explanation of the contemporary economic situation and a policy framework for responding to the secondary depression. While the language employed by the leading Keynesian theorists expressed a fundamental break with the status quo, the fact that many of the specific policies proposed by the Keynesians were already an established part of the interventionist arsenal certainly helps to explain the receptivity of policy-makers within the economic/political elite to this new theoretical system. Thus, the Keynesian theoretical system provided a comprehensive framework for "rationalizing" and expanding the isolated interventionist measures of the preceding period.

In an even more profound sense, the Keynesian mode of analysis represents merely one variant of macro-economic theory that emerged during the early decades of the twentieth century. In addition to Keynes, Wesley Clair Mitchell, John R. Commons and Irving Fisher elaborated comparable theoretical frameworks for macro-economic analysis, which provided the underpinnings of the doctrines of the "monetarist" school.[47] The macro-economic orientation shared by both the Keynesian and monetarist schools were particularly adapted to the advanced stage of political capitalism which emerged following the cartelization of the banking system under the Federal Reserve System.

The systematic and sustained intervention in the capital market undertaken during this period generated effects on a "macro-economic" level which seemed inexplicable in terms of acting individuals and seemed to require a separate theoretical framework for analysis. Such a conclusion, of course, was misleading and, under the guise of "explaining" the dynamics of advanced industrial economies, these theoretical formulations remained permanently trapped at the level of describing superficial manifestations, rather than penetrating the substance, of political capitalism. The underlying causes of the economic distortions arising under political capitalism thereby remained unanalyzed. Of course, such misleading modes of analysis also tend to serve objective interests by focusing attention on artificial aggregate constructs and effectively obscuring the extent to which specific individuals in society benefit from political intervention at the expense of other individuals.

The problem addressed by the Keynesian theoretical system is precisely the problem which advanced political capitalism confronts in an increasingly acute form: how to prolong the expansionary growth of the economic system by maintaining effective demand for the higher orders of production without subjecting the economic system to accelerating rates of inflation. Historically, as already mentioned in an earlier section, the most important policy instrument in the Keynesian arsenal for maintaining effective demand has been military-related expenditures. An example of the explicitly Keynesian dimension to contemporary military expenditures is provided by the following excerpt from a study by an economist:

> Capital expenditure items within the military budget, which are particularly consumptive of labor, tend dually to counteract cyclical unemployment and to stimulate those basic industries that frequently receive the initial and most severe impact of economic recession. In this manner, the allocation of resources to the military should become less disruptive of the civilian economy. Along with other similarly designed programs, they are able to assist in placing a floor under the economy so as to cushion cyclical declines in employment and production.[48]

War, and the threat of war, also serves a particularly valuable ideological function by facilitating the mobilization of popular support for government policies. By focusing attention on an external enemy – an undifferentiated "we" confronting an equally undifferentiated "they" – the threat of war further obscures the "who benefits?" questions raised by domestic interventionism. The compatibility between Keynesian economic policies and as system of economic fascism dominated by an increasingly war-oriented state apparatus, a compatibility which even Keynes himself acknowledged,[49] is based at least in part on the recognition that enemies have become an economic necessity for political capitalism.[50] The growth and consolidation of a sprawling domestic and foreign "military-industrial" complex is accompanied by the emergence of an ideological paradigm of national security management, which incorporates the Keynesian theoretical system.[51] This new paradigm, which focuses attention on the economic system and the military system as interdependent components of a broader, over-arching system, represents a culmination of the ideological evolution associated with political capitalism.

Keynesian demand management policies presupposed the existence of a self-contained economic system so that the dislocations produced by interventionism will not be externalized in the sphere of international trade. In *The Road to Serfdom*, Hayek commented on the tendency of collectivism to become particularistic and exclusive", observing that

> The definitely antagonistic attitude which most planners take toward internationalism is further explained by the fact that in the existing world all outside contacts of a group are obstacles to their effectively planning the sphere in which they can attempt it. It is therefore no accident that, as the editor of one of the most comprehensive collective studies on planning has discovered to his chagrin, "most 'planners' are militant nationalists."[52]

Thus, economic nationalism tends to strengthen with the sustained implementation of a Keynesian program of domestic interventionism and these nationalistic tendencies in turn reinforce the broadening of the concept of national security to embrace economic and political, as well as purely military, concerns. In fact, every policy issue that arises tends to be evaluated explicitly in terms of its impact on this broadly defined national security. Moreover, as the Keynesian paradigm proves increasingly unable to "explain" the contradictions inherent in political capitalism, the ideological paradigm of national security management already provides a more comprehensive theoretical framework for responding to the intensifying dislocations threatening the viability of the entire system.

11. *ZWANGSWIRTSCHAFT* AND THE QUEST FOR IDEOLOGICAL HEGEMONY

While much of the foregoing analysis has concentrated on the growing "rationalization" and centralization of political intervention in the economic system, there are also strong parallel tendencies compelling ideological uniformity with the social system. One of the central themes stressed by Hayek in *The Road to Serfdom* is that comprehensive planning presupposes complete unity with regard to a scale of priorities necessary to select among competing planning objectives. Thus, "an economic plan, to deserve the name, must have a unitary conception."[53] Since complete unanimity cannot be achieved within the framework of democratic political institutions: "the conviction grows that, if efficient planning is to be done, the direction must be 'taken out of politics' and placed in the hands of experts – permanent officials or independent autonomous bodies."[54] The conflict between democratic political institutions and planning was summarized by Hayek:

> Our point, however, is not that dictatorship must inevitably extirpate freedom but rather that planning leads to dictatorship because dictatorship is the most effective instrument of coercion and the enforcement of ideals and, as such, essential if central planning on a large scale is to be possible. The clash between planning and democracy arises simply from the fact that the latter is an obstacle to the suppression of freedom which the direction of economic activity requires.[55]

Moreover, since comprehensive planning requires "general acceptance of a common *Weltanschauung*, of a definite set of values,"[56] the transition to a system of *Zwangswirtschaft* is accompanied by increasing efforts to assert ideological hegemony over the social system and thereby mobilize popular support for the planning priorities selected within the state apparatus. As a consequence, ideological purity becomes a prominent concern and the educational system in particular is progressively integrated into the overarching system subjected to national security management. Just as the marketplace of goods has been progressively subjected to controls, so must the marketplace of ideas submit to the dictates of the state as "wrong" ideas are perceived as a potentially disruptive element within the system and hence as a threat to the national security. To quote Hayek once again:

> The most effective way of making everybody serve the single system of ends toward which the social plan is directed is to make everybody believe in those ends. To make a totalitarian system function efficiently, it is not enough that everybody should be forced to work for the same ends. It is essential that the people should come to regard them as their own ends. Although the beliefs must be chosen for the people, and imposed upon them, they must become their beliefs, a generally accepted creed which makes the individuals as far as possible act spontaneously in the way the planner wants.[57]

12. INTERVENTIONISM AS A PROCESS OF RETROGRESSION

In analyzing the evolution of political capitalism and its eventual transformation into a qualitatively different system, it should be stressed that each stage in the interventionist process is socially and economically retrogressive in comparison with the preceding stage. In seeking to promote full employment of economic resources, the interventionist policies adopted under political capitalism in fact promote a highly wasteful misallocation of resources from the consumer's point of view, thereby resulting in widespread malinvestment and, in the ultimate irony of political capitalism, ensuring the impossibility of full employment.

Zwangswirtschaft is clearly the most retrogressive system of all since it entails the final abandonment of the only mechanism, which can effectively assure the optimum allocation of economic resources – the market price mechanism. In its place, a highly bureaucratic and centralized planning apparatus emerges, becoming heavily dependent on national security related expenditure programs. As von Mises and Hayek have persuasively demonstrated, the abandonment of the market price mechanism inevitably results in a deterioration of economic welfare. Even more importantly, however, such as system of comprehensive planning also necessarily entails a rapid surrender of political, social and intellectual freedom.

13. A CONCLUDING COMMENT: THE FUTILITY OF REFORMISM

This analysis of the dynamic of political interventionism in state capitalist systems leads to a disturbing conclusion: interventionism, once initiated, is an inherently retrogressive and unstable social and economic process which, if not halted, leads inevitably to a variant of economic fascism and, ultimately, to either economic stagnation or collapse. While a detailed analysis of the strategy necessary to oppose such a process of social retrogression effectively is probably not appropriate here, it must be stressed that opposition to this process through any gradualist strategy will fail to reverse the interventionist dynamic and reformist movements will always be manipulated to produce even greater intervention in the market process. The utopians are those who believe that limited reforms can ever be effective in the face of such firmly entrenched interests benefiting from the systematic application of the political means. Only the simultaneous presence of the objective conditions of an economic "crisis" or panic within the state capitalist system and the subjective conditions of a strong ideological movement firmly adhering to an anti-interventionist ethic will provide an opportunity to halt the interventionist dynamic and to return to a pure market system.

NOTES

1. See in particular the essays by Ludwig von Mises, "Planning for Freedom" (1945) and "Middle-of-the-Road Policy Leads to Socialism" (1950), reprinted in *Planning for Freedom*, Libertarian Press (South Holland, IL, 1962); and Friedrich A. Hayek, *The Road to Serfdom*, University of Chicago Press (Chicago, 1944). Unfortunately, the important essay by von Mises, "Interventionismus" (1926), which was reprinted in *Kritik des Interventionismus: Untersuchungen zur Wirtschaftspolitik und Wirtschaftsideologie der Gegenwart*, G. Fischer (Jena, 1929) is not yet published in an English translation.

2. For detailed statements of Austrian economic theory, see Ludwig von Mises, Human Action, Yale University Press (New Haven, 1949); and Murray N. Rothbard, *Man, Economy and State*, 2 vols., Van Nostrand (Princeton, 1962).

3. For a statement of the Austrian view of the market as a process unfolding over time rather than as a static entity, see Israel M. Kirzner, "Methodological Individualism, Market Equilibrium and Market Process", *Il Politico*, Vol. XXXII, December 1967, pp. 787–799 as well as his more extensive analysis in *The Economic Point of View*, Van Nostrand (Princeton, 1960). For a succinct critique of "macro-economic formalism" and the resulting focus on economic aggregates, see Ludwig Lachmann,

"Macro-Economic Thinking and the Market Economy", Institute of Economic Affairs (London, 1973). A general summary of the methodological presuppositions of Austrian economic theory is available in Murray N. Rothbard, "Praxeology as the Method of Economics'" in M. Natanson, ed., *Phenomenology and the Social Sciences*, Northwestern University Press (Evanston, IL, 1973), Vol. II, pp. 311–339.

4. F.A. Hayek, "Economics and Knowledge" (1936) and "The Use of Knowledge in Society" (1945), both reprinted in *Individualism and Economic Order*, Regnery (Chicago, 1972). See also William E. Hutt, *The Theory of Idle Resources*, J. Cape (London, 1939).

5. Israel M. Kirzner, *Competition and Entrepreneurship*, University of Chicago (Chicago, 1973) and Kirzner's subsequent paper, "Capital Competition and Capitalism", *Champion of Freedom*, Hillsdale College Press (Hillsdale, MI, 1974).

6. F.A. Hayek, "The Meaning of Competition" (1946), reprinted in *Individualism and Economic Order, op.cit.*, p. 94. Also Dominic T. Armentano, *The Myths of Anti-Trust*, Arlington House (New Rochelle, 1972) provides a systematic critique of anti-trust regulation based on prevailing theories of monopoly.

7. R.H. Coase, "The Nature of the Firm" in George Stigler and Kenneth E. Boulding, eds., *Readings in Price Theory*, R.D. Irwin (Chicago, 1952); George Stigler, "Imperfections in the Capital Market", *Journal of Political Economy*, June 1967; and Armen A. Alchian and Harold Demsetz, "Production, Information Costs and Economic Organization", *American Economic Review*, Vol. LXII, December 1972, pp. 777–795.

8. For a detailed analysis of this point, see Murray N. Rothbard, Chapter 10, "Monopoly and Competition" in *Man, Economy and State*, *op.cit.*, pp. 560–660. See also Yale Brozen, "Is Government the Source of Monopoly?", *Intercollegiate Review*, 1968.

9. Gabriel Kolko, *The Triumph of Conservatism*, Quadrangle (Chicago, 1963); and Arthur S. Dewing, *Corporate Promotions and Reorganizations*, Harvard University Press (Cambridge, 1914). For a narrower case study of one industry, see Gerald P. Nash, *United States Oil Policy, 1890–1964*, University of Pittsburgh Press (Pittsburgh, 1968); and the definitive study of M.A. Adelman, *The World Petroleum Market*, Johns Hopkins University Press (Baltimore, 1972).

10. Franz Oppenheimer, *The State*, Vanguard Press (New York, 1914). This path-breaking sociological study will soon be reprinted by Free Life Editions in New York. For complementary studies, see Albert Jay Nock, *Our Enemy, the State* (1935), Free Life Editions (New York, 1973) and Frank Chodorov, "The Economics of Society, Government and the State" (Mimeographed manuscript, New York, 1946).

11. For a more detailed and systematic analysis of the class structure of political capitalism, see Walter Grinder and John Hagel, *op. cit.*

12. Many Austrian economists share an unfortunate ambiguity in their acknowledgment of the absolute incompatibility of the economic means and the political means. For example, Hayek in certain parts of *The Road to Serfdom*, *op.cit.*, indicates that various forms of political intervention may be compatible with the operation of the market mechanism, as when he notes that" … the case for the state's helping to organize a comprehensive system of social insurance is very strong." (p. 121). Yet, Hayek at another point suggests that the two principles are

diametrically opposed: "Both competition and central direction … are alternative principles used to solve the same problem, and a mixture of the two means that neither will really work and that the result will be worse than if either system had been consistently relied upon." (p. 42). This is immediately followed by the rather cryptic formulation that "planning and competition can be combined only by planning for competition but not by planning against competition." Murray N. Rothbard, *Power and Market*, Institute for Humane Studies (Menlo, Park, CA, 1970) systematically analyzes the incompatibility between the political and the economic means.

13. Ludwig von Mises, "Middle-of-the-Road Policy Leads to Socialism", *op.cit.*

14. *Ibid.*, pp. 22–24.

15. Ludwig von Mises, "Inflation and Price Control" (1945) reprinted in *Planning for Freedom*, *op.cit.*, p. 75.

16. C. Jackson Grayson, the head of President Nixon's recent experiment in wage/prince controls has written an interesting account of his own disillusionment with such programs in Dow Jones-Irwin, ed., *Confessions of a Price Controller*, (Homewood, IL, 1974). Also see Walter Guzzardi, "What We Should Have Learned About Controls", *Fortune*, March 1975, pp. 102–105, 176–178. This article notes that "controls on profits may have increased concentration throughout the industrial sector." For a comparable historical study, see Colin Campbell, *Wage-Price Controls in World War II: United States and Germany*, American Enterprise Institute (Washington, 1971).

17. Keith C. Brown, ed., *Regulation of the Natural Gas Producing Industry*, Johns Hopkins University Press (Baltimore, 1970), in particular Paul W. MacAvoy, "The Regulation Induced Shortage of Natural Gas", pp. 169–191. Also see R.W. Gerwig, "Natural Gas Production: A Study of the Cost of Regulation", *Journal of Law and Economics* (1962); and E.W. Kitch, "Regulation of the Field Market for Natural Gas by the Federal Power Commission", *Journal of Law and Economics* (1968).

18. Another historical illustration of this use of the political means is provided by the struggle between the railroads and the shippers for control over the Interstate Commerce Commission which regulates the activities of the railroads. One reference to this struggle occurs in Murray N. Rothbard, "War Collectivism in World War I" in Ronald Radosh and Murray N. Rothbard, eds., *A New History of Leviathan*, Dutton (New York, 1972), pp. 90–92.

19. Ludwig von Mises, "Middle-of-the-Road Policy Leads to Socialism", *op.cit.*, p. 28.

20. Albert Jay Nock, *Memoirs of a Superfluous Man*, Harper & Row Co. (New York, 1943).

21. Once again, for a more detailed analysis of this point, see our earlier paper, *op.cit.* For an elucidation of the concept of the ruling class as "ultimate decision-makers", see Gabriel Kolko, "The Men of Power", *The Roots of American Foreign Policy*, Beacon Press (Boston, 1969) and Gabriel Kolko, "Power and Capitalism in Twentieth Century America", *Liberation*, December 1970.

22. Gabriel Kolko, *The Triumph of Conservatism*, *op.cit.*; James Weinstein, *The Corporate Ideal in the Liberal State*, Beacon Press (Boston, 1968); G. William Domhoff, *The Higher Circles*, Random House (New York, 1971); and David Eakins,

"The Development of Corporate Liberal Policy Research in the United States, 1885–1965", unpublished Ph.D. dissertation, University of Wisconsin, 1966.

23. Perhaps the most prominent and influential formulation of this myth appears in Ayn Rand, "America's Persecuted Minority: Big Business" reprinted in *Capitalism: The Unknown Ideal*, New American Library (New York, 1966). Unfortunately, it is highly prevalent within conservative, and even libertarian, circles.

24. Carl Menger, *Principles of Economics*, The Free Press (Glencoe, IL, 1950); and Ludwig Lachmann, *Capital and Its Structure*, London School of Economics (London, 1956).

25. Ludwig von Mises, "Middle-of-the-Road Policy Leads to Socialism", *op.cit.*; and Robert A. Brady, *Business As a System of Power*, Columbia University Press (New York, 1943).

26. Ludwig von Mises, *ibid.*, p. 24. The progressive weakening of the price mechanism as a means of information dissemination within the market system might possibly be useful for understanding at least one element in the phenomenal growth of the "information" industry as noted by Peter Drucker and other social analysts during the post-World War II period.

27. As already mentioned, Murray N. Rothbard's *Power and Market, op. cit.* demonstrates the fundamental incompatibility of the economic means and the political means. See in particular his chapter "Binary Intervention: Taxation" for an analysis of the distortion in the allocation of resources produced by taxation itself.

28. For an analysis of the intimate relationship which is forged in the early stages of political capitalism between banking institutions and the state apparatus, see our earlier paper, *op.cit.*

29. Two historical essays which analyze this role of war are Murray N. Rothbard, "War Collectivism in World War I", *op.cit.*; and William E. Leuchtenburg, "The New Deal and the Analogue of War" in John Braeman et al., eds., *Continuity and Change in Twentieth Century America*, Harper & Row (New York, 1967). Also see the concluding chapter in James Weinstein, *The Corporate Ideal and the Liberal State, op.cit.,* entitled "War as Fulfillment".

30. Donald Read, *Cobden and Bright*, Edward Arnold (London, 1967); William Dawson, *Richard Cobden and Foreign Policy*, George Allen & Unwin (London, 1926); E. Berkeley Tompkins, *Anti-Imperialism in the U.S.: The Great Debate, 1890–1920,* University of Pennsylvania Press (Philadelphia, 1970); and Robert L. Beisner, *Twelve Against Empire: The Anti-Imperialists, 1898–1900,* McGraw-Hill (New York, 1968).

31. Randolph Bourne formulated the maxim that "war is the health of the state" in his essay "Unfinished Fragment on the State" in *Untimely Papers*, B.W. Huebsch (New York, 1919). Murray Rothbard paraphrased Bourne's original maxim to argue that "inflation is the health of the state" in his essay "Money, the State and Modern Mercantilism" in Helmut Schoeck and James W. Wiggins, eds., *Central Planning and Neo-Mercantilism*, Van Nostrand (Princeton, 1964).

32. John T. Flynn's comparison of fascist economic systems in Europe and New Deal economic policies in the U.S. constitutes a highly perceptive study of an advanced stage of political capitalism and stressed the function of defense expenditures as an inflationary pump-priming mechanism. See *As We Go Marching* (1944), Free Life Editions (New York, 1973).

33. William M. Magruder, "Technology and the Professional Societies", *Mechanical Engineering*, September 1972, cited in Seymour Melman, *The Permanent War Economy*, Simon & Schuster (New York, 1974), p. 23.

34. Melman, *ibid.*, pp. 23–24. See also Melman's earlier studies for systematic analyses of the distortionary impact of military expenditures within the economic system: *Our Depleted Society*, Holt, Rinehart & Winston (New York, 1965) and *Pentagon Capitalism*, McGraw-Hill (New York, 1970). Additional studies which provide important insights into the impact of military expenditures on the economic system are H.L. Nieburg, "The Contract State", *In the Name of Science*, Quadrangle (Chicago, 1966); Charles E. Nathanson, "The Militarization of the American Economy" in David Horowitz, ed., *Corporations and the Cold War*, Monthly Review Press (New York, 1969); and N. Finger, *The Impact of Subsidy Systems on Industrial Management*, Praeger (New York, 1971).

35. A penetrating analysis of the challenge presented by market systems to the feudal societies of Europe and England and of the unfinished capitalist revolution which resulted from this confrontation is presented in Murray Rothbard's seminal essay "Left and Right: The Prospects for Liberty" which has been reprinted in M.N. Rothbard, ed., *Egalitarianism as a Revolt Against Nature*, Libertarian Review Press (Washington, 1974).

36. Murray N. Rothbard, *Man, Economy and State, op.cit.* and Murray N. Rothbard, *Power and Market, op.cit.* present the most systematic elaboration of this point which is at least implicit in much of Austrian economic theory.

37. Gabriel Kolko, *The Triumph of Conservatism, op.cit.* Kolko defines political capitalism as "the utilization of political outlets to attain conditions of stability, predictability and security – to attain rationalization – in the economy" (p. 3). His book, however, concentrates on a narrower phase in the evolution of political capitalism which roughly corresponds to the second sub-stage identified in our paper.

38. Kolko, *ibid.*, p. 3.

39. G. William Domhoff, "How the Power Elite Shape Social Legislation" *The Higher Circles, op.cit.* For a more detailed historical analysis of the role of organized labor in political capitalism, see Ronal Radosh, "The Corporate Ideology of American Labor Leaders from Gompers to Hillman", *Studies on the Left*, November–December 1966; and Ronald Radosh, *American Labor and United States Foreign Policy*, Vintage (New York, 1969).

40. James Weinstein, *The Corporate Ideal in the Liberal State, op.cit.* Regarding the emergent "systems" consciousness during this period, James Gilbert has focused attention on the role of collectivist intellectuals in articulating a new framework for social theory which proved highly influential in the adoption of more comprehensive forms of political intervention. *Designing the Industrial State*, Quadrangle (Chicago, 1972).

41. John T. Flynn, *op.cit.*, p. 193.

42. Robert A. Brady, *Business As a System of Power, op.cit.; The Rationalization Movement in German Industry*, University of California (Berkeley, 1933); and *the Spirit and Structure of German Fascism*, Viking Press (New York, 1937).

43. Robert A. Caro, *The Power Broker*, Knopf (New York, 1974).

44. Ludwig von Mises, *Socialism*, Jonathan Cape (London, 1951); F.A. Hayek, ed., *Collectivist Economic Planning*, George Routledge and Sons, Ltd. (London,

1935); and Trygve Hoff, *Economic Calculation in the Socialist Society,* William Hodge and Co. (London, 1949).

45. See James Weinstein's account of the conflict between the National Civic Federation and the National Association of Manufacturers in *The Corporate Ideal in the Liberal State, op.cit.*

46. Wilhelm Roepke, *Crises and Cycles*, William Hodge and Company (London, 1936); and Gottfried Haberler, "Some Reflections on the Present Situation of Business Cycle Theory", *The Review of Economic Statistics,* February 1936.

47. Wesley Clair Mitchell, *Business Cycles*, University of California Press (Berkeley, 1913); John R. Commons, *Institutional Economics*, Macmillan (New York, 1934); John R. Commons, *Economics of Collective Action*, Macmillan (New York, 1934); Irving Fisher, *The Rate of Interest*, Macmillan (New York, 1907); and Irving Fisher, *Stabilizing the Dollar*, Macmillan (New York, 1920). G. William Domhoff in his *the Higher Circles, op.cit.*, provides an illuminating account of the influence of Bismarck's social welfare state experiments in Germany on American academic circles and stresses the role of German-influenced economists such as Richard Ely in establishing the American Economics Association. Wesley C. Mitchell was a founder and research director of the National Bureau of Economic Research, a prominent research organization for corporate liberal policy makers, while J.R. Commons was a founder of the National Civic Federation, which emerged as a leading vehicle for corporate liberal pressure to adopt a broad panoply of social legislation. The increasing interest in the German Historical School among American and British economists which occurred during this period should not be surprising in view of that school's focus on institutions and other social aggregates. In particular, the German concept of *Volkswirtschaft* or *Staatswirtschaft* proved very conducive to a macro-economic theoretical perspective. This German Concept, roughly translated as National Economy, has a long history and it has been described by J.A. Schumpeter in the following manner: "This National Economy is not simply the sum total of the individual households and firms or of the groups and classes within the borders of a state. It is conceived as a sort of sublimated business unit, something that has a distinct existence and distinct interests of its own and needs to be managed like a big farm." *History of Economic Analysis*, Oxford University Press (New York, 1954), pp. 163–164. Some leading representatives of the German Historical School are Gustav von Schmoller, Werner Sombart and Karl Bücher.

48. J.J. Clark, *New Economics of National Defense*, Random House (New York, 1966).

49. Keynes' *The General Theory of Employment, Interest and Money* appeared in a German language edition late in 1936 and Keynes wrote a foreword to this edition addressed specifically to the prospective German audience. In this foreword, Keynes noted that the "theory of aggregate production which is the point of the following book, nevertheless can be much easier adapted to the conditions of a totalitarian state than the theory of production and distribution of a given product put forth under conditions of free competition and a large degree of laissez-faire. This is one of the reasons that justify the fact that I call my theory a *general* theory." The original German language foreword and an English language translation have been reproduced in full in James J. Martin, *Revisionist Viewpoints*, Raph Myles Publishers (Colorado Springs, 1971).

50. Inspired by George Orwell's novel, *1984*, Harry Elmer Barnes developed this point at length in an unpublished manuscript entitled "How 'Nineteen Eighty-Four' Trends Threaten Peace, Freedom and Prosperity" which is discussed in Murray N. Rothbard, "Harry Elmer Barnes as Revisionist of the Cold War" in *Harry Elmer Barnes: Learned Crusader,* Ralph Myles Publishers (Colorado Springs, 1968). See also, Lawrence Dennis, *The Dynamics of War and Revolution,* Weekly Foreign Letter (New York, 1940); John T. Flynn, *As We Go Marching, op.cit.*; and the provocative, if unorthodox, satire entitled *Report from Iron Mountain on the Possibility and Desirability of Peace*, Dial Press (New York, 1967).

51. Leonard P. Liggio, "American Foreign Policy and National Security Management" in Murray N. Rothbard and Ronald Radosh, eds., *A New History of Leviathan, op. cit.* Liggio's study is essential for an understanding of the transformation of the Keynesian theoretical framework which occurred during the New Deal. He argues that "the failure of the New Deal as an economic system caused the redifinition of the New Deal as a system of national security management ... the cause of American economic difficulty was externalized and the economy subsidized by the needs defined by the national security concept" (p. 237).

52. F.A. Hayek, *The Road to Serfdom, op.cit.*, pp. 142–143. See also the perceptive observation by William A. Williams on this point: "A Keynesian system need not literally be confined to one nation, but when it is extended it has to be done as a system – in this case an American system. For, by its very reliance upon various controls to stabilize the business cycle, the Keynesian approach cannot by definition even be attempted beyond the limits of such central authority. The climax of that aspect of American policy came in the sharp struggle between Lord Keynes and Harry Dexter White, both of whom understood the principle at stake and sought therefore to define the postwar international monetary organizations in terms of their respective Keynesian systems." William A. Williams, "The Large Corporation and American Foreign Policy" in David Horowitz, *Corporations and the Cold War, op.cit.*, pp. 88–89.

53. F.A. Hayek, *The Road to Serfdom, op.cit.*, p. 64.

54. *Ibid.,* p. 62.

55. *Ibid.,* p. 70.

56. *Ibid.,* p. 113.

57. *Ibid.,* p. 153.

AUSTRIAN ECONOMICS, PRAXEOLOGY AND INTERVENTION

Walter Block and William Barnett, II

1. PRAXEOLOGY

Praxeology is defined by Rothbard (1962, p. 64) as "The formal implication of the fact that men use means to attain various chosen ends." While men use means to attain ends in areas other than economics (e.g., war, voting), the dismal science is the only deeply elaborated subdivision of praxeology. Rothbard (1962, p. 63) defines praxeological economics in contrast with

> psychology [and] … the philosophy of ethics. Since all these [three] disciplines deal with the subjective decisions of individual human minds, many observers have believed that they are fundamentally identical. This is not the case at all. Psychology and ethics deal with the content of human ends; they ask, why does the man choose such and such ends, or what ends should man value? Praxeology and economics deal with any given ends and with the formal implications of the fact that men have ends and employ means to attain them.[1]

Austrian or praxeological economics is based on a few basic axioms; for example, individual man acts purposefully, values are subjective, man uses means to achieve ends, causes have effects, man acts through historical time in the real world of uncertainty, the past is immutable, there is scarcity, time is a constraint, there are resources, leisure is good and work brings disutility.

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Coupled with the laws of logic, these axioms lead to the irrefutable principles of economics.[2]

The method employed, then, is the same as that used in mathematics, or logic: deductions from premises to conclusions. The path to correct economic theory has nothing to do with inducing generalizations from empirical observations; rather, everything to do with syllogistic reasoning.

2. WHAT TESTS WHAT?

Neoclassical economics, one form of economics practiced at the polar extreme from praxeology uses the methods of logical positivism. Here, the dismal science is not conceived of as vast latticework of deductions. It is rather modeled on the physical sciences, where empirical observation and induction are the order of the day. Friedman (1953, pp. 7, 9, 40, 41) maintains that:

> "The ultimate goal of a positive science [including economics] is the development of a 'theory' or 'hypothesis' that yields valid and meaningful (i.e., not truistic) predictions about phenomena not yet observed …
>
> "As I shall argue at greater length below, the only relevant test of the *validity* of a hypothesis is comparison of its predictions with experience. The hypothesis is rejected if its predictions are contradicted ("frequently" or more often than predictions from an alternative hypothesis); it is accepted if its predictions are not contradicted; great confidence is attached to it if it has survived many opportunities for contradiction. Factual evidence can never "prove" a hypothesis; it can only fail to disprove it, which is what we generally mean when we say, somewhat inexactly, that the hypothesis has been "confirmed" by experience…
>
> "Reliance on uncontrolled experience rather than on controlled experiment does not affect the fundamental methodological principle that a hypothesis can be tested only by the conformity of its implications or predictions with observable phenomena…
>
> "Any theory is necessarily provisional and subject to change with the advance of knowledge."

In mainstream economics, there is indeed room for theory. But the theory, as in the case of the physical sciences, must be tested by empirical observation. Here, econometric testing is the dog, which wags the tail of theory. In praxeology, in contrast, it is found the reverse: theory is the bedrock of the enterprise, or the "dog," while very peripheral is the tail of real world facts.

Perhaps an example will better illustrate this distinction. According to virtually all practitioners, rent control has negative repercussions on the economy.[3] Governmentally mandated below-market, ceilings on rents cause excess demands for rental housing to develop – and consequent shortages. The incentives of entrepreneurs to invest must of necessity atrophy, since profit opportunities in other endeavors are still uncontrolled. This means less new building of residential units, ceteris paribus. Nor do landlords of extant dwellings have as much incentive to maintain, much less, upgrade them.[4]

But suppose someone runs an econometric regression on the relationship between this legislation and all of those incidences of housing disarray, and fails to support microeconomic theory in this regard. How are we to interpret such a finding? For the Austrians, matters are simple. At best, statistical correlations (the tail of the dog) based on unique historical events can illustrate economic theory. They can never call it (the dog itself) into question. In this particular instance, the empirical generalization was incompatible with apodictic (necessary and certain) economic theory, and so the *former* must be thrown out as unreliable.

For the logical positivists, things are different, and, indeed, embarrassing. After checking to the best of one's ability, one's data and calculations to ensure the accuracy of the statistics, what must economists of this sort conclude when rent control is not associated with shortages, or inferior housing, or reduced investment, or any of its other typical correlates? They are forced by their own methodology to infer that the supply and demand analysis that underlies this law is mistaken, or that for some reason economic law has failed to operate in this one case, or at this time, or in the particular geographical locale from which the data were drawn. Nor will it help them to maintain that since thousands of regressions have shown rent control to be associated with housing inefficiencies, the present study must be flawed. Very much to the contrary,[5] they are forced, by the laws of logic, to acquiesce in the notion that in *this* particular case all bets are off and economic theory cannot be relied upon. For why believe the 99 percent of empirical studies which show rent control in a bad light, and not the 1 percent which show it in a good light? As empiricists, the ultimate determination of truth is *not* the coherence of the theory, as it is for the Austrians, but instead the statistical tests performed. If they are 99 percent in one direction and 1percent in the other, one can only deduce that economic theory is operational merely in a (overwhelming) majority of cases, or epochs, or locales, but not in all of them.

In sharp contradistinction to the preceding, for the Austrians, supply and demand analysis, based as it is upon the *laws* of supply and demand, is either valid or it is not. It is not like gravity. If, in a vacuum tube on earth, you tossed a weight up n times and even if only once it failed to come down, then no matter how great is n, there would be no law of gravity. That is one of the fundamental flaws of the falsificationist positivistic method – you can never know any truth because, in theory, the "next time" could always turn out to be first time that the expected result did not occur; that is, all truths are tentative and subject to being disproven by the next event. Therefore, there are no laws, only provisional hypotheses.

In our view, this is a rather awkward admission to make, for a discipline that wishes to be taken seriously as a science. However, an objection to this thesis might be couched as follows: "Why should this be considered an awkward admission? That is exactly what the 'hard sciences' do. When they find anomalies in their observations they run their experiments again and again or collect new data in non-experimental situations; for example, astronomical observations. If the anomalies continue to appear they start looking to modify the theory, or find a new theory, that will account for the previously anomalous results."[6]

Despite its superficial plausibility, this objection will not suffice. For there is a gigantic philosophical difference between the praxeological science of human action, for example, Austrian economics, on the one hand, and the physical sciences on the other. The difference is that in the former case, we *know* things with absolute apodictic certainty, whereas in the latter no such knowledge is possible.

Take an example even conceptually simpler than rent control: the undeniable claim that there are mutual gains, ex ante, from *voluntary* trade. This absolutely *must* be the case. It is a synthetic a priori statement.[7] There is no possibility for this not to be true. If A agrees to give up an X in return for B's Y, then we are *compelled* to conclude that A and B inversely value X and Y; that is, that A prefers Y to X, and B values X more than Y, ex ante. No other conclusion is logically compatible with the fact that they have traded. In very sharp contrast indeed, no such certainty obtains in physics, chemistry or biology. It may be false to claim that a water molecule is not composed of two atoms of hydrogen and one of oxygen, or that water runs uphill, but there is no internal self-contradiction involved in asserting such claims. Whereas to deny that voluntary trade is mutually beneficial, ex ante, is indeed to mire oneself in logical contradiction.

Next, consider a strong analogy, from the sphere of geometry. Suppose that teams of geometricians went out and measured the angles of all two-dimensional triangles they could find. In 99 percent of the cases, they found 180 degrees, but in 1 percent their measurements (checked and rechecked) came to a different conclusion. We would steadfastly and resolutely refuse to accept any of the minority quantifications on the ground they *must* be mistaken. So, also, with economics. Suppose an economics Ph.D. student were to submit a dissertation in which he "proved," using the best available data and the most sophisticated econometric methods, that rent controls improved the quantity and quality of the housing stock so regulated, would a degree be forthcoming, on that basis, from any respectable university?

It all depends. If this university were a neoclassical one that stuck, steadfastly, to its positivist roots (assuming such a university exists), it would indeed award a degree in our example. This is because, from that perspective, statistics never lie, particularly if, we stipulate, arguendo, that no compilation errors were made by this student. For the mainstream economist, at least the one who is logically consistent, if "reality" and theory do not jibe, the latter must be jettisoned. Thus a statistically unchallenged econometric equation model supporting the contention that rent control is beneficial would indeed be interpreted in such a way as to suppose, that there are at least some exceptions to supply and demand analysis, or, in the extreme, that such analysis is entirely invalid.

In contrast, the university with an Austrian economics department would surely and summarily reject such a dissertation proposal. And this applies, also, to a supposedly neoclassical school that had any respect for economic theory at all. If a student found that rent control did not create housing shortages but rather surpluses, and/or that voluntary trade was not mutually beneficial ex ante, this would be rejected even if no flaw was found in the statistical work supporting these conclusions. It is only the consistent mainstream department, which would then really have to be considered a throwback to the German Historical School,[8] that would accept such conclusions and reject economic theory.

In other words, we are here attempting to distinguish between two very different types of mainstream economists. On the one hand, there are those who are consistently devoted to their own philosophical methodology; through thick or thin, they adhere to it. Call them the "fundamentalist," "rabid" or "maniacal" neoclassicists. For them, if the "data" show that voluntary trade is *not* mutually beneficial in the ex ante sense, well, then, voluntary trade is not mutually beneficial in the ex ante sense. They live or die based on the "evidence," and if this is conflict with economic theory, then so much the worse for the latter.

On the other hand, there are what we can call the "rational" neoclassicists (i.e., those who would reject findings that rent controls lead, ceteris paribus, to improved housing conditions or voluntary exchange is not, ex ante, mutually beneficial). These economists do not really and fully accept the positivist/falsificationist methodology. When push comes to shove, when there is a conflict between the purported "facts" and basic economic theory, they jettison their adherence to the former. If we judge by their behavior and not by their words, talk being cheap, as the saying goes, not all supposed mainstreamers cleave to this philosophy when the going gets rough.

Consider another case for purposes of illustration. Card and Krueger[9] made the empirical claim that minimum wage legislation did not in a specific case lead to unemployment of unskilled workers, but, rather, was associated with a slight increase in employment for this kind of labor. On the basis of their statistical findings, they were quite content to suggest that introductory econ 101 type reasoning would have to be reconsidered. By doing so, they revealed themselves as what we are characterizing as fundamentalist positivist/falsificationists. In sharp contrast, there were others, with equally good positivist/falsificationist credentials, who reacted very differently. Not for them a docile acceptance of the latest empirical equations as reported by Card and Krueger. Instead, they entered the ring with real fire in their eyes. They *knew*, even before any detailed examination of the Card and Krueger equations, that their findings *must* be wrong, and they set out to discover the flaws in their study. These are the scholars we are characterizing as "rational" neo-classicals, or, really, Austrians in mainstream clothing.[10]

3. SYNTHETIC A PRIORI

Another way to probe the distinction between Austrian and "scientific" mainstream economics is by use of the concept of the synthetic a priori. For the logical positivists, there are two and only two kinds of statements. The first, the analytic, is apodictically true but only in the trivial sense of definition, which has nothing to do with the real world. For example, it cannot be denied that bachelors are unmarried men, or that $2+2=4$, but these statements are unfalsifiable. Since nothing in reality can falsify them, they are not about the real world at all. Rather, they pertain, merely, to how we have decided to use words. They are known a priori, by their pure logic, but they avail us nothing in explaining and understanding real world events, since they are in a different universe of discourse.

The truth of the second kind of sentence is contingent, or synthetic, or applicable to the world. For example, water runs downhill, rent control reduces the quantity and quality of regulated housing and a molecule of water is composed of two atoms of hydrogen and one of oxygen. Information of this sort is said to be known a posteriori; that is, through experience. And further empirical data, incompatible with the first set, can always overturn it. For example, water might one day run uphill, and rent control contribute to housing betterment, and no contradiction of the laws of logic would have taken place.

Perhaps these points can be clarified in diagrammatic form. Accordingly, the columns are headed by the concepts of analytic and synthetic, which depicts whether application to the real world is in force: no in the former case, yes in the latter. In contrast, the rows are labeled a priori and a posteriori, which categorizes ways of knowing, or epistemology. Here, the former means through logic, the latter through experience. When we put the four concepts together we derive a two by two matrix: A, the analytic a priori, B, the synthetic a priori, C, the analytic aposteriori, and D, the synthetic aposteriori.

	Analytical	Synthetic
Apriori	A	B
Aposteriori	C	D

There is no dispute about the status of D, ordinary empirical claims that pertain to the world, and are derived from experience: the sun appears yellow, the earth is round, the per capita income in the US is greater than that in Cuba. Nor about A, purely definitional matters which emanate from logical considerations, whose denial would involve self contradiction and have to do with definitions and logically trivial matters: bachelors are unmarried men, $2+2=4$, plane triangles have 180 degrees. Nor yet about C, the null category, since we do not derive matters of pure logic from experience.

The highly contentious ground is B, the synthetic a priori. Here are statements whose denial involves self-contradiction, and yet which apply to the real world. In this category we have apodictically certain undeniable knowledge of empirical reality.

It is the cornerstone of logical positivism from whence is derived the methodology of neoclassical economics, that B, too, is the null set. Let statement "X" be: "Either a statement applies to the real world, in which case it is forever contingently true, unless repudiated by further empirical evidence, in which case it is false and, therefore, in either case it is not apodictically true; or it is necessarily so[11] – its denial involves self contradiction – in which case it is only trivially true, and cannot concern empirical reality." According to X, then, there are only two kinds of (meaningful) statements: those in category A, the trivial definitional ones, and mathematics, and D, ordinary empirical, falsifiable ones. B is the null set.

But how can we categorize statement X, itself? Into which of these four quadrants does X, itself, fall.[12] If in A, it does not involve the real world; it is purely a matter of definition, or convention, and adds nothing to our store of knowledge. It may be dismissed as "trivial." If statement X belongs in category D, we cannot know it for sure. Its denial hardly involves self-contradiction. Why, then, are mainstream economists so certain of it? No one would claim it to be in category C, which leaves only one option: it is a category B statement. Yet this too creates grave problems for the neoclassicals, in that they are on record as asserting there is, there *can be*, no such thing as a member of B. If X belongs in this category, it undercuts the core of their own philosophy. Let us put this in other words, since the importance of this point cannot possibly be overemphasized: for X to belong in category B would be a downright self-contradiction. It would be equivalent to claiming both that something is, and is not. On the one hand, the mainstream is in this interpretation arguing that B is the null set; i.e., B is the set with no members, and on the other it would be maintaining that X is a member of X.

Let us consider some examples of true synthetic a priori (category B) statements put forth by Austrian economists to solidify our understanding of this claim. These statements both apply to the real world *and* are necessarily true. Consider the following:

(1) Man acts purposefully. This certainly applies to the real world, where we see people acting so as to render the future more desirable to them than had they not so acted. It is impossible to deny, since the very act of denial is itself a purposeful action. Teleological thinking may be illicit anthropomorphism in the hard sciences, such as physics and chemistry, but not in economics, the practice of neoclassical economics to the contrary notwithstanding.

(2) There is a tendency for the rates of return (RoR) on invested capital to equalize in all industries, assuming away differential risk. Obviously, given that man acts so as to better his position, there will be a tendency for capital to move from lower RoR opportunities (thus driving up RoR there) to higher RoR areas (thus reducing RoR there); only if "equilibrium," where there are no further gains available from shifting resources, were attained would this process come to a (temporary) stop. But this claim is not falsifiable, for at any given time when RoR are unequal between industries, this cannot be used to deny there is a

tendency in this direction. Even though this is apodictically true, it still applies to the real world of differing industrial RoR.

(3) All voluntary trade attains mutual benefit in the ex ante sense. Why else would two parties engage in such a commercial interaction were it not for the expected gain involved to each of them. This is part and parcel of acting purposefully, in order to be better off, only now it involves two people engaging in a "capitalist act between consenting adults."[13] True, such attempts need not always succeed. It sometimes occurs that attempts to gain through trade are met with failure. But this is only in the ex post sense. In the ex ante sense of anticipations, mutual benefit *must* be the underlying explanation of the event. To deny this is to involve oneself in self-contradiction. Nevertheless, even though this conclusion is apodictically certain, it cannot be denied that trade pertains to the real world of commerce, and that mutual gain certainly accounts for these empirical acts.

4. INTERVENTION: METHODOLOGY

As a positive, deductive science, economics is *wertfrei*.[14] Therefore, with respect to intervention, an economist qua economist may only deduce the consequences of any particular intrusion by the government into the market place. Thus, for example, a praxeologist deduces that, ceteris paribus, a legally mandated minimum-wage greater than the market clearing wage rate would result in reduced quantity demanded for labor in that market, with consequent less employment. He would also note that the "lucky" ones who were able to secure the remaining employment, if there were any such, would be employed at the higher, minimum-wage rate. He would determine that the employers who provide less employment at the minimum-wage rate than at free-market-wage rates are worse off, else they would have paid the minimum-wage rate without the intervention. Similarly, he would conclude that those workers who would have been employed at free-market-wage rates but are not employed at the minimum-wage rate are also worse off, else they would have been willing to work at the free-market rates. He would also infer that some of the workers employed at the minimum-wage rate, but employed for fewer hours than they would have been at free-market-wage rates, might also be worse off. Additionally, because of increased labor expenses, prices of the goods produced with this labor would increase. Fewer of these goods would be purchased. Those who were priced out of the markets for these goods would suffer. They would then necessarily, save in the case of literal hoarding (i.e., actually putting money in mattresses or burying it in a jar, or some such), spend their money on some other good(s). This would cause the prices of these other goods to increase, which would make the other buyers in those markets worse off. Moreover, the higher labor expense would cause employers to seek to substitute now relatively cheaper resources for labor. This would have an additional depressing effect on employment in the affected industries. Those who otherwise would have kept their jobs will not receive the non-remuneration benefits of employment; e.g., development of good work habits and various types of on-the-job training. The loss of such benefits would harm them, especially with respect to future employment opportunities and income. The effects could be traced further and in all directions.

However, there are two things the economist, qua economist could not legitimately address: the magnitudes of these unemployment effects[15] and, the desirability of the minimum-wage-rate law. This applies, too, to any other type of intervention, always with the same two caveats.

Why, then, is it that virtually every Austrian economist[16] is a strong advocate of free markets?

Although there may be other possible reasons, two seem most likely. First, there are those who value individual liberty highly and who think that praxeology is the correct way to do economics. These are economists who, were they not Austrians, would almost certainly be "right-wing," or neoclassicists who advocate economic freedom. Second, there are economists who maintain that only praxeology is methodologically sound and who consider the consequences of intervention as undesirable from their own personal point of view. (If they hold such regulations as undesirable from the *economic* point of view, they are conflating the normative with the positive.) For example, they think that the misallocation of society's scarce resources in the forms of substitutions of capital goods and more-skilled for less-skilled labor that results from an effective minimum-wage rate law leads to lower standards of living, which they oppose.

Most likely it is a combination of the two foregoing reasons. That is, an individual who supports free markets for noneconomic reasons, tends to be attracted to Austrian economics because its analysis of various types of interventions leads to the conclusion that they do not achieve their stated goals, especially in the long run, and have effects (e.g., lower standards of living) that are undesirable by almost any set of criteria. Therefore, the individual can use Austrian economics to buttress his positions as a supporter of free markets. And, someone who has no position on free markets and then becomes an Austrian economist is likely to be drawn to the free market position because of the (undesirable by virtually any set of criteria) consequences of interventionism as elucidated by Austrian analysis.

5. INTERVENTION TYPOLOGY

Another connection between praxeology and interventionism is provided by Rothbard (1993, 1970). He provides a typology[17] which not only enables us to distinguish in a comprehensive, even exhaustive way between the different varieties of interventionism, but also to shed light on this phenomenon not forthcoming from other modes of economic analysis. For Rothbard, interventionism consists of the initiation of force or the threat of force on the part of anyone (governments, robber gangs,[18] labor unions, it matters not which) against a person or his legitimately owned property.[19] In his view there are three types of interventionism. First, autistic, where the command concerns only the victim. For example, when government orders people to salute its flag, or pledge allegiance to it, or to refrain from indulging in certain kinds of drugs. Second, there is binary, a relationship between the victim and the victimizer. Instances would include governments compelling people to pay taxes,[20] a pirate extracting booty from a hapless ship owner, or organized labor forcibly preventing competing workers ("scabs") from offering their services to a struck employer. And the third type is triangular, where the state either requires that two other parties interact with each other in a certain way, or prevents them from so doing. Price control examples are rent control and minimum wages; in both these cases government places limits on how consenting adults may interact with one another on an economic basis; it mandates that if they are to interact at all, it must be on the basis of certain wages and rents, not others. In the case of product control, government forbids one party to sell certain goods to another; e.g., addictive drugs, food not approved of by the Food and Drug Administration, etc. A good Samaritan Law would be a case in point where the state forces one person to come to the aid of another.

Does this Austrian analytical framework differ from that of Public Choice theory, neo-classical welfare analysis, and Marxism? Yes, indeed. Let us consider each of these in turn.

First, Public Choice.[21] There are several objections that have been leveled at this contention that state activity necessarily involves intervention, defined in terms of the initiation of violence against those who have not first initiated violence. One claim is that by paying taxes, and voting, people have demonstrated their agreement with the system. But Spooner (1966) has disposed of this on the ground that both are done under duress, and for defensive purposes. If a robber gang gives you a choice of rulers, when you do not wish to be ruled at all, and you choose the lesser of the two evils, that does not at all logically imply that you agreed to the entire process. If you hand over your valuables to a holdup man, under the threat of bodily injury or death, the praxeologist, at least, cannot infer that this was a voluntary transaction.

Another argument is that the government is really akin to a large voluntary club. And, just as you cannot get out of paying your dues, if you wish to remain a member of that sort of organization, merely because your favored candidate lost, or the dues were set under democratic procedures at a level not to your liking, so must you pay your taxes to the state, which in this interpretation are the exact equivalent of club dues.[22] But the difficulty with this argument is that it puts the cart before the horse. According to the tradition under which the public choice theorist writes, the citizen predated the state. Indeed, if a contractual theory of government is to be at all coherent, the people, the contracting parties, *must* have existed before the advent of the state; how else could it have come into existence with their agreement? However, if the voluntary participation of the citizen was necessary to set up the government, what of the few who did *not* agree? It is not at all sufficient to tell them "love it or leave it": if you do not like the state apparatus, you may leave. Why can they not *stay*, on their own private property (or that which they inherited from their ancestor, who predated the creation of the government)? After all, if a golf club gets set up all around your own property, and you do not wish to join, it is a bit harsh for them to insist that you become part of their operation. It comes with particular ill grace for this "club" to *insist* that you link up with them, in the name of voluntary agreement; and that if you refuse, while you personally are free to depart (there are no laws against emigration) *they* get to keep your land.

Second, neoclassical welfare economics. Mainstream economists do not so much as *distinguish* between the initiation of violence and consensual behavior. For them, the government is merely one other economic institution, perhaps a bit bumbling and inefficient, but intrinsically indistinguishable from all others. It must be the rare neoclassical indeed who ever made a hard and fast distinction between these very different market and non-market institutions. Forget about the state per se. This applies even to their treatment of non-governmental crime. To add insult to injury, they are apt to draw supply and demand curves for criminal behavior,[23] as if they were for the butter or beer markets, completely obliterating the crucial distinctions the Austrian would insist upon.

Here is another bit of evidence in this regard: a constant refrain among mainstream economists is the concept of "market failure."[24] The argument, for simplicity, may be put into the form of a syllogism:

(a) The market is imperfect (there are monopolies, external effects, public goods, income inequality, etc).
(b) We must have, or at least we must aim at, perfection.
(c) Therefore government intervention to correct market imperfections is justified.[25]

This is not the place for an analysis of the numerous errors herein committed. Rather, we focus only on the fact that this argument overlooks the concept of intervention. That is, while there is nothing in the premises that pertains to the initiation of violence, the conclusion is an embodiment of this sentiment. For how else but through the use of force can government conduct its supposedly ameliorative function? That is, the "correctives" for such "failures" as monopolies, external effects, public goods, income inequality all require that the state *force* people, under the threat of fines or jail sentences, to act differently than otherwise they would have, and not a one of them is guilty of violating property rights in the first place, such that the claim might be entertained that the government is acting to quell an uninvited border crossing, not engage in one on its own account.[26]

Third, Marxism. Say what you will about the Marxists, and plenty but never enough criticism has been leveled at them (Mises, 1975, 1981; Rothbard, 1991; Boettke, 1988, 1990; Steele, 1992; Salerno, 1990; Reynolds, 1998), at least it must be noted to their credit that they distinguish between legitimate and illegitimate activities. They successfully eschew the neoclassical adamant refusal to recognize this distinction. For the Marxists, there are indeed the victimized, and the victimizers. Unfortunately, this divergence is not in terms of the initiation of violence, but rather it is based on whether one is an employee or an employer. Why should this matter at all? It is because of the labor theory of value, which maintains that the worker creates the entire product, and any subtraction from the sale price for profits, interest, rent, etc., amounts to theft. In short labor creates the entire product, and thus is entitled to it all. But a moment's reflection can convince any reasonable person of the error embedded in this philosophy. A cherry pie and a mud pie can incorporate identical amounts of labor, and yet one be worthwhile, and the other valueless. A common Marxist rejoinder is to maintain that value is conferred only by "socially useful" labor, not any old labor, but this is to argue in a circle. How can we know what is "socially useful" and what not, without recourse to *other* factors of production, and parts of the structure of production other than labor, e.g., entrepreneurship, capital, savings, profit seeking, consumer tastes, etc. But if we do this, then labor scarcely accounts for the entire value of the product (Bohm-Bawerk, 1959).

NOTES

1. For an alternative view of the relationship between economics and psychology, see Gunning (2000).
2. For further elaboration, see: Block (1973, 1986, and 1999); Fox (1992); Garrison (1993); Gordon (1993); Hoppe (1991, 1995); Huerta de Soto (1998); Mises (1978); Rizzo (1979); Rothbard (1957); Selgin (1988); Smith (1994, 1996); and White (1984).
3. Frey, Pommerehne, Schneider, and Gilbert (1984) and Block and Walker (1988).
4. For more on the economic analysis of rent control, see Baird (1980); Block and Olsen (1981); Block (1980); Block (1993); Block (2002); Block, Horton, and Shorter (1998); Salins (1980); and Tucker (1990).
5. Again, on the assumption that no statistical mistakes can be shown in the present case.
6. This, at least, is the ideal scenario. For a less flattering one, see Kuhn (1970).
7. See below for a discussion of this concept.
8. See Schmoller (1897); see also Mitchell and Burns (1946) and Mitchell (1927).
9. Card and Krueger (1994).
10. See Becker (1995).
11. More exactly, not all a priori–analytical statements are true; some are false, such as "people never act purposefully" or "a square is a circle." This possibility seems to be excluded in the text. The key for any analytical statement is the "necessarily" part. That is, an analytical statement is either *necessarily* true or *necessarily* false.
12. We owe this line of criticism to Hoppe (1991, 1995).
13. In the felicitous phraseology of Nozick (1974, p. 163).
14. Although the vast majority of economists would agree that economics is a positive, wertfrei science, they would not assent to the proposition that the dismal science is a deductive enterprise; rather they consider it to be an inductive discipline. However, though they would say that economics is *wertfrei*, their own work, whether deductive or inductive, would belie them on this point, in that it is often value laden. Moreover, they place little, if any, importance on matters of methodology. As a consequence they use any and all methods of analysis that furthers, as they see it, their work. That usually means a mix of deduction, with mathematics as the primary tool, and induction, with statistics as the tool. Of course, other methods are used; see, e.g., McCloskey (1983) "… introspection … thought experiments … uncontrolled cases … authority … symmetry … definition … and … analogy … ."
15. This is not to deny that he could state that a specific effect would be greater under certain circumstances than under others. However, he could never quantify the effects. This, of course, applies only to Austrian economists, who know there are no

constants in human action, given free will; the positivists may claim knowledge in this regard, but it is a chimera. See Rothbard (1993, p. 920, ft. 59).

16. One important exception is von Wieser. See, e.g., von Wieser (1967).

17. An alternative typology of interventions can be found in Barnett, Dauterive, and White (1985). See also Lavoie (1982), Rothbard (1982).

18. For the definitive analysis making the point that government is praxeologically indistinguishable from a robber gang, see Spooner (1966).

19. This, in turn, is based upon Locke (1960) homesteading theory and what Nozick (1974) has called title transfer theory: any voluntary means of transferring property from one person to another: e.g., trade, gifts, gambling, bequests, etc.

20. Whether taxes are justified or not, or, indeed, whether government itself is justified or not, is an issue that lies entirely outside of the realm of the present paper; herein, we are content, merely, to point out that they necessarily constitute interventions. Did they not do so, there would be no need to threaten sanctions against nonpayers.

21. For the Public Choice, defense of the (democratic) state apparatus as a quasi market entity, see Buchanan and Tullock (1971). For an Austrian critique, see Rothbard (1997), Block and DiLorenzo (2000, 2001), DiLorenzo and Block (2001), DiLorenzo (1988).

22. For an articulation of this perspective, see Holcombe (1985, 1986). For a rejoinder, see Block (2003).

23. See for example Becker (1974), Ehrlich (1973, 1974, 1979, 1982).

24. For example, see Bator (1958); for a corrective to this philosophy, see Cowen (1988).

25. The alternative syllogism is not at all as popular within the profession, even though it takes on precisely the same format: (a) the government is imperfect; (b) we must have, or at least we must aim at, perfection; therefore (c) market action to correct government imperfections is justified. This, too, fails, since the neither the market nor, certainly, the state, is "perfect." The advantage of this latter argument over the former, however, is that no coercion is called for by it.

26. The one exception to this claim might be the negative externality, or external diseconomy of pollution. On this see Rothbard (1990).

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REGULATION, MORE REGULATION, PARTIAL DEREGULATION, AND REREGULATION: THE DISEQUILIBRATING NATURE OF A RENT-SEEKING SOCIETY☆

Bruce L. Benson

1. INTRODUCTION

Mises (1949[1963], p. 692) explains that market-failure justifications for state actions, such as economic regulation "ascribe to the *state* not only the best intentions but also omniscience." He then points out that neither assumption is valid: government is not benevolent since both, those who are employed by the state and those who demand state actions, have subjective

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self-interests, and it is not all knowing since knowledge is widely dispersed and the cost of coordination is infinitely high, particularly without market profits and prices as coordinating mechanisms. Furthermore, Mises suggests that dropping either assumption undermines the conclusions that state intervention is necessarily desirable even if some sort of market failure is actually identified. Austrian economists in the Mises tradition have tended to focus on the knowledge problem in their challenges to regulation, however. Many Austrians obviously recognize the interest problem, of course, but they often assume it away in order to illustrate that government interference with markets is not desirable even if it is well intended. In contrast, public-choice analysis tends to focus on the interest problem as source of government failure, although some public-choice analysts also obviously recognize the knowledge problem. Indeed, this difference in perspective is so pronounced that Ikeda (1997, p. 240) explicitly distinguishes between Public Choice and Austrian political economy by suggesting that the Austrian approach assumes benevolence on the part of government officials, while the public-choice approach assume narrow interests.[1] Ikeda (1997, p. 150) also suggests that the separation of these two approaches is justified because "Austrian political economy and public choice are each capable of standing on their own [so] public-theorists ... find it optimal simply to continue to pursue their research along the line of either the former or the latter approaches." The following presentation questions this assertion. Instead, both assumptions should be dropped, and the resulting integrated Austrian-public-choice model should be expanded to include assumptions about the relationships between regulations, property rights security, and both market and political behavior.[2]

The major flaws with the public-choice approach reflect its reliance on static-equilibrium analysis (although there are some exceptions) and its general failure to consider the knowledge problem facing entrepreneurs in the political, bureaucratic, and market processes who are bound together by regulation. These shortcomings mean that rent-seeking and rent-avoidance costs are underestimated, in part because they actually arise in an ongoing (dynamic) regulatory process, so they are much larger than static-equilibrium models imply. Furthermore, and more importantly, the impact on market entrepreneurs' incentives are not recognized. As Kirzner (1985, p. 135) stresses,

> In the face of these controls, regulations, and interventions there remains, nonetheless, a genuine market ... . Government controls constrain and constrict; they rearrange and repattern the structure of incentives; they redistribute incomes and wealth and sharply modify both the process of production and the composition of consumption. Yet within

> the limits that such controls impose, buying and selling continue, and the constant effort to capture pure entrepreneurial gain keeps the market in perpetual motion.

In this context, regulations are likely to have a significant impact on the market discovery process, however. Deliberate efforts to impose rules create incentives to find and exploit uncontrolled margins in order to avoid the full consequences of the rules (Benson, 2001b, 2002). Thus, the discovery process tends to be redirected along a new path. This means, as Kirzner (1985, pp. 141–144) explains, that discoveries, which probably would have been made in the absence of the regulation, are never made. The opportunity costs of regulation include such stifled discoveries. Indeed, they are conceivably the most significant microeconomic costs of regulation, costs that the static-equilibrium analysis of Public Choice do not reveal. In addition, regulation creates a "wholly superfluous" discovery process because within the regulated market there will be "entirely new and not necessarily desirable opportunities for entrepreneurial discovery" (Kirzner, 1985, p. 144). In other words, rent-seeking and rent-avoidance costs occur in the market as well as in the political arena. Furthermore, the perception that rents are available through political action means that some entrepreneurial efforts will be shifted out of the market process and into the political arena where individuals look for potential rent-seeking opportunities (Benson, 2002). In this context, both the Austrian and public-choice approaches can also benefit from insights of the neoinstitutional focus on property rights, as, in a larger macroeconomic sense, the ease of property rights alterations through the political arena means that property rights become increasingly insecure, shortening time horizons, and reducing incentives to innovate and produce in the market arena as a whole, not just in the market that happens to be regulated.[3]

The shortcomings with Austrian political economy arise because of the benevolence assumption. First, since laws and regulations influence the distribution of wealth, rational individuals should look for opportunities to gain subjective well being through political as well as market processes. Assuming away such rent-seeking *demands* for government actions clearly violates the rationality assumption unless it is assumed that at least in some dimensions, benevolent public officials do not face a knowledge problem so they can recognize and ignore political demands that are motivated by self-interest. After all, even if public officials are benevolent themselves (or if they feel that it is necessary to provide "public-interest" rhetoric to justify their actions), it becomes rational for political entrepreneurs to cloak their self-interest demands in public-interest rhetoric. Furthermore, surely the subjective values of individuals in the political and bureaucratic arenas should also matter. In other words, government officials are also rational and self-interested, and those individuals have opportunities to pursue their own objectives due to the knowledge problem facing the rest of the population who will not be able to monitor them effectively (indeed, as the public-choice school stresses, it is rational for voters and taxpayers to be ignorant about most of what is going on in the political arena). And importantly, in this context, Ikeda (1997, pp. 76–77, 81, 146) points out an assumption of benevolent government officials actually makes it very difficult to "even speak of a governmental process in which public agents spontaneously adjust to changing circumstances" in part due to the fact that the kinds of signaling and exchange mechanisms that develop in government (log-rolling, campaign contributions, bribery, budget maximizing efforts) are "inconsistent with a public-interest viewpoint," leading to an absence of "self-correcting mechanisms." In other words, while Austrians see the regulatory process as a spontaneously evolving one with new regulations arising to deal with unanticipated unintended consequences (e.g., see Mises,1949[1963], p. 763; Ikeda, 1997), their model of benevolent government lacks an explanation for how this process really works because there is no logically deducible alternative to the price signals and self-interested entrepreneurial discovery process that drives the evolution of markets.[4] Applying the self-interest assumption to political and bureaucratic actors creates incentives for them to develop signaling and exchange mechanisms. Indeed, many of the institutions of the political process clearly develop in order to coordinate the demands of special interest groups by generating signals or facilitating exchange (e.g., legislative committees, logrolling–Benson, 1981; Kroszner & Stratmann, 1998). Therefore, in contrast to Ikeda (1997, p. 150), dropping the benevolence assumption does "substantively" alter the conclusions of Austrian political economy.

Ikeda (1997, p. 150) does suggests that since Public Choice and Austrian Political Economy appear to be quite complementary, particularly once the static-equilibrium focus of Public Choice is dropped, so it may well be appropriate for public-policy theorists to attempt to combine the two into "a general theory of political economy" (also see Boettke & López, 2002). This presentation involves an attempt to at least take a few steps in that direction, while also adding insights from neoinstitutional economics. While the following analysis does not provide a complete integration of Public-Choice/Austrian-Economics/neoinstitutional-economics approaches to political economy (and therefore, is not intended to review all the literature that might be relevant to the subject), the economic regulation component of rent seeking is characterized as (1) an effort by special interests to influence the allocation of property rights, in (2) a continuous path-dependent spontaneous evolution (as apposed to a static equilibrium), driven by (3) entrepreneurship in ongoing market, political and bureaucratic discovery processes.

Section 2, on "Regulation," reviews, and supports (with some key modifications, particularly by emphasizing a property rights perspective) the Public-Choice-School interest-group explanations for why regulation initially arises, stressing the signaling and coordination mechanisms that drive the political process. Section 3, on more regulation, deregulation, and reregulation adds concepts that have been stressed by Austrian and neoinstitutional economists in order to explain that the original objectives of regulation will not be achieved due to entrepreneurial responses in both market and political arenas, and that more regulations are likely to be added in an effort to accomplish those objectives. These added regulations arise through the political and bureaucratic processes, which operate through mechanisms that evolve to facilitate the pursuit of self-interests, however, rather than the pursuit of benevolent objectives. Deregulation can conceivably arise for the same reasons, although complete deregulation is not likely to ever occur. Furthermore, if a significant degree of deregulation does occur, reregulation becomes likely, since the same incentives arise that existed in the first place. The concluding section focuses on the efficiency (or more accurately, inefficiency) implications of such an unstable political environment.

2. THE PUBLIC-CHOICE STATIC-EQUILIBRIUM MODEL OF SPECIAL INTEREST REGULATION

Economic regulations provide benefits for "special interests," which are able to influence the political process, by imposing costs on individuals who have less political power.[5] Monopoly is not a market failure that calls for government regulation in order to move in the direction of Pareto optimality, for instance, but rather, it is a product of government actions to provide wealth (monopoly rents) to the politically powerful firms through actions, such as the division of the potentially competitive market into exclusive marketing territories, creation of legal barriers to entry, and/or imposition of limits on price competition (Tullock, 1967; Stigler, 1971). In this context, Tullock (1967) emphasizes the striking analogy between monopoly achieved through regulation, tariffs achieved through legislation, and theft. Thieves use resources, particularly their time, in order to steal, and potential victims employ resources (e.g., locks, alarms, private security, public police) in an effort to deter or prevent theft. Tullock then points out that precisely the same analysis applies to the political transfer process, or what has come to be known as ‘‘rent seeking’’ (Krueger, 1974). Some individuals and groups expend resources (e.g., time to organize interest groups, lobbyists, investments in political campaigns to exchange support for those who have the discretionary power to create or change regulations) in an effort to gain wealth in the form of artificial rents created by government actions (e.g., monopoly franchises, licenses, quotas, tariffs), and others expend resources in an effort to defend against such transfers. Because such resources have opportunity costs (they could be used to produce new wealth rather than to transfer existing wealth), they are ‘‘wasted.’’ Lobbying and exchange of political support are necessary for rent seeking, however, as they provide important signals and coordination mechanisms for the political process in the absence of money prices (given that bribes are heavily sanctioned), as explained below.

The opportunity cost of rent seeking is even greater than the suggestions made so far, however, even in a static-equilibrium model. When rents are available (wealth is vulnerable to transfer), different individuals and/or groups may have incentives to try to capture them. Thus, competition for rents arises, given that a process exists to facilitate such competition (an issue examined below). Several different rent seekers may invest resources in an attempt to gain the same rents, and while some may gain rents that more than compensate for their investments, others may not. Suppose, for instance, that a particular monopoly franchise will produce an expected $1,000,000 in discounted present value of monopoly rents and that 10 entrepreneurial individuals recognize this. If each has an equal chance of winning the franchise and each is risk neutral, then each invests $100,000 worth of resources in an attempt to gain the franchise. The result is that the entire value of the rents are dissipated in the competitive process, suggesting that to measure the social cost of a static monopoly, one should include not only the dead-weight loss triangle, but also the transfer from consumers to producers (the monopoly rent rectangle) since an equal value in resources are dissipated in the rent-seeking competition (Tullock, 1967; Posner, 1975). Different circumstances (e.g., risk aversion, high transactions costs for organizing a rent-seeking group, and enforcing the group’s decisions) can reduce the dissipation of rents, of course, but under some circumstances the dissipation can even be greater than the rents that are transferred (Tullock, 1980).

A useful framework for considering some of the other implications of this view of regulation is developed by Stigler (1971), who describes government regulation as a supply and demand process with interest groups on the demand side and legislative representatives (and their political parties) on the supply side. In particular, Stigler (1971) contends that interest groups demand wealth transfers from their political representatives. This political market distributes wealth to those with the highest effective demand. Of course, demand is not in terms of money prices, so another currency (or currencies) is required, but before turning to this issue, consider an alternative "object" of interest group demand and political supply. Rather than focusing on rents or wealth, define the object of exchange as (Benson, 1984; Eggertsson, 1990): (a) the assignment of property rights, and (b) enforcement of property rights assignment. Property rights "convey the right to benefit or harm oneself or others" (Demsetz, 1967, p. 348), after all, so they dictate the distribution of rents and of wealth. Consequently, changes in property rights destroy some rents and create others, and therefore, transfer wealth. Whenever an interest group is successful in altering the assignment of property rights, other individuals lose. Thus, political competition is likely even if some groups are not seeking monetary or physically measurable wealth or rents, because their successes impose costs on others.[6] Governments govern by assigning and enforcing rights, and by more or less continuously modifying and changing them in the face of changing interest group demands (Benson, 1984).[7] This perspective will facilitate the transition to and understanding of the evolutionary arguments developed below.

Within this supply and demand process, small interest groups with large per capita stakes tends to dominate over larger groups with more diffused interests. This conclusion is widely recognized, of course, but it is worth stressing because it influences the nature of the political institutions, which will evolve to facilitate the political signaling and coordination process. Small interest groups generally dominate because of the relationship between group size and the cost of obtaining favorable political treatment. There are at least two costs involved. The first is the cost of information. Voting for legislative representatives (who pass laws) is infrequent, for instance, and usually concerned with a package of issues. Thus, individuals must incur costs to inform themselves about particular issues and politicians. This investment is not worthwhile unless the expected gains are relatively large. Consequently, individuals with potential but small per capita gains through regulation will not have a significant incentive to obtain the information – they are rationally ignorant. As Friedman (1973, pp. 180–181) suggests, for example,

> Imagine buying cars the way we buy governments. Ten thousand people would get together and agree to vote, each for the car he preferred. Whichever car won each of the ten thousand would have to buy it. It would not pay any of us to make any serious effort to find out which car was best; whatever I decide, my car is being picked for me by the other members of the group. Under such institutions the quality of cars would quickly decline.
>
> That is how I must buy products on the political marketplace. I not only cannot compare alternative products, it would not be worth my while to do so even if I could. This may have something to do with the quality of the goods sold on that market – *Caveat emptor*.

The problem goes well beyond what Friedman's example suggests, however. Voters do not choose individual products like cars. They generally vote for a political candidate offering to advocate a bundle of "services" (transfers, rents) some of which may be desirable for a particular voter while others are not. To make a "good" decision (i.e., obtain enough information to actually vote for the candidate that is most likely to advocate the policy bundle closest to the voter's preferred bundle), the voter would have to determine what each candidate is actually offering (not an easy task, given the obfuscation that politicians often practice in an effort to keep voters from finding out about the costs they are likely to bear if the candidate is elected), weigh the attractive parts of each candidate's offered bundle against the unsatisfactory parts, and then compare these weighted bundle of costs and benefits. If the voter makes the considerable investment in time and effort that this would take, there still is no guarantee that the preferred candidate will win or that if he wins he will be able to achieve the goals he promises to advocate, or that he will even advocate the promised policies. Thus, the expected benefits of making a "good" decision are very low. The costs to a voter of making a "bad" decision (e.g., voting for a candidate that is actually least likely to advocate the voter's preferred bundle of policies, given the candidate field available), are also very low. After all, the chances that the vote will be decisive are infinitesimal. The candidate may well lose, and if she does win, the chances that she will be able to get the voter's desired set of policies implemented, are also low. Furthermore if the candidate who gets a vote due to an "uninformed" decision wins, the uniformed voter will bear only a small part of the costs of the bad decision. The costs are shared by widely dispersed voters and non-voters. Thus, voters are rarely if ever informed about the candidates' full platform. Instead, those individuals who expect that large personal benefits can be gained (or losses can be avoided) from a particular piece of favorable legislation have incentives to obtain information about potential candidates' views on policies related to their narrowly focused self-interests, and then attempt to influence those views, both before and after the election.

In order to influence legislation, individuals generally must organize with other like-minded individuals, in part, because the expression of interests (demands) requires the mobilization of votes and/or money in order to be able to offer something of value to politicians in exchange for favorable legislation, as explained below, as well as informing government officials of the group's desires and political strengths (e.g., lobbying). These organizing costs tend to rise faster than group size. Indeed, Posner (1974) adds to Stigler's (1971) interest group theory with a more detailed discussion of the costs of organization in the context of the theory of cartels and the free rider problem. He notes that there are two major costs of organizing both cartels and interest groups: (1) the cost of arriving at an agreement, and (2) the cost of enforcing an agreement. Individuals who are potential members of an interest group view the cost of organizing as an investment. In return they expect some gain. Individuals are likely to make this investment if they do not have alternative investments that are more attractive. That is, the expected net per capita gain from participation in interest group activities will be compared to other investments by individuals, a point that becomes relevant when the dynamics of the regulatory process are considered below. Once members of a potential interest group have agreed on objectives and strategies, however, each individual member has the incentive to cheat – that is, avoid paying a full share, either monetarily or in terms of time. Such organizations tend to break down because of the free rider problem (Posner, 1974, pp. 344–345). The free rider problem explains the observation that small groups may be effective in obtaining regulatory benefits while large groups may not be effective. It is easier to organize an effective interest group and disperse the costs if the group is small. If one potential benefactor refuses to participate in the cooperative effort, the effort will generally collapse: "Thus all will tend to participate, knowing that any defection is likely to be followed promptly by the defection of the remaining members of the group, leaving the original defector worse off than if he had cooperated," when the group is small (Posner, 1974, p. 345). The cost of arriving at an agreement also tends to be less when the potential interest group has homogeneity of interests. The group can arrive at a common position more easily than a potential group of similar size but with heterogeneous interests. Thus, groups with very narrow focuses (single interests) are often successful. It is for this reason that Stigler (1971) contends that economic regulation will tend to be for the benefit of the firms in the regulated industry rather than the customers of those firms, and he cites very convincing evidence in support of this expectation (e.g., the fact that most industrial regulation tends to define markets and prevent competition, limit entry through licensing restrictions and other means, and/or set minimum rather than maximum prices).

Groups can be effective even when they are large, of course, or when they have heterogeneous interests. Stigler (1974) argues that, although small groups can generally organize easier than large groups, with asymmetry in interests a large group of individuals may be effectively represented by one or a few individuals with especially strong interests. Essentially, Stigler recognizes that there is a role for political entrepreneurs similar to the role Kirzner (1997) describes for market entrepreneurs, except that they recognize opportunities for potential gains from regulatory transfers rather than from market innovations, and they represent groups interests in order to influence the allocation of property rights, and therefore wealth or rents (the role of political entrepreneurs becomes particularly important in the dynamic process described below). In fact, of course, it is likely that an entrepreneurial effort is required to form any interest group, whether large or small, and even when the interests are relatively homogeneous. Some individual will probably have to take the lead, persuading others to join, and perhaps even pointing out the potential benefits of doing so, since many individuals may not have the kind of knowledge that would attract their participation if they were fully informed.

The Stigler (1971, 1974) model assumes that the suppliers of regulation are elected legislators, and Peltzman (1976) provides a formal model of Stigler's (1971) theory of regulation by assuming a competitive process for individuals seeking to be legislators, which in turn implies that utility maximizing behavior by these politicians can be predicted by viewing them as majority maximizers (i.e., rather than seeking profit as in the market process). After all, a non-vote maximizing strategy leaves open the possibility that a competitor can offer a different bundle of political actions that will win the next election. In this context, Posner (1974, p. 347) notes that there are three bases for interest groups' political influence, and therefore, for successfully obtaining wealth transfers. A group can exchange: (1) the votes of the members of the interest group; (2) monetary payments (e.g., campaign contributions) that can be used to influence other voters, and/or (3) a promise not to disrupt the political equilibrium by using its ability to retaliate with political opposition, or with some sort of violence, disorder, work stoppage, or grumbling that could reduce the legislator's voter support. Willingness to pay in one or all of these "currencies" creates the signals of relative interest-group demands that politicians respond to. Assuming that these signals are accurately read, Peltzman's model concludes that: (1) the legislature will favor the most politically powerful interest groups (the groups that can deliver the most votes, either directly from members or indirectly through campaign contributions, etc.); (2) more than one organization may be favored at the expense of others (e.g., industrial regulation may favor existing firms by preventing entry and establishing legal minimum prices, but require those firms to set relatively low prices for select groups of consumers who have political influence, provide higher wages or other benefits to unionized labor, etc.); (3) when there are differences between members of an interest group, the benefits (or costs) to the members which result from a particular legislative transfer will differ between members; and (4) the favored interest group (groups) will not be favored to the extent that it (they) could be. The last three points mean that a legislature never acts as a perfect broker for a single interest group. The reason for this is that the "marginal political return of a transfer must equal the marginal political cost" in order for a legislator to maximize his majority (Peltzman, 1976, p. 217).

Because of the focus on reelection by politicians and the rational ignorance of voters regarding issues that do not have large per capita impacts on their well being, political decisions made by elected officials tend to be made on the basis of a limited time horizons (Lee & Buchanan, 1982; Benson & Johnson, 1986). Politicians have little motivation to consider consequences much beyond their next reelection efforts. Thus, politicians who increase tax rates in order to provide additional transfers to supporters, or impose regulations that provide relatively immediate rents to particular powerful individuals or groups, obtain short-term reelection advantage over opponents who contend that such tax increases or regulations have a significant negative impact on economic activity. By the time the potential evidence accumulates the election is over, and by that time it is very difficult to measure the negative consequences of pre-election political actions or determine the causal linkage (furthermore, as explained below, those individuals or groups that do recognize their losses can be compensated with subsequent transfers with delayed negative impacts). As Lee and Buchanan (1982, p. 354) note, "so long as government makes its … decisions on the basis of a time horizon shorter that the period required for full … adjustment to … changes, observed tax rates will be higher [and observed regulations creating artificial rents will be more abundant] than those that a far-seeking or 'enlightened' government would impose." This also adds impetus for a path-dependent evolution of regulations, however, as explained below.

This self-interest theory of government suggests that political institutions should facilitate the interest-group signaling and exchange process, and many characteristics of government can be explained from this perspective (Benson, 1981; Kroszner & Stratmann, 1998). A legislature could make all decisions itself, as a committee of the whole, for example, but this is a very costly way to make decisions in order to meet interest group demands (Buchanan & Tullock, 1962, Chapter 7). More importantly, every legislator would have to measure the demands of all interest groups, and interest groups would have to expend resources to lobby all legislators. Therefore, given the short time horizons for most legislative decisions and the fact that "interest groups cannot enforce fee-for-service contracts with legislators, legislators have an incentive to create specialized, standing committees which foster repeated dealing between interests and committee members. The resulting reputational equilibrium supports high contributions and high legislative effort for the interests" (Kroszner & Stratmann, 1998, p. 1163). Kroszner and Stratmann (1998, pp. 1164–1168) explain that many characteristics of the committee process in legislatures are consistent with this view of committees, including the standing committee system, the stability of committee assignments, and the specialization of committees. When a legislature splits itself into small committees specializing in the production of special interest legislation, trade is going to be required in order to get committee actions passed by the legislature as a whole, of course, so the committee system and logrolling go hand in hand (Benson, 1981). While a benevolent legislature might divide into small committees in order to specialize in information gathering (Krehbiel, 1991), vote trading should be much less likely since benevolent legislators should trust their fellow benevolent legislators and not require an exchange of favors in order to vote for what they believe is public-interest legislation. In this context, Stratmann (1992b, p. 1162) also devises empirical tests to distinguish between logrolling votes and ideological votes, and his finding reveal vote trading coalitions while casting "doubt on the importance of personal ideological interests of legislators." In addition, an examination of the impact of political party on the organization of logrolling with regard to a broad range of votes that affect urban, labor, and farm interests, demonstrates that "logrolling agreements are widespread, … many Democratic congressmen changed votes because of logrolling agreements, and … the Democratic party served to facilitate logrolling between members" (Stratmann, 1995, p. 441). The existence of vote trading provides evidence that legislators' primary objectives are to meet interest group demands. The committee system facilitates the logrolling process that is vital for determining and responding to (supplying) interest group desires.

Kroszner and Stratmann (1998) explain that the committee system also helps legislators attract contributions from interest groups. In this same context, Stratmann (1991, 1992a, 1996, 1998) explores various relationships between the amount and timing of Political Action Committee (PAC) contributions, the votes of recipient congressmen, and the impact of such contributions on elections. He finds that contributions are a significant and important determinant of votes by congressmen, and that relatively small contributions can have a significant impact on the outcome of congressional elections (Stratmann, 1991). He also shows, in Stratmann (1992a), that in the context of an interest group theory of government, PAC behavior is quite rational (in contrast to much earlier literature suggesting unsophisticated behavior departing from rational behavior). For example, contributions that are intended to influence votes are allocated according to the likelihood of congressmen's votes. Congressmen who have a strong farm constituency in their home district get less money from farm PACs than congressmen whose constituencies suggest that they are less likely to be supportive, for instance. Finally, Stratmann (1996, 1998) finds that the timing of PAC campaign contributions are intended to and do influence congressional votes on particular legislation, and that contributions are also intended to and do influence election outcomes.

Additional evidence of the committee role in special interest legislation comes from studies of the actual legislation process. Most legislation arises through an "agreed bill" process wherein lobbyists from affected groups and a few members of relevant legislative committees negotiate directly in making important decisions (Berk, Brackman, & Lesser, 1977, pp. 11, 85–86; Heinz, Gettleman, & Seeskin, 1969). Any open legislative debate generally is simply rhetoric for public consumption after the negotiations have been concluded. Thus, the important part of the legislative process takes place behind closed doors and involves only groups representing narrow ranges of interest, which includes only a few major lobby groups. In fact, legislators generally do not initiate or shape legislation – they simply reacted to the demands of these major lobbies. Neely (1982, p. 80), a former West Virginia legislator, wrote, for example, that because of tremendous demands on legislators' time and resources,

> It is not possible to initiate programs; the most we can expect for legislators is to react to programs … paid lobbyists on all sides bang out the compromises and refine legislation long before a legislator is required to take a position on it. The development of comprehensive, politically acceptable legislative packages requires scores of man-years of work, and no single legislator or even group of legislators has resources like that at their disposal. It is the business of paid lobbyists to bring to legislators proposed packages of legislation from which to work … .
>
> When … changes [are proposed] to the legislature, … [the interest group provides a] completed, polished bill already drafted and ready for introduction by members of each

> house … . Not only do lobbyists draft bills and provide legislative packages, they follow the progress of the legislation as well, organizing support, informing supporters of impending obstacles, and structuring trades that will perhaps assure some compromised but on balance favorable action.

Many of the characteristics of the legislative process appear to have evolved to facilitate the signaling of interest group demands, and the exchange of special benefits (property rights assignments and their accompanying rents) for election support. The committee system, logrolling, and PAC contributions, and negotiations in the agreed bill process are all part of this political process, which corresponds (imperfectly) to the price system in markets, but the process extends beyond the exchange between interest groups and legislators. After all, enforcement (and often rule making) powers are also delegated to agencies for the same reason that legislatures delegate many decision-making powers to committees. Of course, when enforcement and rule-making powers are delegated to agencies, the incentives of these bureaucrats must also be examined to see if they prefer to regulate as the legislature and interest groups want them to, unless the bureaucracies are effectively controlled so that they only do what the legislators want.[8]

In a static setting, regulatory authorities can be viewed as firms producing a service or a set of services – enforcement of legislatively determined regulatory policies. Enforcement authorities exchange their enforcement services for a budget. This type of exchange has been modeled by Niskanen (1975), with significant changes made in his initial model (Niskanen, 1968, 1971) in light of comments by Mique and Belanger (1974) and Breton and Wintrobe (1975). Niskanen (1975) assumes that a bureau manager is a utility maximizer with income and non-monetary perquisites (e.g., prestige, staff support, travel, leisure time or shirking, social and physical amenities, discretion to do the job) as arguments in the utility function. Income and perquisites are in turn assumed to be functions of both bureau output (i.e., the size of the bureau) and the discretionary budget. The bureau also faces active oversight monitoring from the sponsor (e.g., legislature). Control devices go beyond direct monitoring by the oversight sponsor itself or even by a "political appointee" charged with controlling the bureau. They can include the establishment of competing bureaus that might monitor their competitors and report improprieties in order to expand their share of the political market. Niskanen's (1975) model has been adapted to describe a regulatory process (Benson & Greenhut, 1986). The model predicts that mangers of enforcement bureaus prefer stricter enforcement of whatever market regulations exist than the legislature wants. Bureaucratic agencies also will try to inefficiently enforce rights in the sense of spending a larger budget per unit of enforcement than is necessary, if they can appropriate part of the budgets allocated by the legislature for their own benefit.

Some writers (e.g., Fiorina & Noll, 1978; McCubbins, Noll, & Weingast, 1987, 1989; Weingast & Moran, 1983) see legislative monitoring and institutional constraints on bureaus as being quite tight, so that bureaucrats are not able to depart very far from the wishes of their sponsors.[9] Others see political control to be weak (e.g., Tullock, 1965; Niskanen, 1968, 1971, 1975; Breton & Wintrobe, 1975, 1982; Benson & Greenhut, 1986; Benson, 1995b), however. Naturally, if there were no constraints on legislators' time, resources, and knowledge, they would force politically efficient behavior, but constraints do exist (Tullock, 1965, pp. 72–73; Niskanen, 1975; Breton & Wintrobe, 1982). In fact, much more time and effort apparently ends up being directed at dealing with interest groups than with bureaus (Neely, 1982, pp. 67–80; Johnson & Libecap, 1994, p. 139), and knowledge of many aspects of actual bureaucratic production is very costly to obtain, as explained in more detail below (also see Breton & Wintrobe, 1982). Thus, control of a bureau should be "imperfect" in the sense that politically ideal outputs are not likely to be produced and production is not likely to occur at minimum costs (discretionary budgets exist). Let us consider some of the empirical evidence in this regard.[10]

In one of the most prominent studies of bureaucratic control, Weingast and Moran (1983) examine Federal Trade Commission (FTC) behavior, and finding evidence of FTC responses to political demands of Congressional oversight constituencies, conclude that bureaucrats are effectively controlled by Congress. As Johnson and Libecap (1994, p. 158) point out, however, "Showing that Congress had sufficient power to control a 'runaway' agency does not deny the existence of independent bureaucratic behavior." Indeed, the fact that bureaucracies do respond to political influences on their oversight sponsors simply suggests that the modified Niskanen (1975) type model may apply: bureaucrats rationally respond to the incentives and constraints that they face. Lindsay's (1976) findings are revealing in this light. He recognizes that many bureaus produce numerous outputs, some of which are easily measurable and some of which are not. Therefore, a bureaucrat has incentives to produce the measurable outputs in qualities that correspond to the monitor's desires, while exploiting the uncertainty associated with unmeasurable outputs (e.g., to gain discretionary budget). Lindsay (1976) finds that the Veteran's Administration in the United States provide expected levels of easily measured outputs (hospital beds, patient days) while producing relatively low-quality services for unmeasurable outputs. On measurable dimensions then, the bureau may look like it is effectively controlled by the monitor, "but if all dimensions cannot be monitored, then some power to scrimp on these attributes rest with those in the bureau, who can use the savings to forward their own interests" (Mueller, 1989, p. 258).

Clearly, bureaucrats are not totally free to pursue their own goals, but some discretion remains. Indeed, Faith, Leavens, and Tollison (1982, p. 342), who examine very similar issues to those explored by Weingast and Moran (1983), conclude that "we would not be so hasty in discarding [either] budget-maximizing (arguing against Weingast & Moran, 1983) or congressional influence hypotheses (arguing against Katzman, 1980 who finds no evidence of congressional influence on FTC behavior) about regulatory bureau behavior." In general, the empirical literature suggests that an uncontrolled bureaucracy model does not explain bureau behavior, but neither does a model which assumes that the bureaus have no discretion and simply respond to the demands of legislatures (Benson, 1995b). Thus, for instance, Giroux (1989), in his examination of the effectiveness of financial and compliance audits as control devices to assist in monitoring local bureaucrats, finds that such efforts can be effective to a degree but that their effectiveness can be reduced as bureaucrats use strategic roadblocks to thwart the audits. Similarly, Zardkoohi and Giroux (1990) find that bureaucratic discretion and employment both rise as monitoring costs rise.[11]

Adding the Public-Choice perspective on bureaucratic enforcement to the static regulatory model clearly adds additional resource costs to the regulatory process, thus reinforcing the conclusions of the rent-seeking literature. After all, the resources consumed in bureaucratic regulation also have opportunity costs in that they could be used for productive purposes, but because of the rent-seeking process, they are diverted to the production of transfers. Thus, for instance, the cost of monopoly include the traditional deadweight loss triangle and the opportunity cost of the resources consumed in rent-seeking competition (perhaps approximated by the monopoly rent rectangle), plus the opportunity cost of the resources allocated to the regulatory bureaucracy, which tend to be relatively large due to bureaucratic incentives and imperfect legislative control. There is another implication, however. As Tollison (1987) explains, the delegation of the actual regulatory powers to agencies means that there are at least two stages to the rent-seeking game. The first stage involves legislative creation of artificial barriers in a market in order to generate the potential for rent flows. Once the regulatory apparatus is in place, rent seekers must compete to capture the rents that arise due to the artificial barriers. They must gain licenses or franchises and prevent the granting of additional entry rights to others, obtain exclusive marketing territories and make sure that those territories are not reduced, influence the rate-setting process in order to maintain high prices, and so on. This is quite consistent with the Peltzman (1976) point that the distribution of benefits will vary if the members of an interest group are heterogeneous, of course, but much of the actual distribution of rents occur through bureaucratic rather than legislative actions. Furthermore, given imperfect monitoring and the resulting bureaucratic discretion, those who want to avoid losses can also continue to compete in the second stage in an attempt to minimize loses, even if the first stage goes against them. Much of this competition focuses on the regulatory commissions or bureaucracies that the legislature establishes to create and maintain the artificial monopoly rents. This second stage of competition obviously could have feedback effects, however, if, for instance, bureaucratic decisions frustrate either interest group or legislative intentions. This suggests that the regulatory process could have some interesting dynamic implications. Indeed, these implications may be even more important determinants of the "inefficiencies" of rent seeking stressed by the public-choice school than those implied by the static analysis of interest group competition or bureaucratic performance.

3. THE DYNAMICS OF A REGULATORY PROCESS: MORE REGULATION, PARTIAL DEREGULATION, AND REREGULATION[12]

The transactions costs of fully delineating property rights and of enforcing any property rights that are assigned, especially if the assignment arises though special-interest regulation, mean that enforcement will be imperfect (Barzel, 1989; Benson, 2002). This in turn implies that property rights to an asset or resource are never likely to be perfectly delineated and secured, as some value remains "in the public domain," using Barzel's (1989) terminology. Incentives always exist to discover ways to capture such value, but a new regulation intended to assign property rights to particular interested parties will be difficult to enforce (for reasons expanded upon below), creating new incentives for entrepreneurial individuals to attempt to capture any unprotected value. Thus, as Austrians such as Mises (1949[1963], pp. 758–776 and elsewhere), Kirzner (1985, pp. 133–145), and Ikeda (1997, pp. 94–99 and elsewhere) stress, a regulation leads to spontaneous responses, many of which are not anticipated by members of the interest groups, the legislature, or the regulatory bureau. Therefore, let us characterize economic regulation or rent seeking as an effort by special interests to influence the allocation of property rights, in (1) a continuous path-dependent spontaneous evolution (as apposed to a static equilibrium), driven by (2) market, (3) political, and (4) bureaucratic entrepreneurship in an ongoing discovery process (with (1)–(4) discussed below).

3.1. The Spontaneous Evolution of Regulation

The concept of spontaneous order refers to an ordered arrangement, which evolves spontaneously out of the interactions of separate choices made by individuals governed by general rules or constraints, but in the pursuit of their own subjective ends. The outcome of spontaneous evolution (i.e., spontaneous order, or equilibrium) has been widely recognized by virtually all economists in their analysis of markets, of course, assuming general rules, such as enforceable obligations to respect private property. However, Menger ([1883]1963), emphasizes that the origin, formation, and ultimate process of many social institutions, including the system of rules and supporting institutions, is essentially the same as the spontaneous evolution Smith (1976[1776]) described for markets. While much of economic analysis focuses on the "order" (equilibrium) that should emerge if conditions remain stable, the focus here is on the inherently destabilizing evolutionary process that characterizes special-interest regulation. Indeed, as Hayek (1937) argues, while the equilibrium concept in economics is of use, its power is limited, and what is needed is a better understanding of the underlying process that examines how and when an equilibrium state will come about. This does not deny the value of equilibrium analysis in many situations, of course, since the direction of change often can be predicted with comparative statics, and this is an integral part of the analysis of change. It implies that the process itself is worthy of more attention than it tends to get from economists, however, as the static equilibria that are being compared are not in fact likely to be achieved.

One particular problem with equilibrium analysis deserves mention in this context. A spontaneous order is often contrasted to a deliberately designed social arrangement created by some centralized ordering authority. In a static framework such a designed order might appear to be reasonable, but in a dynamic world it is not. The evolution of regulation and regulatory institutions clearly involves deliberate "human design," for instance, and significantly, designed rules can disrupt spontaneous orders, but the result is not likely to be a designed order, as Hayek (1973, p. 51) explains:

> It is impossible, not only to replace the spontaneous order by organization and at the same time to utilize as much of the dispersed knowledge of all its members as possible, but also to improve or correct this order by interfering in it by direct commands … it can never be advantageous to supplement the rules governing a spontaneous order by isolated and subsidiary commands concerning those activities where the actions are guided by the general rules of conduct … the reason why such isolated commands requiring specific actions by members of the spontaneous order can never improve but must disrupt that order is that they will refer to a part of a system of interdependent actions determined by information and guided by purposes known only to the several acting persons but not to the directing authority. The spontaneous order arises from each element balancing all the various factors operating on it and by adjusting all its various actions to each other, a balance which will be destroyed if some of the actions are determined by another agency on the basis of different knowledge and in the service of different ends.

While balance created by a spontaneous order does tend to be destroyed by efforts to deliberately implement "isolated and subsidiary commands," these deliberately designed rules are rarely able to completely dictate the targeted behavior because knowledge is incomplete for the rule maker (Hayek, 1973; Kirzner, 1985, p. 145; Ikeda, 1997, pp. 50–52), and because policing is imperfect (Benson, 1999, 2001b, 2002). The knowledge problem suggests, among other things, that there are too many uncontrolled margins and unanticipated responses for a rule designer to recognize and anticipate, in part because the changes create a new set of opportunities that have not previously been available. As Kirzner (1985, p. 135) stresses, a market remains even though regulations are instituted. The regulations alter incentives, redistribute income, and alter the process of production as well as the composition of consumption (an example is provided below), but exchange continues as does the entrepreneurial discovery process. Because of the change in incentives regarding access to rents, regulations will significantly impact the discovery process, however, as efforts are made to find and exploit the uncontrolled margins and/or avoid the full consequences of the rules (Benson, 2001b, 2002). The discovery process continues but along a new path. As a consequence, discoveries which probably would have been made in the absence of the regulation are stifled and never made (Kirzner, 1985, pp. 141–144). This unmeasurable consequence of regulation may well be the most significant microeconomic cost of rent seeking, although the static-equilibrium analysis of public choice does not reveal it. Furthermore, regulation creates a "wholly superfluous" discovery process as new opportunities are opened up along a new evolutionary path that is not likely to be desirable (Kirzner, 1985, p. 144), either from the perspective of the interest groups involved or from an efficiency perspective.

Mises (1949[1963], p. 859) stresses that "As soon as something happens in the economy that any of the various bureaucratic institutions does not like or that arouses the anger of a pressure group, people clamor for new interventions, controls, and restrictions." Thus, signals (lobbying, campaign contributions) arise as interest group efforts increase. The reason legislators respond, however, is because of their own subjective self-interests centering around reelection. Such signals might arise for a benevolent government too, but there is no obvious reason for such a government to respond to them, as emphasized above. As entrepreneurs discover new opportunities, many of which involve ways to avoid or mitigate the intended transfer consequences of the regulations, the intended benefits of the regulation for interest groups fall, they pressure the rule makers to do something about it, and the likely response is new rules intended to block such maneuvers. Those subject to the new rules react again, however, leading to more "clamor," new blocking efforts, and so on. Therefore, deliberately designed rules and institutions also evolve spontaneously as regulators and market entrepreneurs attempt to discover ways to achieve their subjective and often conflicting ends. In other words, the evolution of intentionally created rules also is path depend, as such rules are influenced by what has come before and they in turn influence the path of the spontaneous evolution that follows, but the result is not likely to be equilibrating. The perception that a deliberately designed market order (equilibrium) through regulation is an alternative to spontaneous order is incorrect (Ikeda, 1997, pp. 74–75, 143–144; Benson, 2001b).[13]

3.2. Market Entrepreneurship in a Regulatory Environment

An entrepreneur is someone who intentionally searches for opportunities to expand personal well being. In an unregulated (free) market economy characterized by limited knowledge, such opportunities can arise through discovery of a new product that will fulfill consumer's desires more effectively, or of a production technique that lowers the costs of providing an existing product. They can also arise through discovery of an "error" (or a "difference in knowledge") in a market that creates an opportunity for arbitrage, for entry into a profitable niche in an existing market, or entry into an untapped market for an existing product. And they can arise through discovery of an organizational innovation that lowers transactions costs. Thus, as Kirzner (1997, p. 62) explains, entrepreneurial discovery of opportunities in a market environment gradually and systematically pushes back the boundaries of ignorance, thereby driving down costs (both production and transactions) and prices while increasing both the quantity and quality of output. When a market is subject to regulation, the potential for entrepreneurial discovery may actually be enhanced, although importantly, it is also redirected (Kirzner, 1985, pp. 141–145). Regulations introduce errors into markets, so by finding ways to circumvent regulations or reduce their impact, entrepreneurs capture some of the rents that are suppose to go to members of powerful interest groups. Perhaps this can best be illustrated by an example.

Consider Mises' (1949[1963], pp. 762–766) and Cheung's (1974) analyses of the consequences of price ceilings, focusing first on the following question: How are property rights allocated to a commodity that is sold at a money price below the market equilibrium?[14] The standard neoclassical textbook prediction is that a permanent shortage arises with a price ceiling. However, the contention that the shortage is borne proportionately, randomly, or even arbitrarily, ignores the potential for rational responses by individuals to the resulting situation. Essentially, the price ceiling is indented to transfer rents to consumers but it actually puts the value between the price consumers are willing to pay and the legal price into the public domain (i.e., creates "gaps between costs and revenues," as Kirzner (1985, p. 132) explains), creating incentives for both buyers and sellers to attempt to capture that value. One question that must be asked even when a price is controlled is: can the buyers and/or the sellers take additional steps to get or to provide another unit at a cost below added gain? If the answer is yes, then the shortage is not a permanent equilibrium, as adjustments will be made. For instance, consumers compete for the limited supply by searching and queuing. These activities are costly, however, so the full price consumers pay is much higher than the money price. Conventional demand curves based on money prices no longer apply, and demand based on full price implying that the shortage will shrink, ultimately disappearing unless other changes occur. Some consumers may be better off (e.g., those with low values of time) but others are worse off. Other margins of adjustment also often exist, however, so this "full price" equilibrium is not actually likely to arise as both entrepreneurial buyers and sellers will "take advantage of disequilibrium conditions" (Kirzner, 1985, p. 129) by making adjustments that lower their costs or increase their benefits.

Barzel's (1989) discussion of an example, the price ceiling on gasoline during the early 1970s, suggests the kinds of reallocations of resources, a la Mises (1949[1963], p. 763), and superfluous discoveries, a la Kirzner (1985), inevitably arise. In this case, sales were in terms of tanks of gasoline, so consumers actually tended to queue up relatively frequently (not allow their tanks to get as close to empty as they would if there was a market clearing price) in order to avoid running out of gasoline, raising their time costs even more. To avoid some of these time costs, some consumers (particularly those with trucks, pickups, and perhaps large cars) added gas-tank capacity, and others with high-time values paid people to wait in the queue for them. Entrepreneurial sellers had more margins to adjust on, however. Under the law, they were supposed to maintain pre-price control money prices, but regulations did not control numerous characteristics of the product. Producers were able to capture part of the value from the public domain by reducing quality (e.g., octane), unbundling products (e.g., removing additives to sell them separately, removing the "services" that had been bundled with gasoline by moving to self service, reducing the hours of operation and therefore the level of convenience that consumers had previously enjoyed), rebundling products in different ways (e.g., selling gasoline only to consumers who purchased an oil change or a lube job at prices for those services raised to capture the value of the accompanying gasoline), refusing to sell on credit and requiring cash payments instead, and so on. All of these adjustments were perfectly consistent with the regulations on price, and therefore legal, because the regulation did not control any of the margins of adjustment other than price. Furthermore, enforcement of the price regulation itself was imperfect, so some sellers also gained part of the value in the public domain by illegally selling on the black market at prices much higher than would be necessary to clear a free market. The point is that the discovery process continued, apparently at an accelerated pace (although this cannot be determined for sure because the discoveries that were stifled by the regulations are not known), but with largely superficial discoveries. The full costs of the regulations will never be known, however, because the path of market evolution was altered (e.g., the massive shift from full service to self service stations was never reversed after price deregulation), suggesting that at least some of the discoveries, which would have arisen had the controls not been imposed, never have been (motivations for deregulation are discussed below). One reason for not returning to the original path in this case is that the initial very profitable (because of the size of the gap between costs and revenues that had been artificially created) entrepreneurial discoveries under the regulatory regime tended to sharpen the awareness of other entrepreneurs to such profits, promoting the emergence of a competitive profit-seeking process that quickly evolved along a new path (e.g., see Ikeda, 1997, p. 60), thus creating a very different market environment for which the post-price-ceiling discovery process proceeded. In addition, the fact that the government had been willing to impose such controls once probably created an expectation that it could do so again, making property rights to the distribution of deregulated value relatively insecure and creating a different set of expectations, post-regulation, than those that had existed before regulation. Another reason is that superfluous discoveries under price controls spawned additional regulations, as Mises (1949[1963], pp. 763–764) predicts, and even when the price control was abandoned some of the other regulations were not, as noted below.

In this context, augmenting a Misian analysis of price controls with explicit consideration of efforts to capture property rights to value, as in Cheung's (1974), is useful because it brings out the complexity of transactions and the multiplicity of attributes to most assets, and illustrates that market participants have many margins besides price and quantity along which they can adjust. Indeed, some patterns of superfluous discovery become predictable. It also illustrates that resources are consumed in such adjustments. This dissipation adds to the rent seeking costs themselves, of course, as it results from the initial attempt to reallocate property rights. Thus, rent-seeking and rent-avoidance costs are not simply the costs of political activity. They spill into the regulated market as well, and the opportunity costs of resources used in the superfluous adjustments that arise as entrepreneurial producers and consumers attempt to capture value by adjusting along uncontrolled margins and new paths should be considered as part of the wealth dissipation that occurs in such an environment (Benson, 2002). Similarly, the opportunity costs of stifled discoveries can be very high. Cheung's (1974) analysis of price ceilings fails to bring out important implications that are recognized by Austrians, however, in part because he sees the process as ultimately equilibrating.[15] This ignores the fact that since the superfluous discovery process directs rents away from their intended recipients, those target recipients are likely to demand even more regulations from regulators and/or bureaucrats (Mises, 1949[1963], pp. 763–764; Ikeda, 1997, pp. 99–136; Benson, 1999, 2001b, 2002).

3.3. Political Entrepreneurs and More Regulation

In a rent-seeking society entrepreneurship is not restricted to market innovations. Entrepreneurs may also discover opportunities in the political arena.[16] This may involve the identification of an unexploited political opportunity that can be pursued through the organization and leadership of an interest group. Indeed, entrepreneurship of this kind presumably is the source of the initial demands for regulation. Political entrepreneurs demand regulations expecting the benefits from them to accrue to the entrepreneur and the members of his organization, but many of the benefits are dissipated (e.g., as time costs rise for consumers under a price ceiling, for instance), or redirected (e.g., as both market and other political entrepreneurs adjusted along numerous margins to capture value that was intended for members of the interest group constituencies). Thus, political entrepreneurs who initiate the original regulations are likely to demand more regulations (e.g., in the price ceiling case, to reduce time costs by instituting some other rationing mechanism, such as the use of rationing coupons or a lottery – for instance, see Boyce, 1994) and control the previously uncontrolled margins along which superfluous adjustments are being made [e.g., new regulations were created in many states to prevent reductions in octane levels by firms selling gasoline in the price ceiling case]. Bureaucratic enforcement cost will rise as the regulatory apparatus expands to apply these new regulations. If entrepreneurial adjustments ultimately mean that these additional regulations fail to allocate the rents to the targeted group, more regulations will be demanded. Enforcement and compliance costs rise both to implement new regulations and to control illegal activities. But more importantly, the path of superfluous adjustments continues and the unmeasurable losses grow as more potential efficient discoveries are stifled.

Some regulatory rents are likely to be captured by the intended recipients, but they are then capitalized into the value of artificially created unique assets, such as licenses or quota rights. If the regulations do not create such artificial assets then the rents tend to be capitalized into the price of assets that are uniquely suited for capturing the intended benefits (e.g., the value from farm subsidy programs tend to be capitalized into the price of farm land). This capitalization of rents means that those rents, which do accrue to members of the privileged group are captured by those individuals that initially own the relevant unique assets. Subsequent entrants must purchase those assets, so they do not benefit from the regulation. Over time, as such assets are exchanged, new market participants will not benefit from the regulatory limitations, so they will have incentives to demand new types of regulations so they too can obtain rents. Thus, even if anticipated rents are not diverted through superfluous market innovations, more regulations are likely to be added over time as the membership in relevant interest groups evolves.

Political entrepreneurship raises the cost of protecting property, as those who lose transfers in light of new regulations now have incentives to organize and attempt to regain and retain their wealth. Therefore, more resources are diverted into the rent-seeking arena, raising the resource waste described in the static Public-Choice approach to regulation. Indeed, the likelihood of a spiraling process of more and more rent seeking has been recognized in the public-choice literature (Buchanan & Tullock, 1962; Olson, 1965; Benson, 1984), a process that is at least complementary to, if not dominant over the Austrian political economy description of increasing regulatory intervention (e.g., see Mises, 1949[1963], pp. 763–764 and Ikeda, 1997, pp. 99–137), since the special interest assumption explains the signaling and exchange institutions that develop to coordinate the process.[17] Self-interested politicians with short time horizons have incentives to respond to the demands of new groups by transferring wealth from unorganized individuals (because they are less likely to have an impact on the next election), but in doing so, some of those unorganized but self-interested individuals also may organize and enter the rent-seeking/rent-avoidance competition (since organizing an effective political pressure group takes time, their impact is probably not felt until after the next election). Rather than transferring wealth back from the previously favored group, however, politicians again have incentives to find rents that can be taken from as yet unorganized individuals, creating more incentives to organize. Furthermore, because a regulation places value into the public domain and political entrepreneurs, like market entrepreneurs, have incentives to capture it, new interest groups may emerge who are neither initial rent seekers nor rent avoiders (Benson, 2002 provides examples).

Deregulation may also occur (although it is likely to be only partial, as the bureaucracy will probably survive as will some form of regulatory activity, as noted below) if the regulation effort fails to produce or protect most of the anticipated rents and political support for the regulations wanes. Thus, the price controls on gasoline discussed by Barzel (1989) were short lived (probably not a generalizable example since they were actually part of a massive wage-price freeze that proved to be extremely costly and disruptive), for instance, and partial deregulation has occurred for such markets as interstate trucking, airlines, some financial markets, long distance telephone markets, and some state electric utilities markets. Even in these cases, related regulations often remain (e.g., states have minimum octane levels for various classifications of gasoline, which apparently were passed while gasoline price ceilings were in place, in order to limit unbundling options Barzel, 1989). Of course, many regulatory regimes, including some involving price-ceilings persist, by continually evolving in the face of market and political changes. An examination of the complex and multidimensional system of New York rent controls would reveal that the regulatory authority has made many changes and additions to regulations, for instance, in an effort to maintain the system. Similarly, interstate trucking has been deregulation but its regulation, discussed in Benson (2002), continued for about 45 years, in part by changing dramatically over time as both market and political entrepreneurs discovered ways to avoid or redirect the rents and political and bureaucratic entrepreneurs attempted to prevent such adjustments. Furthermore, despite deregulation, the bureaucratic apparatus remains in place and seems to have a lot of work to do. In this context, the dynamic bureaucratic institutional process can also be characterized as one dominated by "entrepreneurial competition" in an Austrian sense (Breton & Wintrobe, 1982, pp. 108–131), wherein individual bureaucrats look for opportunities to pursue their subjective goals by selectively seeking and implementing policy innovations.

3.4. Bureaucratic Entrepreneurs and Policy Changes

Mises (1944, pp. 80) explains that

> The bureaucrat is not only a government employee. He is … at the same time a voter and as such a part of the sovereign, his employer. He is in a peculiar position: he is both employer and employee. And his pecuniary interest as an employee towers above his interest as employer, as he gets much more from public funds than he contributes to them.
>
> This double relationship becomes more important as the people on the government's payroll increase. The bureaucrat as voter is more eager to get a raise than to keep the budget balanced.

In this context, Breton and Wintrobe (1982, pp. 108–131) characterize much of what bureaucrats do as "policy advocacy" rather than simply the policy implementation implied by static-equilibrium models, and characterize the bureaucratic institutional process as one dominated by "entrepreneurial competition" wherein individual bureaucrats pursue their subjective goals by selectively seeking and implementing policy innovations. The multi-dimensional competition includes the general struggle for budgets, as well as competition for positions and promotions in the formal bureaucratic structure.

Bureaucrats have clearly demonstrated a willingness to "propagate" their own policy agendas.[18] Furthermore, they have a relative advantage in interest group competition. They are already organized, and they are naturally well informed about a narrowly focused political issue. Bureau managers also can generally appropriate a portion of their discretionary budgets to cover some or all of their lobbying costs while other interest groups generally have to solicit contributions. They also have ready access to elected officials who pass laws and set budgets, as they are virtually always called upon to provide "expert opinions" and evidence when issue that affect them are considered.[19] Indeed, much of the "agreed bill" legislation passed in any session is written and pursued by bureaucrats rather than by representatives of other interest groups (e.g., see Berk, et al., 1977; Neely, 1982, p. 80; and Benson, Rasmussen, & Sollars, 1995b).

Bureaucrats' power and discretion depend on the degree of uncertainty, and they themselves are often in a position to expand that uncertainty through "selective distortion" (Breton & Wintrobe, 1982, p. 39).[20] Thus, the oversight sponsor faces the duel problem of determining both what the bureau's output should be from a political perspective, and how it should be produced, with the potential for bureaucrats misleading them on both counts. Bureaucrats also have incentives to "educate" sponsors, by selectively informing law makers of the strength and wishes of other interest groups. Consequently, interest groups press their demands to bureaucracies as well as (or instead of) to legislatures, as suggested above. Yet another implication is that bureaucrats have incentives to "educate" potential interest group allies and to "propagate" their agenda indirectly through "public information" or miss-information campaigns. Indeed, competitive strategies employed by entrepreneurial bureaucrats include: "(i) alterations in the flows of an information or commands as these move through or across the hierarchical levels of the organization; (ii) variations in the quality or quantity of information leaked to the media, to other bureaus in the organization, to special interest groups, and/or to opposition parties and rival suppliers; and (iii) changes in the speed of implementation of policies as these are put into effect" (Breton & Wintrobe, 1982, pp. 37–38). These strategies and selective behavior in general are possible because of the way bureaucratic organizations and hierarchies work, including the fact that monitoring by superiors and sponsors is costly and the measurement of bureaucratic performance is generally difficult or impossible. Indeed, such strategies increase monitoring costs and make measurement of performance even more difficult. After all, individuals who depend on a particular bureaucratic process for their livelihood have strong incentives to maintain it and prevent the implementation of competitive alternatives.[21] Thus, as Tullock (1965, p. 193) explains, when a bureaucracy is set up to accomplish some political goal, it inevitably fails (e.g., for reasons suggested above, as entrepreneurs find ways to exploit uncontrolled margins), and

> The continuous failures of bureaucracies are met in part by continuing reorganizations, the reasoning being that the failure has resulted from organizational details. In part, he failures are met by concealed shifts in the objectives for the organization. As an

> experiment, if one examines the original arguments for establishment of almost any government bureau and compares these arguments with those that may be currently offered for the retention of the bureau, one is likely to find that a considerable shift has occurred in the specification of the objectives that the bureau is supposed to attain. The governmental bureau becomes a permanent fixture, with the objective continually changing. Over time the vested interests of the bureaucrats themselves become more and more important in justifying the organization, although this can never be the sole argument in discussions with outsiders.

Bureaucracies fail because of the knowledge problem and the superfluous market and political discovery process. Once a regulatory regime is in place, however, the bureaucratic enforcers have incentives to maintain the system whether it accomplishes its objectives or not, so they have incentives to add more regulations, seek new objectives that might be achieved, and so on. Thus, the bureaucracy is a spontaneously evolving institution. Even if the demands for regulation wane because they continually fail to provide the anticipated rents, and the demands for deregulation grow as losers organize, the bureaucracy is not likely to disappear. It will have to supervise the deregulation process, after all, and it will probably retain some regulations to enforce as well (e.g., see the discussion of the Interstate Commerce Commission's role in trucking regulation and deregulation in Benson, 2002). Furthermore, with deregulation, wealth is again transferred (e.g., from those who have paid prices for licenses, quotas, farm land, etc., which reflect capitalized regulatory rents) and some property rights temporarily move back into the public domain, waiting to be captured. Reregulation, perhaps in some new form, becomes attractive to some interest groups, and the cycle starts over. A bureaucracy might survive and prosper for a long time in such a dynamic environment even if it is not achieving the "politically efficient" objectives that it was intended to provide.[22]

4. CONCLUSIONS: THE INHERENT INEFFICIENCY OF REGULATION

The discussion of special interest regulation in Section 2 draws freely from two related schools of political economy: the Public-Choice (or Virginia) School, and the Chicago School. While these approaches have much in common (Tollison, 1982), they also have some important differences.[23] Perhaps the main difference is that the public-choice approach stresses government failure including the inefficient "waste" of resources consumed in the rent-seeking process. In contrast, an emphasis on the efficiency of the political process (e.g., Becker, 1983; Wittman, 1989; Stigler, 1992) traces, at least in part, to Stigler's regulation article and characterizes subsequent contributions to the Chicago-School view of regulation.[24] Peltzman's (1976) formal model of Stigler's theory suggests, for instance, that since legislators wish to meet the marginal conditions of the political exchange, this transfer process should efficiently accomplish what it is designed to do. As Posner (1974, p. 217) explains, "A corollary of the economic theory of regulation is that the regulatory process can be expected to operate with reasonable efficiency to achieve its ends. The ends are the product of a struggle between interest groups, but it would be contrary to the usual assumptions of economics to argue that wasteful or inappropriate means would be chosen to achieve those ends." So, the Chicago version of interest group theory of government implies that legislators attempt to efficiently transfer wealth – i.e., minimize the deadweight losses arising with transfers (Becker, 1983). After all, if a particular regulatory arrangement is inefficient in the sense that transactions costs are not minimized, politicians who established it will have less political support than they could obtain by reducing those costs. Therefore, they will make adjustments in order to maximize their support (if they do not, competitors will offer a better arrangement and gain enough political support to win the next election). Thus, the argument continues, any regulatory arrangement that survives over time must be efficient in this sense (Stigler, 1992). This political efficiency desired by legislators is not equivalent to static-equilibrium allocative efficiency, of course. It can be thought of as a "second-best" kind of efficiency – given the existence of a political process with the power to transfer wealth, Pareto optimality is impossible, but the legislature attempts to efficiently meet desires that are in the interests of small powerful groups with a minimum of costs imposed on political losers. And in this context, part of the apparent difference between the two school's efficiency conclusions is simply definitional. The Public-Choice School's focus is much more in line with the traditional definition of efficiency employed in economics. There is a deadweight loss due to monopoly, for instance, because the marginal value consumers place on another unit of the good (the price they are willing to pay) exceeds the marginal cost of the resources needed to produce it, implying that a monopolist under allocates resources to the production of the monopolized good, preventing a Pareto optimal allocation of resources, and rent seeking actually adds to this loss. Essentially, potentially productive resources are diverted into the competition for rents and as a result, the economy cannot reach its production possibility frontier. In contrast, the Chicago School emphasizes that transactions costs exist, which prevent the ideal Walrasian equilibrium. Political transfers cannot be prevented so the economy is constrained by more than just the availability of resources and production technologies. However, if the political process tends to minimize the transactions costs associated with political transfers, as the Chicago School concludes, then given the transactions costs associated with political institutions, efficiency prevails in a second best sense. These two views are in fact quite compatible, of course, at least up to this point. The regulatory process that is inefficient in the "first-best" sense suggested by the rent-seeking literature could still be efficient in the second-best sense suggested by the Chicago School, at least in a static-equilibrium model. Both views miss important costs of economic regulation, however.

Victims of the transfer process have incentives to defend their property rights, for instance, and while part of these defense costs are rent-avoidance costs arising through investments in political information and influence that both schools consider, there are other options for potential victims to pursue. Exit may be possible, for example, whether by moving to an alternative political jurisdiction, or by hiding economic activity and wealth (e.g., moving transactions "underground" into black markets). Yet another option, as Kirzner (1985) stresses, is that market entrepreneurs can find many opportunities to make what tend to be "superfluous," but none the less profitable, adjustments in the face of the artificial regulatory constraints, that frustrate the intended objectives of the regulations by diverting rents. Therefore, in order to induce compliance with regulation's discriminatory transfer rules, the rule makers will generally have to create new rules and rely on an enforcement bureaucracy, in an effort to prevent exit, to execute the rules as intended, and to block superfluous adjustments. Ignoring the opportunity costs of such superfluous innovations for now, these enforcement efforts are still another source of opportunity costs that accompany a regulatory wealth transfer process. The Chicago School ignores the bureaucracy, for instance, implicitly assuming that bureaucratic behavior is effectively controlled by legislative oversight and/or other institutionalized constraints, but even though this is not the case (Benson, 1995b) the Chicago School can still argue that the result is efficient. After all, even if monitoring costs prevent perfect control of the bureau, the political gains from allocating regulatory power to bureaucrats must exceed the political costs arising from the allocative inefficiencies and excesses associated with bureaucratic production or the bureaucraticized regulatory process would not survive. Thus, given the political reality of transactions costs, second-best efficiency apparently prevails! Consideration of insights from the Austrian and neoinstitutional schools of economics tend to undermine these Chicago School conclusions, however. For instance, in contrast to Chicago-School assumptions, the institutions and the transactions costs that arise under them are not exogenous (Breton & Wintrobe, 1982; Twight, 1988; Crew & Twight, 1990; Benson, 1999, 2001b, 2002), and therefore, the evolution of a regulatory regime is path dependent. Thus, the political efficiency emphasized by Becker (1983), Stigler (1992), and other contributors to the Chicago School is cast in a different light. There may well be incentives to minimize the wealth dissipation that occurs in such an environment, but the efficiency that is achieved is specific to the evolutionary path. Had a different path been initiated, the level of wealth dissipation may well have been considerably less. Thus, the Chicago School's efficiency arguments do not really even apply in a second-best sense. Perhaps they can be thought about as third-best efficiency arguments because they suggest that *given the institutions that exist* actions should be take to minimize wealth dissipation, and while this can be an important issue to consider in some circumstances, it would appear to be a relatively uninteresting and unimportant one to focus on when considering the efficiency of interest-group regulation (let alone an entire political system, as in Wittman, 1989). Instead, a return to classical political economy, comparative institutions analysis, is a more fruitful approach to political economy. Buchanan (1989) calls for such an approach, of course, but the arguments made here are that even that approach misses important points if it is carried out within the framework of static-equilibrium analysis.

The transactions costs of assigning and enforcing property rights mean that entrepreneurial opportunities to exploit uncontrolled margins inevitably exist, so the disequilibrating consequences of efforts to use legislation and regulation to produce wealth transfers may be much more significant than any of the consequences discovered through static-equilibrium analysis. Kirzner (1985) explains that one consequences will be the stifling of entrepreneurial innovations in the regulated market. Potentially beneficial (wealth increasing) innovations will not occur as entrepreneurs are diverted along a new evolutionary path involving superfluous innovations that are motivated by efforts to capture artificially created rents. Such "microeconomic" effects may be far more costly in the long run than the costs identified in the rent-seeking literature, and it is difficult to imagine how the Chicago School could argue that these costs are somehow minimized by political actors since there is no way to even observe or measure them. If such an argument could be made, perhaps we would arrive at a fourth best efficiency conclusion, but there is a broader "macroeconomic" effect as well, as suggested by North (1981, 1990) and implied by Olson (1965): faced with the probability of involuntary transfers, productive individuals' property rights to their resources, wealth, and income flow are perceived to be relatively insecure, so their time horizons are relatively short, reducing incentives to invest in maintenance of and improvements to their assets, and their incentives to earn income and produce new wealth that might be appropriated, also are relatively weak. Thus, a rent-seeking society is, in a macro sense, a relatively unproductive society. As the rent-seeking process becomes more intrusive, property rights become increasingly insecure, and the opportunity costs of regulation can become tremendous, stagnating an entire economy or putting it into absolute decline (not to mention the corruption, violence, disease, starvation, and other drastic consequences that typically arise in such economies). Surely, Chicago School political economists cannot believe that the political processes in places like Haiti and most of sub-Sahara Africa are efficient, even in a sixth-best sense?

NOTES

1. Also see Boettke and López (2002). Actually, the members of the various "schools" of thought discussed below (public choice, Austrian, neoinstitutional, Chicago) are far from homogeneous, and there can be considerable overlap between them. The following discussion uses these categories in order to label different perspectives on the political economy of regulation, recognizing that many people who might identify themselves with one of the schools may not adopt the views in their entirety.

2. The focus here is on economic regulation, but similar conclusions are likely to apply for other forms of government intervention, including government ownership of productive resources (i.e., socialism or partial socialism), as well as government taxes and transfers.

3. Austrians and public choice scholars obviously recognize the vital role of property rights, of course, but they tend to be much more central to at least some neoinstitutional analysis (e.g., as in the work of North, 1981, 1990; Cheung, 1974; and Barzel, 1989, among others), and as a consequence, some Austrians and public choice scholars miss the subtleties and nuances of property rights analysis. Neonstitutionalists similarly recognize important consequences of interest group activities, ignorance, spontaneous order, and entrepreneurship, although they do not play the central role in this approach that they do in Austrian analysis, and many of the subtleties and nuances of Austrian and public choice analysis are, therefore not recognized.

4. While Ikeda (1997) clearly recognizes this problem, he attempts to maintain the benevolence assumption anyway. However, when he discusses the dynamic evolutionary process he tends to slip out of the benevolence assumption, at times by explicitly doing so as suggested by the above quotes, and at times by simply assuming that the non-price adjustment mechanisms are in place. See for instance, his discussion of the government process (Ikeda, 1997, pp. 72–90) where only one page (85) raises the self-interest issue.

5. Special interest views of regulation have been around for a long time (e.g., capture theories), but they attracted relatively little attention in economics before the 1970s. Since then, two prominent strands of "special interest" regulation have developed, each tracing back to the publication of seminal papers. The Chicago School's focus on regulation was stimulated by Stigler (1971) while the rent-seeking literature of the Public–Choice-School traces its roots to Tullock (1967). These two strands of literature actually have much in common (Tollison, 1982) since both Stigler and Tullock clearly build on earlier theoretical work by many of the same writers (e.g., Downs, 1967; Buchanan & Tullock, 1962; Olson, 1965). They both reject the "public interest" or "market failure" explanations for regulation that dominated economics before their publication, emphasizing instead that regulation is the outcome of a political competition between relatively narrowly focused interest groups seeking wealth transfers or artificial rents. Both also rely on static-equilibrium modeling (game theory is relatively prominent in the rent-seeking literature but it tends to focus on one shot games). Therefore, the following overview of static-special interest regulation models draws freely from both schools. These two approaches do diverge, however, particularly in their conclusions regarding the efficiency of such transfer processes – see Section 4 for discussion.

6. Stigler (1971), Peltzman (1976), and others who adopted the interest group theory of government assume that the object of interest group demand is a transfer of wealth. This might be somewhat misleading, however, if it is interpreted to imply that individuals become involved in interest group activities only if they can gain (or avoid losing) monetary or physical wealth. Clearly this is not the case. In fact, while potential self-interest motives can often be identified for groups seeking changes in laws and regulations, many members of the relevant groups firmly believe that the changes they demand are in the "public interest." Of course, the "public interest" is totally a normative concept – it is what each individual subjectively believes it to be. Indeed, beliefs may well be endogenous as individuals rationalize their self interests (Ikeda, 1997, pp. 110–117; Benson, 2001a). Furthermore, because of pervasive ignorance, and inherent uncertainty, those beliefs and interests (preferences) are likely to be continually changing as time passes and people undergo the experiences of life (Vaughn, 1994, p. 80). Of course, if "wealth" is more broadly defined to mean well-being or satisfaction then there is little cause for confusion, but then the model can lose considerable predictive power as testable hypotheses are not readily apparent. The rent-seeking approach suffers in a similar way. Rents are returns to the use of unique assets (real resources, such as fertile land, advantageous locations, personal skills, or artificially created assets, such as licenses, franchises, or legally defined markets), but some interest groups do not appear to capture any "economic returns." Again, if these rents are considered more broadly to include gains in well being or satisfaction then the concept might be applied to such groups, but the model then loses predictive power. Therefore, the focus here is on the allocation of property rights. As a result, the model applies to the members of groups like the Sierra Club and the American Civil Liberties Union, who may not think that they obtain any personal gain (wealth, rents) from their political activities (even though they clearly gain subjective value). This property rights perspective has advantages beyond clarifying the consequences of actions taken for the benefit of successful interest groups – see Section 3.

7. Consider Tullock's (1967) analysis from this perspective. Theft is an attempt to claim assets or resources that are not perfectly protected – that is, property rights are not completely secure. Thus, thieves use resources, particularly their time, in order to claim these assets, and potential victims use resources in an effort to deter or prevent theft. Tullock then points out that precisely the same analysis applies to the political transfer process, but if property rights were perfectly delineated and perfectly secure there could be no rent seeking. It is because they are somewhat less than secure, that they are vulnerable to takings through the political process. So some individuals and groups expend resources in an effort to get property rights altered so that the assets will be used as they want them to be, and others expend resources in an effort to defend their claims. Both theft and rent seeking arise because property rights are not perfectly and completely delineated.

8. Recall Note 5 and note that the Chicago School's model of regulation generally ignores the bureaucratic regulatory process itself, suggesting that they assume effective legislative control – a major source of departure between the Public Choice and Chicago Schools (Benson, 2002).

9. If this is the case, then the Chicago School's perspective on the regulatory process alluded to in note 8 is supported – the interests of the bureaucrats can be ignored, with focus on the interests of legislators and interest group members, but as explained below, the evidence tends to reject this view.

10. For a more detailed discussion of both theoretical models of and empirical evidence regarding bureaucratic performance, see Benson (1995b).

11. Additional empirical evidence of bureaucratic discretion and the importance of discretionary budgets is provided by Kress (1989), Benson et al. (1995), and Mast, Benson, and Rasmussen (2000).

12. This section draws heavily from but expands upon Benson (2002).

13. It should be noted, in this context, that property rights precede the rise of the state (Ellickson, 1993; Benson, 1999). The state is not necessarily the source of property rights, but the state is a threat to property rights because of its coercive power and ability to reassign or attenuate rights.

14. Neither Mises nor Cheung explicitly begin their analysis of price controls with interest groups demanding such regulation, but assume that such a group successfully lobbies a legislature to set prices below the market clearing level in order to transfer wealth to consumers from producers. Rent controls are expected to benefit tenants rather than landlords, for instance, and they arise in communities with large populations of renters who have considerable political influence.

15. In fact, Cheung (1974) contends that rational responses by economic agents imply that wealth dissipation should be a constrained minimum, as people should use the lowest-cost methods available to them under the constraints that exist in order to claim the value that the regulations place in the public domain.

16. Note that there are important differences between entrepreneurial discovery in markets, and entrepreneurial discovery in the political arena (e.g., price signals are not likely to be relevant in non-market settings, except through bribery and "contributions," so barter exchange is generally required), as Ikeda (1997, pp. 77–83) explains, but these differences do not alter the prediction made here.

17. Political entrepreneurs might also pursue political offices where they are in a position to make and/or enforce rules in ways that will generate personal benefits

(for instance, once in office they may simply have to threaten to reallocate some property rights in order to extract part of the existing rents for themselves–McChesney, 1987). Furthermore, the bureaucratic institutional process can be characterized as one dominated by "entrepreneurial competition" in an Austrian sense (Breton & Wintrobe, 1982, pp. 108–131), as explained next. Also recall the issues raised in note 4 and recognize that in the context of traditional Austrian political economy, which assumes benevolence on the part of the government, notions of political and bureaucratic entrepreneurship cannot be convincingly motivated.

18. See Tullock (1965); Benson (1983, 1995b); Benson et al. (1995); Mast et al. (2000); and other references discussed in Benson (1995b).

19. Government employees' unions are also likely to play a considerable role in the policy-making process (Johnson & Libecap, 1994, pp. 76–153). These unions have a relative advantage because of their ability to: (1) promise to bring large numbers of narrowly focused voters to the polls (Johnson & Libecap, 1994, pp. 126–136), (2) contribute large amounts of funds to campaigns (Johnson & Libecap, 1994, p. 127), and (3) threaten to disrupt services that only they can legally provide or cause other political problems for elected officials (Benson, 1983). Furthermore, their primary goals are often not in direct opposition to the goals of any other powerful and well organized group (Johnson & Libecap, 1994, p. 138). General taxpayers lose when government employees are paid more than they need to be, for instance, but the per capita gains for the organized government employee union members are much larger than the per capita losses to individual taxpayers, the unions are organized, and taxpayers are not.

20. In contrast to Chicago School analysis that sees transactions costs exclusively as the cause of institutional evolution, the argument here is that transactions costs are endogenous, at least to a degree (also see Twight, 1988; Crew & Twight, 1990; and Benson, 1999, 2001a, 2002 in this regard).

21. Others may also support the bureaucracy in this regard. Individuals facing large potential losses due to the discretionary application of complex rules will want to avoid the negative consequences of such rules, for instance, so specialists in interpreting rules and avoiding their consequences are likely to offer their services to such individuals. Like bureaucrats, however, these specialists (e.g., lawyers, tax consultants) also rely on the process and its complexity for their livelihood, so they have incentives to organize and gain political influence in order to resist changes in the system that might reduce the demand for their services, and to demand stronger barriers to exit from the jurisdiction in which they have developed specialized expertise (Benson, 1995a).

22. The most detailed analysis of bureaucratic institutional evolution, Johnson and Libecap's (1994) study of the United States federal bureaucracy, supports this prediction. In political competitions the winners rarely receive all that they want (Peltzman, 1976), but Johnson and Libecap (1994, p. 97) find evidence of "remarkable lobbying success" by the federal employee unions.

23. See Notes 5, 8, and 9.

24. Other roots of this view include Coase (1960), where the Coase Theorem is developed, which suggests that the assignment of property rights does not affect efficiency as long as bargaining is possible but that high transactions costs prevent bargaining when such costs exceed the expected benefits, and Stigler (1958), where

the "survivor principle" is proposed as a test of efficiency for firms (the Chicago School's political economy extends this principle to political institutions).

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THE AUSTRIAN THEORY OF THE BUSINESS CYCLE: REFLECTIONS ON SOME SOCIO-ECONOMIC EFFECTS☆

Walter E. Grinder and John Hagel, III

PREFACE

Of all the various interventions into the market economy, which have been invented and implemented by man and state, those that historically have caused the gravest consequences in the advanced industrialized economies surely are the inflationist policies, which lead inexorably to the business cycle in all of its various aspects and manifestations. In this paper, we shall attempt to trace through a number of socio-economic consequences and implications of the business cycle. We are convinced that ultimately the business cycle has political implications, which are just as far reaching and grave as its numerous economic consequences.

We believe that the monetary interventions leading to the business cycle are the most important in the whole panoply of government interventions

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into the market, all of which are rapidly transforming the market mechanism of exchange and resource allocation into a centrally and arbitrarily controlled economic system. However we are also convinced that along the path from the free market to the controlled economy, other sinister results of the business cycle are encountered as well.

The inflationist policies not only cause purely economic dislocations, they also cause deep sociological divisions within society in general and within the business community in particular. Perhaps the fundamental fact that must be realized about inflation and the business cycle is that all members of the socio-economy are not affected equally, neither at the same time nor in the same manner. There is a process of wealth redistribution and class entrenchment, which takes place such that some in the economic community reap substantial gains at the expense of others. In terms of actual political-economic power relationships, the business cycle tends overwhelmingly to aid the financial sector of the economy at the expense of the non-financial sectors, and the banking institutions attain an increasingly powerful hegemony especially over the more capital intensive corporations.

Monetary interventions into the market set group against group and sector against sector. Ultimately, these and other such interventions lead to the creation of classes, pitting aspiring classes against a further entrenched class in a never ending grasping for rationalization and control of an increasingly impossible situation.

For the purposes of procedural simplicity we shall assume for our analysis a beginning state of an unhampered market economy, which has reached a state of general equilibrium.[1] We shall furthermore assume that such an unhampered market is a "natural" social economy and that the socio-economic and political relationships, which are obtained under such a regime are what we will call in the aggregate, a *social economy*.[2]

We shall then introduce into this fully coordinated social economy the monetary interventions which necessarily led to a number of discoordinations and malinvestments all of which will bias the productive structure in favor of the capital goods' industries (the monetary-over-investments theory of the business cycle). We shall first follow these interventions through the economic structure tracing their purely economic consequences. We shall then attempt to sketch out the wider sociological and political implications of such interventions.

We shall call the pattern of socio-economic relationships, which have thus deviated away from those of the social economy a system of *political economy*. There are, of course, numerous varieties of the political economy, ranging from simple and singular interventions to the more systematic interventions of "political capitalism" and finally to the total interventionism of *Zwangswirtschaft* and socialism. At each stage in this process the "natural" social economy relationships become more and more "politicized" and the incipient class relationships harden until finally only the political relationships remain and the social economy has become completely overwhelmed by an atavistic and feudal caste order.

It is the business cycle in all of its ramifications, which we contend is the unintended but key element in this process which, if allowed to proceed, surely will lead to the demise of the market mechanism as the world has known it for the past 200 years. We do not claim to trace and explain all or even most of the socio-political effects of the business cycle. That would, of course, be both presumptuous and impossible. We do, however, hope that what follows will lead to a somewhat clearer understanding of the heavily hampered market system in which we shall be living in the years and decades ahead.

1. A POSITIVE STATEMENT OF AUSTRIAN BUSINESS CYCLE THEORY

1.1. Central Banking as the Fundamental Intervention

There is nothing in general economic theory (micro-economics) that would lead us to believe that the free market system would sequentially and recurrently waver back and forth between strong upswings and sudden downturns in economic activity. On the contrary, economic theory tells us that the widespread macro-discoordinations such as sudden accelerations of price rise in general, periodic swings in production, and periods of massive idle resources would be virtually impossible on the unhampered market.

Entrepreneurial decisions are made in the face of an uncertain future and since men are not omniscient, some – perhaps many – entrepreneurs will make mistakes in anticipating future configurations of events. Nevertheless, it remains clear that these kinds of mistakes and the consequent malinvestments arising from them would not lead to periodic, sequential booms and busts of productive activity. There is no reason to believe that such mistakes would be distributed in anyway other than randomly. Furthermore, economic theory tells us that in spite of the disequilibrium forces of unanticipated change, the entrepreneurial forces of convergence always *tend* to lead the various markets toward equilibrium. There is no reason to believe that what is true in the individual cases is not also true in the aggregate. While there will surely be many instances of misinterpretation of market signals and consequent misinvestments, there is every reason to believe that the effect of such mistaken interpretations of market data will be isolated and minimized by other equilibrating forces in the market. In any case, we have every reason to believe that these misinvestments will be isolated and random, not pervasive and systematic.

Since there is nothing inherent in the unhampered market, which would lead to the booms and busts of the business cycle, then, of course, the cause must be an exogenous one. The Austrian theory of the cycle as developed by Mises and Hayek[3] explains industrial fluctuations as a result of the infusions of bank credit into the producers' loan market. The Austrians then trace the effects of such monetary influences on the real structure of production. It is here that we find the ultimate cause of *systematic* distortion in the market system, which leads to the periodic boom-bust cycle.

But how does such monetary meddling come about in the first place and why does it (seemingly inevitably) continue to plague all advanced industrialized market economies?

Money is an institution.[4] That is to say, money is the result of an evolutionary process of exchange. Historically, out of exchange one or more *commodities*[5] have been chosen by the market participants as a medium of exchange and a common denominator used for price calculation.

Again, historically, along with the development of the institution of money has come the *development* of another important institution, that of banks and banking. Banks served first as warehouses for the storage of commodity money. In a short time, warehouse receipts began to circulate as money substitutes.

It would seem that a "natural" social economy[6] would remain such only if the circulating money substitutes are equal to the amount of commodity money extant, i.e. 100% reserve money.[7] Any increase in unbacked substitutes (fiduciary media) introduces "unnatural" forces into the exchange nexus, forces, which will lead inevitably to discoordination and *systematic* economic and social dislocation.

But even assuming that the creation of fiduciary media were not treated as fraudulent accretion of assets, a regime of free banking would and historically has put a severe check on the issuance of unbacked money substitutes. Everyone admits that there is an inherent temptation on the part of bankers to expand the supply of money substitutes beyond their commodity reserved (i.e. to engage in fractional reserve banking). On a free market, however, attempts to pursue such a policy are thwarted by competition and the interbank clearing house function. Non-inflating banks will demand payment in specie for another bank's notes or checks, and there will therefore always be an inherent check on widespread inflation as long as competitive banking exists.

It seems clear that there could not be systematic macro-dislocations under a regime of 100% reserve money. It is also clear that free competitive banking would tend to minimize such dislocations even where there are attempts to pursue fractional reserve banking policies under conditions of competitive banking.

The other alternative is for all banks to work in concert, which means to form a cartel. The reasons why voluntary cartels tend to break down in the face of free market competition are too numerous to mention,[8] but historically none has lasted for long. Since voluntary cartels do not work, bankers in one western capitalist nation after another have resorted to forced cartelization in partnership with or under the control of their respective governments.

It is under a regime of central banking that the large scale increases in fiduciary media can be pumped into the economy, increases in notes, but mostly increases in demand deposits. It is furthermore the case under such a regime that systematic dislocations of the business cycle are most pronounced and wreck the greatest havoc.

1.2. Time and the Structure of Production

There are three crucial real economic effects of systematic monetary intervention into the market system. First, there is the periodic recurrent nature of the cycle. Second, there is the cluster of entrepreneurial error phenomenon. Third, the capital goods section is affected more both on the upswing and the downturn than is the consumer goods section. That these three phenomena happen is a fact; why they happen has to be explained.

In the first half of the 19th Century, the Ricardians and the Currency School of English economists[9] explained the problem of periodicity in terms of the quantity theory of money. As the money supply increased (increases in fiduciary media) business activity picked up, a euphoria pervaded the business world, business debt increased, higher risk investments were undertaken, the ratio of commodity money to money substitutes declined, the domestic price level increased, imports increased, exports lagged, the reserve ration declined even further, call loans were called and the overextended financial house of cards began to collapse, a decline in production accelerated, deflation ensued, the reserve ratio returned to a more healthy state, prices fell (including wages), exports increased, reserve ratios and economic activity returned to normal. Hence, the periodic boom and bust.

The big failing of the Currency School's explanation was that in focusing on the price level they overlooked the changes in the compositions of the structure of production that took place during the cycle. It was not until the last days of the 19th Century that the Swedish economist, Knut Wicksell began to see clearly that increases in the money supply led to a deviation of the market rate of interest away from the natural rate, a rate, which was based on the outgrowth of voluntary intertemporal exchange due to differences in time-preference. Wicksell, too, however, focused his attention mainly on the price level and hence did not see the full effects on the structure of production that such a deviation from the natural rate would bring about.

Ludwig von Mises took the Wicksellian insight and began to build what is now known as the monetary-overinvestment theory of the cycle. It was in Mises and in the work of his most famous follower, F.A. Hayek that the answers to questions two and three are to be found.

In an evenly rotating economy where every tomorrow is like every today, the structure of production would be in perfect equilibrium (see Fig. 1). The crucial concept of Austrian capital and production theory, which applies here, is the concept of *complementarity*. Everything "fits together." Each factor of production complements each associated factor of production. The value of all factors of production is imputed to the structure of production. Products flow down the structure of production. Production itself is a series of exchanges through time between the various orders or stages of production. The very highest orders of production are furthermost removed in terms of *time* from the ultimate consumer. The further down the structure of production, the closer the ultimate product is getting to the ultimate consumer in terms of *time*.

Time and complementarity are, then, the two key and ubiquitous elements in the structure of production. In equilibrium, as the product flows down through the structure of production from stage to stage, it can be seen that just the correct amount of demand will be there to purchase the product, and just the right amount of product will be produced to supply each stage. All of this intricate structure is held together by prices, which in equilibrium sends just the right amount of coordinative information throughout the structure. Perhaps the most important of these prices is the structure of interest rates holding together intertemporal exchanges, which in the production process are the only kinds of exchanges, which take

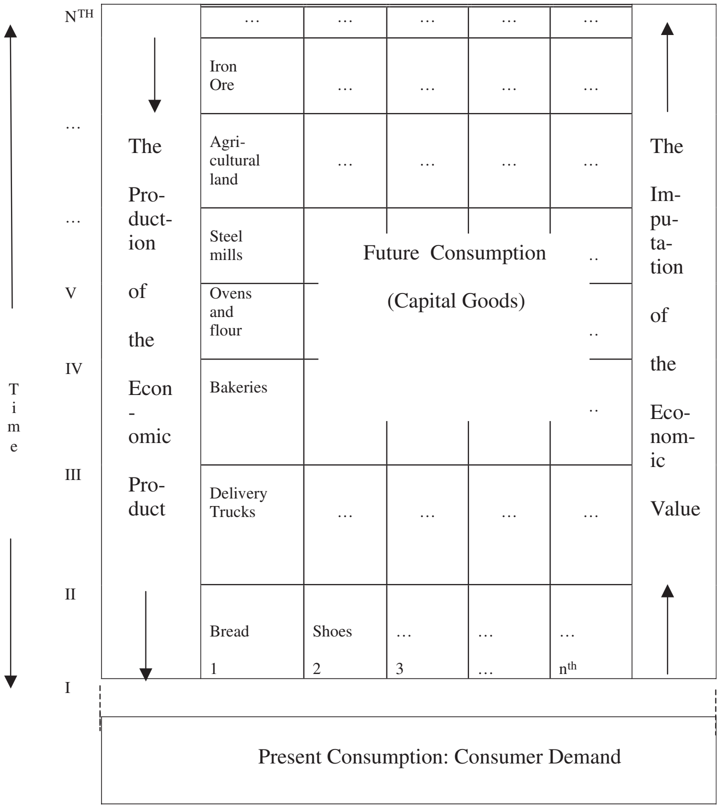

Fig. 1. The Structure of Production.

place. The structure of production is like a delicate latticework[10] held together at each of its points of convergence by intertemporal exchange rates. Although there would be nothing in the real world approximating the perfect complementarity assumed under conditions of equilibrium, there is nevertheless a tendency in a free-market, social economy, toward such complementarity. One of the most important entrepreneurial functions in the real world is to take what is discoordinate (past mistakes), and "fit them in," consequently achieving a continually greater measure of complementarity.

It is imperative to recognize that at any given time, the structure of production of the social economy embodies and reflects the intertemporal preferences of the market participants in the aggregate. The proportion of future goods (capital goods) vis-à-vis present goods (consumer goods) will be a direct reflection of the economic community's social rate of discount or time preference. If there are relatively more producers' goods, that would indicate a low time preference and a higher demand for future goods. If there are relatively more consumers' goods, it would reflect a higher time preference and consequently a lesser concern for the future. In any case, the structure of production will reflect the voluntary savings-consumption pattern; it will embody the community's demonstrated intertemporal preference.

It is this delicately interwoven structure of complementarity into which bursts the infusions of bank credit which wreck confusion and dislocation. It is to these infusions of bank credit that we must look if we are to explain (1) the cluster of entrepreneurial error and (2) over-investment in the higher orders of production and under-investment in the lower orders.

A concerted increase in the money supply distorts the flow of information of the market economy, the price system. Since the changes in the money supply occur *through* time and space and do not mean the same thing to all people in all sectors, such a change will affect different orders of the structure of production differently.[11]

What the cruder from of the quantity theory of money essentially focused its attention on was the effects of the depreciation of value of the supply of money that followed each infusion of new money, i.e. changes in the price level. What the more sophisticated (Misesian) theory of money focuses its attention on is that increases in the supply of money distorts the structure of interest rates away from the natural rate. It is after all this "natural" constellation of interest rates, which reflects the market participants' real time preferences, their real consumption/savings pattern. By tampering with the natural structure of rates there begins a systematic movement of the structure of production away from the true wishes of market participants as they have demonstrated in their consumption/savings decisions.

To counter this insight with the naïve assumption that deviations by the "nominal" interest rate away from the "real" rate will be foreseen and automatically adjusted to, is but to show a misunderstanding of the whole problem. This misunderstanding is a natural result of focusing on the price level rather than on relative prices. The crucial insight of Austrian cycle theory is that not all sectors of the productive structure are affected in the same manner and at the same time by a change in the money supply, and therefore cannot be correctly anticipated. Furthermore, this insight is not merely the important but rather simplistic knowledge that debtors gain and creditors lose during inflation. This latter is simply another way of focusing on the price level at the expense of overlooking the far more important and deeper consequences within the structure of production.

As the supply of bank credit increases, interest rates decline, which is the same thing as saying that the cost of money capital declines. Since the cost of money capital is characteristically the most important cost consideration for future capital expansion projects, as this cost declines, major new capital investment is undertaken which previously was deemed to be economically unattractive. Thus, the projects which were previously seen as unprofitable (and therefore from the point of view of the social economy, socially undesirable at that time) suddenly become profitable.

It must be stressed that this change in profitability has come about solely as a result of monetary expansion and not because of a change in "real" conditions. This artificial lowering of the interest rates is the key distortion in the transmission of information through the price mechanism, and it is caused solely by the expansion of bank credit of a fiduciary nature. The lowering of the interest rates creates the impression that there has been an increase in real savings, that there has been a general lowering of time-preferences among market participants, and that there is more capital available to embark upon more time-consuming production processes. Of course, what there is more of is money, and this critical price distortion soon begins to take its toll. This explains why there is a sudden cluster of entrepreneurial error. It is because they are flooded with a cluster of misinformation, unnatural information, if you will. Yet, this only partially and therefore inadequately explains just why investment funds begin flowing in proportionately greater amounts into the capital goods sector at the expense of the lower orders.

No one has ever put the answer to question number three more succinctly and clearly than Lionel Robbins. Robbins says:

> The fundamental fact on which we must concentrate our attention is that borrowing is cheaper. This means the profitability of all forms of production which involve making things which only yield services at a later date, or over a long period of time, is increased … . The longer lived the capital instrument or the greater its distance from consumption, the more its value is affected by a change in the rate of interest. The shorter-lived it is, or the less its distance from consumption, the less is it affected. The value of flour in the baker's shop is hardly affected at all by a cheapening of the cost of borrowing. The value of mines, forests, houses and heavy factory equipment is enormously affected.[12]

Not only, then, does the cost of money capital decline as interest rates fall, but another aspect of the same phenomenon is that as the interest rate declines, present capital values increase. In Fig. 2 we see that an asset which will produce $10,000 in the present and whose durability ends upon producing the

Year	10%	7%	5%
0	$10,000	$10,000	$10,000
1	9,090	9,350	9,520
2	8,260	8,730	9,070
3	7,510	8,160	8,640
4	6,830	7,630	8,230
5	6,200	7,130	7,840
6	5,640	6,660	7,460
7	5,130	6,230	7,110
8	4,660	5,820	6,770
9	4,240	5,440	6,450
10	3,850	5,080	6,140

Fig. 2. Impact of Interest Rates on Present Capital Values.

present product will also have a present value of $ 10,000. If that asset yields its product one year hence, its present value at a 10% discount rate will be $9,090; five years hence, $6,200; and 10 years hence, $3850. We see that in the one year case a decline in the interest rate to 7% will bring a net gain in present value of $260; in the five year case the present gain would be $930; in the case of 10 years, the gain in present value would be $1,230. If the increase in the money supply were sufficient to drive the interest rate from 10% to 5% the gain in present value of an asset which would pay off after one year would be $430, after five years $1,640, and after 10 years, a very substantial $2,290. The change of $430 in the one year case would be significant but a mere 4.7% gain. The asset which yields the income only after 10 years, would bring about a change of $2,290 in present value, a gain of almost 60%.

The present value of $10,000 income at future dates and at different rates of interest is shown in Fig. 2.

A businessman-borrower in the producers' loan market need not be endowed with any super intellectual powers to see that investments of longer duration are far more lucrative than projects that will reach fruition in the near future. It would seem clear, then, why the preponderant majority of new bank credit will always tend to flow into the higher orders and thus create a greater boom in those higher orders as economic activity begins picking up steam.

1.3. The Anatomy of the Cycle[13]

For purposes of presentation, it is simplest to assume an economy in which there is no problem of idle resources and in which something approximating equilibrium has been achieved.[14] It is into this idyllic setting that the infusions of bank credit stream.

Entrepreneurs will borrow new funds and enter the resource markets, bidding away the factors of production from more socially useful (as determined by the operation of the social economy) projects in the lower orders of production. It is these factors, which are producing lower order capital goods and consumers' goods; hence there will be fewer more nearly present goods being produced than otherwise would have been the case. There follows a misdirection of social capital and a consequent decline in the general economic welfare.

Production processes that are more time consuming will take place at the expense of less time consuming processes. Resources will be bid away from the lower orders into the higher orders. The new money via the entrepreneurs will bid prices up throughout the higher orders. The process leads to a hyper-active boom atmosphere in the higher order capital-intensive industries in general and in the construction industry, raw materials, machine tools, etc., industries in particular.

Since the cost of capital has declined and since the demand pressures of new money begin to bid up the nominal wages, real wages will increase. Given this situation and given a measure of substitutability, entrepreneurs will begin to shift, insofar as it is possible, away from labor-oriented methods into more capital-intensive methods of production. This is what is conventionally known as the Ricardo effect.

It should be clear that there is one other major difference between the switch that takes place in the structure of production caused by a change in time preference, on the one hand, and a change caused by monetary tampering on the other. In the situation of natural change there is a voluntary reduction of current consumption and consequent diversion of factor compensations from the lower orders to the higher orders, the former declining and the latter rising. There is, however, *no increase* in factor incomes in the aggregate. In this situation of monetary-induced change there is no voluntary reduction in consumption and there is actually an *increase* in factor compensations and hence total incomes.

Since there is no reason to believe that resource owners have altered their previous consumption/savings preferences, when these factor owners in the higher orders receive their additional incomes we can assume that they will allocate their incomes on the basis of their previous consumption/savings pattern. Because fewer factors of production in the lower orders result in a lower supply of consumers' goods, the new money thus coming into the consumption market from the increased incomes of the factors of production in the higher orders puts additional demand pressure on a proportionately reduced output of consumer's goods and thereby generates price rises in the very lowest orders of production. Hence, the problem of price inflation begins.

If there are no further increases in the money supply, increases which would have the continued effect of holding (at least in the intermediate run) interest rates below their natural level, then as the resource owners begin to reassert their old consumption/savings pattern with their new and *increased* incomes. Prices, again, will begin to shoot up rapidly in the lower orders. This is truly the pivotal stage in the business cycle, for it is at this point that the investments based on previously distorted price information begin to become apparent.

As prices rise rapidly in the lower orders, the rate of return of investment also rises substantially. In the meantime, demand for the output of production processes in the higher orders fails to materialize. The false or unnaturally induced structure of production and flow of products is rendered *unsustainable*. The monetary authorities either will begin a process of reinflation to attempt to sustain the false structure, or they must allow the prices of resources to readjust. The structure of production must once again move to conform to the demands of the social economy. It must again achieve a high measure of *natural complimentarity*, a structure that can and will be sustained by natural consumption/savings investment decisions.

It is important to underscore just why the anticipated cost/yield relationship upon which the initial entrepreneurial decision was made turns out to be mistaken. As the new money goes from the entrepreneurs to the factor owners, the prices of the factors are bid up higher than was anticipated at the point of the decision. On the other hand, the anticipated demand for the flow of product fails to materialize in the planned time sequence. So there is a double edged assault on the anticipated return: costs rise and yields decline or even fail to materialize altogether. Projects undertaken on the basis of the anticipated cost/yield ratio simply cannot be sustained under the unprofitable real conditions.

If left to happen by itself, the period of price adjustment will tend to move rather rapidly. Higher prices and thus higher returns in the lower orders combined with the failure of anticipated cost/yield relationships in the higher orders will lead to a rapid flow of liquid capital from the higher orders to the lower orders. Unsustainable fixed capital projects will have to be liquidated. They will have to go into receivership and be reorganized in such a manner as to fit back into the natural structure of production, i.e. true complementarity will have to be restored.

The major thing that must happen during the adjustment period is that those prices of factors that were distorted (bid up too high) on the upswing will have to fall back down to where they fit back into the structure of production profitably. Interest rates, now no longer held artificially down, must rise to reflect the true time-preference relationships.

It will be remembered that on the upswing, there was a substitution of capital for labor wherever possible because of the rising real wage rates. As prices in the lower orders begin to rise back to normal levels, *real wages fall*. There will be, therefore, a substitution of labor for capital wherever and to whatever extent possible. This is what Schumpeter rightly calls the Hayek effect. It is obvious that the more intensive the upswing, the more extreme the downturn will have to be. Just as the shift to more capital-intensive methods during the upswing had a very stimulative effect on the higher orders, the substitution of labor for capital during the downturn has a very depressive effect on those same higher orders. It should be noted that any policy which frustrates the period of price readjustment or attempts to stimulate consumption will merely exacerbate the situation and lengthen the period of readjustment, the recession. What is needed to salvage some of the misinvestment is greater savings, not more consumption. But even if there were a great increase in savings, there would nevertheless remain numerous instances of time-consuming projects, which could not be saved until there was a tremendous drop in their market values.

Therefore the recession is a process of extensive liquidation of malinvestments. This means widespread increases in idle resources as well as the temporary abandonment of, in many cases, half-completed projects. While these instances of bankruptcy, liquidation, and idle resources are undoubtedly the most dramatic aspect of the whole business cycle, it should remain clear that the most important aspect of this period is in fact the process of price readjustment during which factor prices fall relative to product prices. These price declines must continue until the spread between factor prices and product prices at *all* stages in the product process once again begin to reflect the prevailing true social rate of discount or time-preference of the market participants.

It is important to repeat that the problem troubling the economic system during the business cycle is a problem of large-scale discoordination of relative prices. It is a problem of *discomplementarity* of the various orders of production. Only when there is a full adjustment of factor prices and product prices at *each* stage of production will the idle factors of production be returned to productive activity.

It should be emphasized that there has been no mention of the general price level because that is not where the problem lies. Nor does the problem lie in the relationships between macro-aggregates, aggregates that are generally ill founded and meaningless concepts anyhow.[15] Although the recession is known as a period of falling prices, it is necessary to stress that this period will not necessarily be characterized by a decline in prices generally (deflation). Once again, the crucial consideration is not aggregate price levels but rather relative price relationships. It is only the misdirected investments, which must be liquidated and redirected into the true scheme of the productive apparatus.

It is the boom period during which the waste of social capital takes place. It is therefore the boom period, which is the antisocial phase of the cycle. The recession is indeed the pro-social period of healthy purgation. Once the point where the Hayek effect begins to take place is reached, the only thing that can postpone the necessary and cleansing phase of the cycle from taking place is further increases in the money supply. The old rate of increase will, however, now prove to be too little to achieve the same level of investment (misinvestment). It is therefore necessary to expand money and credit at an ever-accelerating rate.

Just how long this can go on seems to be a matter of conjecture. Generally, financial disturbances have historically caused slow downs in the money expansion before the currency reaches such a rapid depreciation that it no longer serves its function as a tool of intertemporal price calculation, although we are all aware of the post World War I Germany and post World War II Hungary and China. Nevertheless, whenever the inflation of the currency does stop *or slow down*, the Hayek effect becomes operative and the downturn must begin. As we said before, the longer and more intensive the upswing, the more calamitous the downturn. There is simply no way to put off the recession forever.

2. SOCIO-ECONOMIC IMPLICATIONS OF THE BUSINESS CYCLE

2.1. Central Banking and the Political Economy

In Section 1, we outlined the Austrian theory of the business cycle. Section 1 also serves as the necessary groundwork for much of what we will cover in the remainder of the paper.

Here, we will attempt to trace some of the major sociological and political effects of this business cycle. Here we are treading on what we think is often new territory, but also an area which is of extraordinary importance. Because it is often new application of business cycle theory, we shall only be able to speculatively sketch the areas that we deem important. We hope in later papers to go into some of these areas in more empirical detail. We furthermore hope that we will have induced others to do likewise.

The analysis here also depends for its support on work that we have done previously.[16] This is especially true of our assumption that the capital markets and the financial institutions play an increasingly important ultimate decision-making (entrepreneurial) role in and advancing, industrialized *social economy*. That which is true but innocuous under a regime of social economy assumes a deleterious and even sinister character under a regime of *political economy* where central banking becomes an integral element in the socio-economic infrastructure. Not only does ultimate economic decision-making become more centralized and more entrenched, but as more and more economic relationships become "politicized" or "statized," ultimate political decision-making tends also to become more concentrated and consolidated. This in turn tends to exacerbate the concentration and circumscription of ultimate economic decision-making powers which, of course, leads to a diminuation of competition, an enervation of the market process, a decline in general economic welfare, and ultimately to an aggrandizement of the *political economy* at the expense of the *social economy*.

2.2. Spatio-Temporal Aspects of the Business Cycle

It cannot be emphasized too much that with every intervention into the economy there will be those who will gain from the intervention and there will be those who will lose because of the intervention. It is usually pointed out that debtors gain at creditors' expense as a result of inflationary policies. That is, of course, true but would be misleading if one concentrated his attention solely on this aspect of the gain-loss relationship. One of the key insights of the Austrian theory of money and of the business cycle is that new money does *not* affect all people and all sectors of the economy equally. New money moves through the economy both in temporal and spatial sequences, the results of which are often difficult to discern and follow.[17]

The temporal aspect is of great importance. On their most fundamental level, the inflationary policies made possible by state intervention in the banking sector constitute a mechanism for the redistribution of economic wealth. It is a redistribution of wealth to those who receive the additional increments of fiduciary media first at the expense of those who receive the money only at a *later time*. The spatial element in this temporal relationship adds a great deal of help in understanding where to look for the gainers and the losers. Those closest to the origin of the new money tend to gain at the expense of those furthermost removed from the origin of expansion.

It would take a very sophisticated ongoing empirical study to determine just who are the net gainers and who are the net losers, the latter really being the most difficult to ascertain, with anything even approaching precision. Theory, however, can give us a good idea of where to look for the gainers. The state always gains by its ability to inflate and take advantage of inflation first. In Fig. 3, we can see a rather crude representation of this redistribution process. The center circle represents the state with all effects of inflation spreading outward from the middle in a "ripple effect" through time and space. In the real world of political economy, it is practically impossible to separate the commercial banking system from the state, but for purposes of presentation we shall assume that the banks receive and therefore benefit next from new infusions of money. The banking system is represented by the circle numbered two. Another very difficult real world problem is to separate the state from its contractors and suppliers, although it is not nearly as difficult as is the separation of the state from the state-cartelized banking system. The recipients of the government contracts are represented by the circle numbered three, even though the banks also benefit greatly from government purchases. When the state buys from a "private" contractor, the payment is in the form of an accounting entry in the contractor's *bank* account. Both the contractor and the bank have gained: the contractor, because he can pay for resources before their prices rise, and the bank, because its reserves and therefore its loanable funds (assets) have been expanded. In the initial stages of inflation, it would appear, the state, the banks and the government contractors have a vested interest in inflationary policies.

The circle numbered four is particularly interesting because it represents firms and industries in the higher orders of production. It is these businesses, which seemingly benefit from increases in the money supply because the interest rates are driven down, the cost of capital decreases and present capital values climb. They can borrow in money terms that will likely benefit them at the point of repayment, paying back with a depreciated currency and hence lower real cost.

In the debtor–creditor relationship, debtors, of course, do gain, but the biggest debtors are almost surely to be found in the higher order

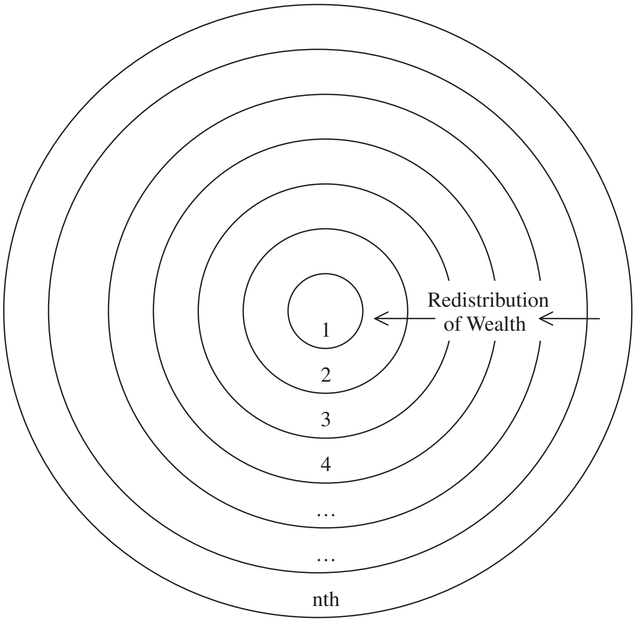

Fig. 3. Inflation, the "Ripple Effect," and the Redistribution of Wealth. The Effects of the Increase of the Money Supply Flow from the Center Circle Outward. The Redistribution of Wealth Moves in Just the Opposite Direction.

corporations, the banks and the state itself, and not among the very poorest citizens as is so commonly assumed by the average layman. The creditors are not the very rich, but rather the middle-income person who is trying to save a little each week at his local Savings Bank or Savings and Loan Association. The middle class, then, not only loses proportionately through direct taxation, but its income and wealth is expropriated by the indirect tax of inflation. Once again, as we can clearly see in Fig. 3, there is a redistribution of wealth from the outer circles to the inner circles, from those who receive increases in incomes last to those who receive incomes earlier.

As we get beyond circle four, it becomes increasingly difficult to trace the gains and losses with any sort of a priori precision. This is an area for numerous empirical studies. We do know that relatively few do in fact gain from increases in the money supply and that the great majority are losers in varying degrees. All we know for certain is that at some point, the "ripple effect" turns inflation recipients from net gainers into net losers as the rate of increase in consumer prices rises faster than the rate of increase in their incomes as resource owners. It seems important to repeat that this redistributionary quality of inflationary policies stems from the fact that a change in the quantity of money will affect prices only successively through time and space. This necessarily produces a gradient in the price structure which assures that those affected later in the process will almost surely never be able to catch up with those who were affected earlier.

Another aspect of the redistributionary effect of inflation is that of "forced savings." Since the increase in the money supply pushes the structure of interest rates below the natural rate that would prevail in the social economy, scarce resources will be turned into producers' goods in the higher orders of production. This means that there will be an underinvestment in goods which market participants by their voluntary choices have demonstrated that they want, i.e., present consumers' goods. They are forced to "save" and are thus denied the full range of consumer goods which would otherwise have been produced.

2.3. Monetary Expansion and Class Solidification

It is important to focus on the role that the business cycle plays in forming and solidifying the gainers and losers of interventionism into more nearly identifiable political-economic social classes.[18] All interventions into the market system of necessity lead to less than optimum market processes and to secondary consequences the sum result of which is always a further deteriorated real situation, which very probably will lead to even further interventions.[19]

All interventions slow the process of market adjustment and, in Paretian terms, slow the all important and necessary "circulation of elites." The monetary cause of the initial phase of the business cycle sends out distorted information which biases both the structure of production and the process of adjustment away from the true social economy and in favor of (1) the owners of the non-financial corporations in the higher orders of production, and more importantly, (2) the financial institutions upon which these non-financial corporations depend for both their long and short-run financing. Since the business cycle is caused by the expansion of new bank credit, and since the banks and higher order industries receive this new money *first*, then it seems clear that the net gainers (the winning class) from this all-encompassing intervention surely will be that very same state-banking network and higher order industries, at least throughout the upswing of the cycle. The "circulation of elites" will be significantly stalled to the degree that these two important sectors are able to continue to benefit at the expense of the rest of the economic community from the continued infusions of bank credit. Insofar as the "circulation of elites" actually is slowed by the intervention, then to that same degree will "the winning class" become solidified into what must be defined only as an entrenched and parasitic political-economic class.

To achieve a clearer understanding of the class interests, which benefit from the expansionary phase of the business cycle, it is necessary to focus our attention on the capital market in general, and the overall banking sector in particular. Then we must focus on the relationship of the capital market and banking sector to the capital-intensive industries concentrated mainly in the higher orders of production.

As was mentioned earlier, banks are particularly susceptible to the temptation to engage in inflationary practices since they particularly reap the unearned benefits of a rapid and continuing expansion of the asset base. This expansion, of course, currently in U.S. banking practices happen mainly through open market operations (purchases) and borrowing by commercial banks at the Federal Reserve's rediscount window. In either case, the reserves of the banks are increased and the loanable funds (assets) are thus also increased. These then are the direct benefits, which clearly motivate bankers in their collective desire to pursue a concerted inflationary policy.

It should be noted here that as the bank's reserves are thus increased, this frees other funds to be channeled into a wide variety of other assets, both highly liquid and real. Therefore the portfolio of the bank grows disproportionately large once again because they have access to and control over the new funds *first.* This is particularly the case when they buy into real estate, which then appreciates in value as time passes. Because, however, appetite tends to get the better part of judgment, as the upswing gathers steam, banks do tend to become overextended both in real estate mortgages and their own real estate pyramiding. This later tends to become a substantial problem when the upswing reaches its end.

In Section 1 , we discussed the necessary role of state intervention in making it possible for the banks to engage in a systematic inflationary policy. Only cartelized banking can result in system-wide inflation. This intervention, however, like all interventions, creates secondary consequences, which in many cases will not be recognized as being in any way related to the intervention. In the case of cartelized banking and its consequent inflationary policy, it is important to point out that there are additional benefits for banking institutions which likely will not be entirely consciously perceived by banking executives.

In particular, Austrian cycle theory gives us every reason to believe that there is a definite correlation between the expansion of the money supply and the increase in long-term external debt of non-financial corporations, especially those corporations in the higher orders of production. This is particularly important because it tends to provide the banks with increased leverage over industrial enterprises. It therefore leads to a further concentration of entrepreneurial control, or *ultimate decision-making*, within the banking sector.[20] The economic consequences are that there will be a further movement away from the optimum dispersion of decision-making than would obtain on the social economy. This must necessarily lead to a decline in general economic welfare. The sociological and political consequences are, if anything, even more important. For this leads to a hardening of class distinctions and further insulates the financial sector from competition, which in turn further increases its growing hegemony *in ultimate political decision-making*. This obviously becomes increasingly important, as the economy becomes less one of social economy and more one of political economy.

It is important to recognize that this process of increasing control by the banks over non-financial corporations, which occurs during the expansionary phase, is achieved without any indication that industrial profitability either has been or will be adversely affected. In fact, because new money is flowing into the higher orders and because interest rate declines bring about increases in present capital values, industrial profitability *does* increase dramatically. Even a businessman well versed in Austrian cycle theory would certainly take advantage of the newly profitable situation, although he would try to "get out" before the Hayek effect became operative (whether he would succeed in this or not would not depend much on his knowledge of Austrian theory, but rather on the efficacy of his entrepreneurial judgment). The point is that all price indicators confirm that industrial managers are correct to expand more time-consuming investment by relying on newly reduced low-cost loans. This distorted set of price relationships clearly creates a real situation in which the lender–borrower relation becomes mutually beneficial to both parties and will last so long as interest rates remain artificially depressed. Yet, the fact remains that even though both the banking sector and the non-financial corporations ostensibly benefit during the upswing, the banking institutions are simultaneously consolidating their control over corporate decision-making. It is very important to see that this *extension* of banking control is, of course, unnatural and dependent solely on state intervention into the banking sector and would not be possible under conditions of the social economy.

The most capital intensive industries, generally those in the higher orders of production, are inevitably the major corporate beneficiaries of the inflationary expansion of bank credit during the upswing of the cycle. The reduction in interest rates during the inflationary period favors these corporations since the cost of money capital plays a particularly important role in their overall cost of production and because their product is so far removed in time from the ultimate consumer. The cost of capital for these industries is important both for their current operations and the plans and actions concerning decisions for capital expansion.

Another aspect of the declining rate of interest is equally important. Although all industrial enterprises enjoy a considerable flexibility in shifting the capital/labor ratio in its production processes (production-function), this degree of flexibility is, of course, not unlimited. Such flexibility is fixed by certain parameters that are determined by the current technological characteristics of the particular production processes involved. These technological parameters vary from industry to industry. It is clear that the most capital-intensive industries are the most amenable to the change in capital/labor ratios known as the Ricardo effect, which operates especially in the initial stages of the boom. It is these industries, which are able to increase the capital component of their production processes to the greatest degree. Given the altered price relationships, it is these capital-intensive industries, which will be assured of the highest *anticipated* return on capital invested. As long as the inflationary process is sustained, such expectations will be fulfilled. These expectations will eventually, of course, be frustrated as the increases in bank credit are slowed down or halted.

2.4. Some Other Beneficiaries of Inflationism

It seems useful to focus on three other categories as leading beneficiaries of the inflationary policies, in addition to the banking sector and capital-intensive industries. The *first* is obvious, but it should be mentioned anyway. Resource owners of all types benefit as the borrowers of bank capital proceed to bid up prices for the limited resources available. This is not only true of raw materials, but also of all forms of labor that can be used in more time-consuming processes of production.

The *second* such category includes all forms of research and development industries, or R&D aspects of industries. R&D must be treated as capital investment, although we might not wish to categorize it as capital intensive. Just as surely as a lowering of the interest rate induces more time-consuming production processes, so too does such a reduction promote research projects whose operational results can be anticipated to be more time-consuming as well. The inflationary upswing can also be expected to result in research projects of increasingly long-term and intensive "pure" research or higher-order practical research which would not otherwise be undertaken because they would surely appear unprofitable.

The longer the upswing, the more "chronic" the overinvestment in the higher orders. This would include overinvestment in longer and more capital intensive R&D projects. Investment and the structure of production would continually be at variance with that of the social economy. Research would go toward the attainment of more and better capital-intensive processes at the expense of less time-consuming processes. (Here it seems important to remind ourselves that capital is limited at any given time, and that more time consuming processes cannot be implemented until more capital has been saved and reconstituted. The only other possibility is to take scarce capital way from other production processes. This, after all, is the very heart of the Austrian cycle theory). What we witness during the upswing of the cycle is the objectification of an idea before its time has come. Production processes, which would automatically have been chosen under conditions of the social economy are passed over in the rush to implement consistently premature and oversophisticated techniques and processes. All of this leads to even more chronic overinvestment in higher orders of production. It should be clear that the vested interests in maintaining the new regime of political economy attained because of such intervention become far more numerous the more time that passes.

In the social economy there tends to be an optimum investment in numerous and different time-structured research projects, just as there tends to be an optimum of time-structured production processes. In neither case would there ever be anything approximating perfect complementarity: neither in the structure of production, nor in the structure of research projects. There would, however, be a continual *tendency* toward just such complementary structures. Under conditions of monetary expansion, however, the tendency is to move toward a false complementarity, one that would collapse quickly if and when the Hayek effect becomes operational.

The *third* of these categories is the educational system in general and the universities and polytechnical institutes in particular. If we wish to view labor productivity as a stream from human capital, then surely the universities and institutes must be considered a higher order of production. Its essential purpose is to produce a more productive labor force in a round about way for introduction into the structure of production at a later time.

Another consequence of the inflationary expansion of the money supply is that it appears that "society" is willing to support more time-consuming methods of producing human capital. Since the costs of borrowing have fallen, it is likely that more educational plant and facility will be built and staffed. Corporations will prove increasingly willing to invest larger amounts of money in the long-term training of their labor force. And, of course, the universities also emerge as major beneficiaries of the general overextension of R&D activity since much of this activity is internalized within the universities.

All of this will presumably lead to an overinvestment in the most time-consuming areas of training. Engineers, scientists, Ph.D.'s of all sorts, teachers, etc., for whom the market would not produce and sustain long-term employment and for whom jobs would "have" to be created. Perhaps just as importantly, the universities themselves – themselves being largely a creation of inflationary expansion – would likely become incipient bastions of the interventionistic ethic. Free market ideas, the implementation of which would surely cut off much of their source of "overinvested" support, probably would be given short shift indeed. It seems highly unlikely that Austrian economics would long reign as the conventional doctrine under any such regime of political economy.

2.5. The Hayek Effect and the Liquidity Crisis

The deceptively comfortable arrangement which seems to benefit both the banking institutions and the higher order capital-intensive industries is severely threatened during the latter stages of the expansionary phase of the cycle. Once the increasing money supply is slowed or halted, the Hayek effect begins. Prices in the higher orders (prices of current output, inventories, capital values, and factor prices) begin to fall relative to those in the lower orders (especially consumers' goods prices), hence real wages decline. As interest rates begin to climb back up to reflect a truer picture of the social rate of time-preference, the margin of benefit from capital invested shifts from highly capital-intensive and more time-consuming methods of production to the less capital-intensive and shorter production processes. Since real wages are falling there is a compelling incentive to replace capital with labor; and because interest rates are rising, investment will be directed to those production processes in which the "rate of turnover" (the number of times the capital is turned over per annum) is higher, i.e., to less capitalistic methods.[21]

The Hayek effect that has just been described in turn leads to a faster reduction in demand for the current and future output of the higher orders. This further hastens the price readjustment process, i.e. the decline in the prices of the higher orders relative to those in the lower orders. As the relative price rise takes place in the lower orders, what liquid capital that there is in the higher orders will flow quickly into less time-consuming investments.

The very sticky problem of fixed assets, nevertheless, remains. The expansionary phase of the cycle always results in a process of the objectification of capital in a not easily liquidatable form. This highly illiquid capital is progressively "frozen into" the higher orders of production, thus severely minimizing the flexibility of these higher order firms during periods of economic crisis.

As costs impinge upon yields and as anticipated demand fails to materialize, higher order firms suddenly and in large numbers, find themselves unable to meet their short-term obligations. They have assets, but the period of maturation of these assets has not yet been fulfilled. The assets therefore are not yet income-producing. These capital assets, therefore, do not "fit in" to the changing real structure of production as the social economy begins to reassert itself.

The liquidity crisis ensues. Corporate managers rush to borrow in an attempt to cover their short-term obligations. For a short period of time the wolves may be held at bay, but soon (in the absence of a return to monetary infusions) all borrowing avenues will have been pursued and exhausted.

If the social economy actually is permitted to fully reassert itself then the liquidity crisis quickly turns into an insolvency crisis. To the degree that a firm actually proves illiquid, then to that same degree must it be considered insolvent. Any attempt to prop it up would be simply a waste of social capital. Such an illiquid-insolvent firm must then declare bankruptcy, go into a state of receivership under the control of its creditors (usually its bondholders and bank creditors), and then be reorganized in such a fashion as to "fit back in" to the "cleansed" structure of production. This process of liquidation would, if permitted, proceed until a high degree of complementarity was again achieved.

2.6. Advancing Liquidity to Ward off the Downturn

One can probably be safe in assuming, however, that not everyone will look upon the gathering liquidity crisis with the same sense of equanimity as displayed by detached economists. Due to the widespread nature of the liquidity crunch, the corporate decision-makers will not likely see that their corporation's problem has anything to do with mistaken entrepreneurial judgments that they themselves may have made in the past. On the contrary, it will simply lead them to conclude that there is obviously too little lending capital available, and that the answer to the "temporary" and merely "financial" problem is to increase the money supply sufficiently to get through the crisis. Then everything will be alright again.

The blame for the crisis is certain to be attributed to the monetary authorities for halting or slowing down the supply of bank credit in the first place. There is no denying that a correlation does exist between a slowing in the increase of the money supply and the beginning of the recession. Without the benefit of sound theoretical understanding, it seems only natural that such a conclusion will likely always be drawn. It is, therefore, unsurprising to find key members of corporate management usually emerging as leading proponents of a further expansion of the money supply to meet their "normal" business needs.

Non-financial corporations are not the only business complexes, which become overinvested (malinvested) and hence find themselves faced with severe liquidity problems. The banking networks (commercial, savings, mortgage, and investment banks) and other intermediaries also become over-extended, especially if the upswing is of a lengthy duration. Inflation tends always to breed a climate, which leads to profligacy and discourages thrift. Banking institutions are hardly immune from this tendency.

As inflation proceeds, banks begin to move away from the proven tenets of sound banking, i.e., of having the time-pattern of their liabilities. In the real world of current banking practices where demand deposits (and time deposits in every practical sense are "on demand" also) are loaned out, all such loans should, at the very least, be of short duration and of self-liquidation nature.

> The theory of the 'self-liquidating' loan is that the transaction which presumably was facilitated by the original making of the loan should itself provide the funds with which to discharge the loan. In this way a bank can speedily reduce its loans, and a reduction of loans and reduction of deposits go hand in hand, it can improve its reserve-deposit ratio and hence its liquidity in a comparatively short span of time.[22]

In discussing a case where banks got into just such liquidity problems (the 1920s), the same authors state:

> This decrease in the proportion of short-term, self-liquidating assets served to lessen the liquidity of the banks and to reduce their ability, both relatively and absolutely, to meet

> their deposit liabilities upon demand on short notice; at the same time the growth of assets of a long-term character made it increasingly difficult for the banks as a whole to realize upon those assets by conversion into cash if necessity for such action arose.[23]

What was true during the 1920s is also true of any lengthy inflationary period.

It seems safe to say that every time there is a long-term expansionary upswing, that the whole banking network will tend to get into these same liquidity problems. When the interest rate is pushed artificially low, the anticipated return on more time-consuming investments will rise. There will be a natural tendency on the part of banks (the most apparently deleterious effects take place in the commercial bank sector) to "stretch" their short-term obligations into longer and less liquid loans. "Liability management" becomes a new, important, and ultimately dangerous banking procedure. Banks will almost surely become over-extended in the mortgage field, witness the current and deep crisis situation in the relation between the banks and the Real Estate Investment Trusts (R.E.I.T.s). Apparently, then, the ratio of short-term, self-liquidating loans to longer, less liquid loans (remembering that the funds being loaned out are of an "on demand" nature) tend always to shrink during long-term inflationary expansions.

It seems therefore evident that the bankers, although perhaps somewhat more hesitantly, will also have a compelling incentive to continue the inflationary expansion of the money supply, just as much (if not more so) to hold off the downturn as to prolong the upswing. Since the representatives of these two most influential decision-making sectors within the system of political economy (state capitalism) share a growing common interest in prolonging the expansion period of the cycle, it is very unlikely that anything approaching the full process of adjustment will be permitted to take place as the first signs of a deepening liquidity crunch become apparent. For the only way that the system of political economy can be maintained *as it exists* is to continue the increases in the money supply.

2.7. Forced Savings: Sraffa vs. Hayek

Increases in the money supply necessarily drive interest rates artificially lower than they otherwise would have been, and thereby bring about the phenomenon of "forced savings." One of the key underlying questions throughout this paper is, just who are both the short- and long-run beneficiaries of this "forced savings?" A relatively unknown but significant controversy between Piero Sraffa and F.A. Hayek[24] in the early 1930s dealt largely with just this question.[25]

Sraffa, in his typically neo-Ricardian fashion, could not see what Hayek was talking about in *Prices and Production* when Hayek differentiates between the effects of savings of a voluntary sort and of "forced savings." Hayek says that the latter is different in that at the end of the artificial stimulation of the money supply, the investments induced on the basis of that stimulation must come tumbling down, whereas in the case of voluntary savings, the gains will accrue to the owners of the investments after the period of production (maturation) has taken place.

Sraffa answers this logic by saying that nothing of the sort will happen:

> One class has, for a time, robbed another class of a part of their incomes, and has saved the plunder. When the robbery comes to an end, it is clear that the victims cannot possibly consume the capital which is now well out of their reach. If they are wage-earners, who have all the time consumed every penny of their income, they have no wherewithal to expand consumption. And if they are capitalists, who have not shared in the plunder, they may indeed be induced to consume now a part of their capital by the fall in the rate of interest; but not more so than if the rate had been lowered by the 'voluntary savings' of other people.[26]

There are certainly a number of problems with Sraffa's position, especially from the point-of-view of pure economic theory. The insights, however, become more interesting if we look at them from the perspective of socio-political economics rather than that of the pure logic of choice.

The Hayekian rejoinder to Sraffa is that as the social economy reasserts itself, the malinvestments will become apparent as such and a move to less capitalistic methods will be necessitated. What should have been stated far more clearly during this controversy was that the Austrian theory of capital is essentially a theory of *complementarity.* Once the previous monetary conditions change (the inflation is reduced), the complementarity of the capital structure also begins to change. This considerably changes the value of the assets owned throughout the structure of production. Therefore, while it is true that "one class has, for a time, robbed another class of a part of their incomes," (i.e., reduced the effective range of the quality and of the quantity of present consumers' goods, hence the "forced savings"), it does not follow at all that this class (the present owners of those thusly created capital assets) will be able to have "saved the plunder." For if the social economy does in fact reassert itself, then the present values of the malinvestments will decline precipitantly.

However, what if the social economy is not permitted to reassert itself? What if the regime of political economy is maintained and ever broadened through a continuous influx of bank credit and by the addition of other now "necessary" rationalization or stabilization interventions instituted in an effort to cope with the dislocations caused by the continuing monetary tampering? Economic theory clearly tells us that this phase of the political economy (interventionism) cannot go on forever. However, as long as it does last, it seems clear that "one class (will continue to rob) another class of a part of their incomes."

2.8. The Privileged Position of the State Banking Axis

We think we can safely assume that those who are in control of the state-banking apparatus will not permit the social economy to reassert itself. It is true that economic law continues to work its vengeful way even in spite of the money managers' decisions, but the process of readjustment certainly can be held off for quite some time. The decision to further intervene causes substantial problems for the economy at large and for the economic czars in particular. Throughout this period, though, the state-banking sector continues to augment its hegemonic position within the system.

Because they choose not to permit a fully purgative economic readjustment, the central bankers find themselves faced with the genuinely impossible task of trying to fine-tune the economy with fiscal, monetary and other interventionistic tools. The expansionary phase of the cycle can never be smooth for two reasons. First, it is impossible to calculate the precise degree of monetary stimulation that is needed to sustain the distorted structure of production, because one can never predict the time-sequence of people's reaction (a reaction which is psychological, not mechanical), to a change in the quantity of money.[27]

This becomes even more difficult as the expansion continues because an ever-accelerating rate of increase in the quantity is needed to achieve the same degree of stimulative effect. This, however, is a rate, which is beyond the ken of mere mortals, and economists do have feet of clay. Second, when the chosen rate proves to be incorrect, which is most likely, there is usually a strong political tendency to overreact to the economic consequences of that wrong choice.

If the rate is too low, a liquidity crisis will ensue, and a recession will begin. The tendency is to monetarily overstimulate, thus reversing the process. But after a lag, prices will surely rise even faster. If the rate proves too high, the tendency is to cut back strongly on the money supply. This will then also lead to a tumbling of malinvested projects. Thus the system is subjected to the continual flipping back and forth between a series of milder, secondary expansionary/contractionary cycles within the underlying, major upswing. This, for instance, has been the case in the United States since the Second World War.

We saw earlier that the artificial lowering of the structure of interest rates led to an increase in external corporate debt and to a consequent increase in the leverage of the financial sector. This is just as true of the banks' position during the mini-cycle as it is over the long haul of the upswing. But what about the downturn? Don't the banks lose just as much leverage on the downswing as they gained on the way up? This probably would be the case if the social economy were permitted to emerge and fully readjust the socio-economic relationships. Such an emergence would, however, run contrary to our assumptions.

The banking system, it must not be forgotten, maintains a very privileged position in the political economy. The banks are far better insulated from the blows of recession than are other sectors of the economy. Socio-economic legislation such as the Federal Deposit Insurance Corporation (FDIC) is very important in giving an appearance of impregnability during the recession. The FDIC is not so important for what it actually can do as it is for what people think it can do. If people think that the FDIC secures the solvency of the banking system, they will then not make a run on the banks. This is true even though the reality is that less than one-seventh of all bank deposits that are now covered by available bank reserves.

The crucial privilege of the banks, however, is that of their spatio-temporal position throughout the liquidity crisis. They retain the ultimate "out" of this otherwise closed system. They can still always go to the Fed's rediscount window. They can rebuild their own liquidity positions *before* anyone else. The banks are the last to be hurt on the way down and the first to be aided on the way up. If they can receive aid before the downward plunge has accelerated and actually hit the banks, then they (at least relative to other sectors of the economy) will have effectively insulated themselves from the painful (cleansing) effects of the downturn of the secondary cycle. Admittedly, this can continue only in the short-run, but the short-run can be quite long. Indeed, the current expansionary phase of secondary cycles in the United States, for example, has lasted for three decades. The long-run in this case, though, is probably now fast approaching.

It seems important to note here that if it should become essential for the state banking system to cut some of its losses, the cuts will not likely be made among the larger banks. Liquidity will be rushed first to the big banks, for it would be politically, as well as economically, disastrous to allow one or several of the big banks actually to fall. This will further entrench the position of the large, established (mainly New York) banks at the expense of potentially new and/or small and aggressive competitors.

2.9. Privilege Leads to Concentration and Further Dislocations

Another alarming aspect of the continual swing back and forth of the secondary cycles is that this process ultimately leads to an abnormal concentration of control over economic resources, and, consequently, will lead further away from an optimum amount of competition, relative to the social economy. The result will be a slowing down of the process of adjustment, a further weakening of the entire market system, a decline in consumer welfare, and an unfortunate but understandable clamor on the part of citizen-consumers against the absurdly inefficient and unstable "free enterprise" system.

During a liquidity crisis, those firms with prime credit rating will be able to borrow funds first and most cheaply. Under conditions of an advanced political economy, however, an important complication arises. A corporation's credit rating no longer depends entirely on its economic efficiency. It depends mainly now upon its survival probability and consequently upon its anticipated ability to repay the loan. In the advanced political economy, it seems highly probable that large firms (either firms with numerous employees or highly capital-intensive combinations which are deemed vital to the "national security") will not be permitted to collapse. A firm's credit rating also often depends on how closely it is tied (and will continue on so being) into the state apparatus through privileges, contracts, subsidies, etc. As it becomes known that larger firms will not be allowed to fall and that privileged firms will continue to be subsidized, such knowledge will serve in effect as a quasi-guarantee on loans to those firms. Such a guarantee will clearly aid their credit rating at the expense of smaller and perhaps far more economically viable firms.

We can also assume that during an expansionary upswing, under conditions of an expanding political economy, the government will be engaging in large-scale spending programs. This is, after all, how they stay in power. Such spending will in all likelihood be deficit spending and will therefore have to be financed by borrowing.

These two abnormalities, both caused by the interventionism of political economy, (1) misassigned credit ratings, and (2) heavy government borrowing, are bound to have grave socio-economic consequences.

If the borrowing is supported by the central bank, then the problem of inflation is likely to get out of hand. If, on the other hand, enough liquidity is not made available to service all comers, then someone is going to get (in the current financial jargon) "crowded out." Marginal firms will surely get pushed aside. Of perhaps even greater significance, however, is that many very efficient, smaller firms will also be forced into insolvency.

It is Social Darwinism in reverse. Fresh and vibrant capital combinations are thwarted and often destroyed in order to maintain the social waste of government spending and the obsolescent dinosaurs of privilege and inefficiency.

When these economically sound firms are forced to fold, they go into receivership and are often merged into the state-maintained firms. Waves of burgeoning conglomerates often lie in the wake of such "crowding out" and financial reorganization. Perhaps it is true that this is the most efficient way of dealing with the situation as it exists, but it is clearly far removed from anything remotely approaching the optimum relationship that would exist under conditions of the social economy.

Both these economic dinosaurs and the reorganized capital combinations are often held tenuously together by sinews of ill-founded financial arrangements that are usually built on a mountain of debt. On the next secondary downturn, there is just that much more misinvestment which has to be rescued and maintained.

As a result of these secondary cycles, the banking networks continually increase their leverage of decision-making control over the non-financial sector throughout the whole of the expansionary upswing. Since the major banks are better insulated both from competition and insolvency, they generally prove more willing to slow down inflation in order to firm up the currency when it weakens in the international currency markets or threatens to move toward runaway inflation. They will tend to tolerate the mini-recessions, but when push comes to shove, they will likely pull out almost all stops to ensure that neither a full-fledged recession nor a runaway inflation will sweep them under also. We shall touch on this a bit more in the next section.

The alternating secondary or mini-boom/bust cycles keep the non-financial corporations highly dependent on the banking sector. This becomes more apparent and more acute as the expansionary phase lengthens and the subsequent liquidity crises deepen.

As inflation continues and accelerates, replacement costs soar. Machines, which must be replaced only every decade or so will cost perhaps one hundred percent more (or even greater) than when they were originally purchased. Profit and loss statements will likely have been reckoned on the basis of historic cost. Firms, who on the basis of returns thus calculated, will be led to believe themselves making a profit when in fact they are very likely to be actually operating at a real loss and perhaps even eating into their capital fund.

Even if the corporation is lucky enough to get out of the predicament in a solvent fashion, the managers will surely have to go to the banking sector to have his replacement costs funded by debt.

As liquidity crises come and pass, each one is likely to become a bit more severe than the last. During the deepening liquidity crises, interest rates shoot up. The stock market and long-term bond markets vacillate and weaken. Equity capital dries up. Once again, the non-financial corporations are forced to go to the banking sector for funding and/or pay phenomenal interest rates on their bond issues (if they can be floated at all) and/or commercial paper I.O.U.'s. In any case, the debt economy grows and the banking sector remains secure in its decision-making authority. Is this security not merely analogous to one's becoming the captain on a sinking ship? Perhaps so.

2.10. Scylla and Charybdis and the Allure of Fascism

As the underlying upswing of the major cycle is prolonged over a lengthening period of time, the distortions in the structure of production become ever more pervasive. The financial condition of numerous firms becomes increasingly fragile and precarious. This reality places before the political and economic decision-makers several alternatives, two of which at some point become equally unacceptable. They become caught between the Scylla of recession and the Charybdis of inflation.

One of the most important characteristics of the evolution of the political economy is that the state increasingly assumes the duty of ensuring corporate survival. Besides the advances of liquidity in time of need that we have discussed earlier, there is a whole panoply of interventionistic socio-economic legislation – contracts, subsidies, guaranteed loans, etc. created – all of which tend to *socialize* private costs while keeping profits private. Any macro-economic policy, which seriously disturbs this arrangement surely would not be looked upon kindly.

Another element in the growth and development of the political economy is the integration of labor unions into the political-economic elite as "junior partners." The trade union leaders almost never assume positions of ultimate decision-making, but they do perform a particularly important limiting function, both politically and economically. Politically they become a force that has to be appeased. Economically, they bring rigidities into the price mechanism. The price system loses much of its flexibility. The unions tend to prevent the downward price adjustments of nominal wages.

These two circumstances, (1) the decision to maintain the corporate status quo and (2) wage inflexibility downward, put tremendous pressure on the political and economic decision-makers not to accept the cleansing of a recession. On the contrary, it will surely lead them to choose what appears to be the lesser of the two evils, a continuation of the inflationary expansion of the business cycle.

A third factor remains always in the background. That is that if the decision-makers were to actually opt for a period of full price readjustment, the hegemonic position of the state banking, financial sector would also come crashing down. When compared to conditions, which would exist under a reign of the social economy, the financial sector of the political economy would be precarious, indeed. The position of political-economic hegemony certainly will not simply be given up so that a free market can be ushered in. This simply is not the way the real world works. On the contrary, the answers very likely will be sought after in the deep reservoir of "political means" which they have constantly at their disposal. It is, after all, the only alternative that will save their privileged position.

In another paper, we deal in further detail with the growth of a static infrastructure during the development of the political economy,[28] especially in the highest stages of state capitalism.

In the present paper, we shall merely reemphasize that an alternative network of institutions, which is parallel and seemingly reinforces and complements the natural institutions is developed throughout the long transitory stage of political capitalism.

In the United States, the sort of state-capitalist infrastructure which has been built up both to socialize costs and to rationalize the economy consists, in part, of the following kinds of institutions: The Export–Import Bank, FDIC, the Small Business Administration, the Farm Credit Administration, and the Federal Home Loan Bank Board. There are, of course, many more.

Perhaps the most important features to watch in the development of this infrastructure are the recent and numerous proposals to revive the Reconstruction Finance Corporation (RFC).[29] A number of businessmen and especially bankers have been calling for an RFC., which would be empowered not only to advance liquidity to faltering businesses and banks, but also to advance *equity* capital. This would surely prove pivotal in the move to a broadened political economy.

Once the route of recession has finally been ruled out, and once it becomes clear that inflation, if continued, will totally destroy the whole economic mechanism and take the privileged position of the decision-makers along with it. The single remaining alternative of comprehensive price control and consequent state planning, although not perhaps joyously embraced, will become nevertheless preferable to losing everything. The "private" financial sector leaders will almost surely have a strong position within the decision-making core of any state planning mechanism, thus they will be able to retain their familiar perquisites of economic and political power.

Comprehensive wage and price controls will be imposed in an attempt to get inflation under control. Many who reluctantly accept these controls will probably convince themselves that the period of controls and planning is but a temporary exercise which will be dismantled after things are straightened out and gotten under control.

The alternative infrastructure can begin immediately to serve as a control mechanism by simply fusing the whole state-banking network into the infrastructure, and then through that network, execute control over the corporate structure; but, of course, problems will still abound. The many problems of shortages which necessitate rationing and which in turn eventuate in resource allocations and cost subsidizations, grow enormous immediately. Thoughts of going back to the market get lost in the maze of unanticipated problems of running the system.

One complication, which almost no one foresees is that the capital structure is not nearly as productive as it was thought to be. Decades of inflation and debt lead to the improper maintenance of the capital structure. Added to the problems which inflation brings to assessments of profitability and hence an eating into the capital fund, the political economy is also characterized by huge social welfare programs which lead to far too much consumption in the present at the expense of real savings and investment for the future. The capital structure is but a shell of what it was thought to be. The "reserve fund" upon which the planners had hoped to sustain their economic plans simply does not exist. Any hope of getting out of this quagmire and back to the market will probably be lost for decades as more and more absolute control passes into the hands of fewer and fewer decision makers.

At this point the last remaining elements of the social economy will have been snuffed out. The market society, which thrives only on the "spontaneous" adjustment to changing circumstances, will be replaced by force and bondage. The social economy will be totally replaced by the political economy. The allure of fascism in the face of the consequences of interventionism will have proven too strong.

Mankind's only hope at this point is the knowledge that the political economy is totally parasitic and cannot function for long. Soon a combination of reforms and revolts will be instituted and then the market system can begin slowly to make its way back.

It is more than anything the socio-economic policies that lead to the business cycle which have been and are continuing to propel us toward this ultimate disaster. These economic policies of inflationism are made possible only by central banking. Only a partnership of the state and the banking sector can cartelize banking into an effective inflationistic force. It is the crucial nexus that must be severed.

If something is not soon done to break this all important state-bank connection and the flow of circumstances, which result from that connection, then we can find no good argument to counter F.A. Hayek's pessimistic prognosis when he recently said:

> What I expect is that inflation will drive all the Western countries into a planned economy via price controls. Nobody will dare to stop inflation in an ordinary manner because as things are at present, to discontinue inflation will inevitably cause extensive unemployment. So assuming inflation stops it will quickly be resumed. People will find they can't live with constantly rising prices and will try to control it by price controls and that of course is the end of the market system and the end of the free political order. So I think it will be via the attempt to regress the effects of a continued inflation that the free market and free institutions will disappear. It may still take ten years, but it doesn't matter much for me, because in ten years I hope I shall be dead.[30]

NOTES

1. Of course, we recognize that all assumptions of equilibrium are theoretical constructs useful only in aiding our understanding of real world processes and that they are neither a substitution nor an approximation of such processes.
2. The term "social economy" is one that was used similarly by both Charles Dunoyer, the early 19th century French economist and social philosopher, and by Friedrich von Wieser, the early Austrian economist and sociologist.
3. Mises, L. von, *Monetary Theory and the Trade Cycle*, A.M. Kelley (New York, 1966), first published in 1933; *Prices and Production,* A.M. Kelley (New York, 1966), first published in 1931; *Profits, Interest, and Investment*, A.M. Kelley (New York, 1969), reprint of 1939 Ed.
4. Menger, Carl, *Principles of Economics*, The Free Press, Glencoe, IL, (1950). Mises, L. von, *The Theory … op.cit.*, pp. 62–94.
5. Mises, L. von, *ibid.* Rothbard, M.N., *What Has Government Done to Our Money?* Rampart College Press (Santa Ana, CA., 1974 Ed.).

6. A "natural" free market system is based on a regime of private property and the protection of that property. It must be stressed that money is property and must be treated like all private property; it must be protected. Hence any increase in money substitutes not backed by the commodity money is by definition theft, and under a regime of private property (social economy), such theft would be deemed illegal and prosecuted just like any other crime.

7. Rothbard, M.N., *ibid.*; *The Case for a 100 Percent Gold Dollar*, Libertarian Review Press (Washington, 1974).

8. Armentano, D.T., *The Myths of Antitrust,* Arlington House (New Rochelle, NY, 1972), see esp. Chapter 7; Rothbard, M.N., *Man, Economy and State*, Van Nostrand (Princeton, 1962), Chapter 10; *Power and Market*, Institute for Humane Studies (Menlo Park, CA, 1970).

9. For an excellent presentation of the struggle between the Banking School and the Currency School which culminated in the passage of Peel's Act of 1844, see L. von Mises, *The Theory, op. cit.,* pp. 368–373.

10. On the structure of production, see Carl Menger's *Principles, op.cit.*; F.A. Hayek's *Prices, op.cit.*; M.N. Rothbard's *Man, Economy and State, op.cit.*, esp. Chapters 5 and 6. On the lattice-work analysis, see esp. Ludwig Lachmann's *Capital and Its Structure*, G. Bell & Sons, Ltd. (London, 1956); see also: Eugen von Bohm-Bawerk, *Capital and Interest,* Vol. 2, Libertarian Press, (S. Holland, IL.); F. von Wieser, *Natural Value* (London, 1893), *Theory of Social Economics* (NY, 1927).

11. Mises, L. von, *The Theory … op.cit.*; for one of the best explanations of the flow of inflation, see Henry Hazlitt's *Economics in One Lesson*, MacFadden-Bartell (NY, 1970); another important study on the spatio-temporal aspects is Murray Sabrin's forthcoming dissertation at the Geography Department of Rutgers University.

12. Robbins, Lionel, *The Great Depression*, Books for Libraries Press (Freeport, NY, 1971), reprint of 1934 Ed.

13. This presentation of the Austrian theory of the business cycle has been distilled and condensed from the following works: Haberler, Gottfried, "Money and the Business Cycle," In *Gold and Monetary Stabilization*, Ed. Q. Wright, University of Chicago Press (Chicago, 1932); Hayek, F.A. *Monetary Theory, op.cit.*; *Prices and Production, op.cit.; Profits, Interest and Investment, op.cit.;* "The Ricardo Effect," In *Individualism and Economic Order*, University of Chicago Press (Chicago, 1948); "Three Elucidations of the Ricardo Effect," In *Journal of Political Economy* (March–April 1969). Lachmann, L.M., "A Reconsideration of the Austrian Theory of Industrial Fluctuations," In *Economica* (May 1940). Mises, L. von, *The Theory, op.cit.*; *Human Action, op.cit.* Phillips, C.A., McManus, T.F., & Nelson, R.W., *Banking and the Business Cycle*, The Macmillan Co. (New York, 1937). Robbins, *The Great Depression, op.cit.;* "Consumption and the Trade Cycle," In *Economica* (November 1932). Rothbard, M.N., *Man, Economy and State, op.cit.*; *America's Great Depression*, Van Nostrand (Princeton, 1963).

14. This assumption is useful but certainly not necessary. See F.A. Hayek's "Capital and Industrial Fluctuation" In *Econometrica* (April 1934).

15. On this see Ludwig M. Lachmann's *Macro-Economic Thinking and the Market Economy*, The Institute for Economic Affairs (London, 1973); also see, L. Lachmann, "Markwirtschaft and Modelkonstruktionen," In *ORDO*, Vol. XVII,

(1966). This essay has been translated into English by R.F. Ambacher and W.E. Grinder as "Model Constructions and the Market Economy," hopefully for publication in the near future.

16. Walter E. Grinder and John Hagel III, "Towards a Theory of State Capitalism: Ultimate Decision-Making and Class Structure," a paper presented at the second Libertarian Scholars Conference, and as yet unpublished.

17. Henry Hazlitt simplifies this process in his "Mirage of Inflation," In *Economics op.cit.* For a very sophisticated and excellent case study of the effects of inflation, see Constantino Bresciani-Turroni's *The Economics of Inflation: A Study of Currency Depreciation in Post-War Germany, 1914–1923*, George Allen & Unwin (London, 1968), reprint of 1931 ed.

18. For a detailed explanation of our view of economic classes see, Walter E. Grinder and John Hagel III, "Towards a Theory of State Capitalism: Ultimate Decision-Making and Class Structure," unpublished manuscript; more importantly, see: Albert Jay Nock's *Our Enemy the State,* Free Life Editions (NY, 1973), reprint of 1935 ed.; and Franz Oppenheimer's *The State*, 1914, soon also to be reprinted by Free Life Editions.

19. For our view of Interventionism, see, John Hagel's "From Laissez-Faire to Zwangswirtschaft: The Dynamics of Interventionism," prepared for the Austrian Economics Symposium, University of Hartford, (June 1975) [Reprinted in this volume – Editor's Note]; we base our views largely on the following: L. von Mises "The Middle of the Road Leads to Socialism" In *Planning for Freedom*, Libertarian Press (South Holland, IL, 1962); and F.A. Hayek's *The Road to Serfdom*, University of Chicago Press (Chicago, 1944).

20. Grinder, W.E. and Hagel, J., "Towards a Theory of State Capitalism: Ultimate Decision-Making and Class Structure," *op.cit.*

21. Hayek, F.A., "Profits, Interest And Investment," In *Profits, Interest and Investment, op. cit.*; "The Ricardo Effect" In *Individualism and Economic Order, op. cit.*

22. Phillips, McManus, and Nelson, *Banking, op. cit.*, p. 109.

23. *Ibid.*, p. 107.

24. Those of us who have the good fortune of attending the Ludwig M. Lachmann Seminar at New York University are indebted to Professor Lachmann for having pointed out to us the true nature and significance of this intellectual repartee.

25. Sraffa, P., "Dr. Hayek on Money and Capital" In *Economic Journal* (June 1932) pp. 237–249; "Money and Capital: A Rejoinder," In *Economic Journal* (June 1932). Hayek, F.A. von, "Money and Capital: A Reply" In *Economic Journal* (June 1932) pp. 237–249.

26. Sraffa, P., "Dr. Hayek on Money and Capital," *op. cit.,* p. 48.

27. Mises, L. von, *Human Action, op. cit.*, pp. 426–428.

28. John Hagel III, "From Laissez-Faire to Zwangswirtschaft: The Dynamics of Interventionism," a paper prepared for the Austrian Economics Symposium at the University of Hartford (June 22–28, 1975).

29. See Walter E. Grinder and Alan Fairgate, "The Resurrection of the Reconstruction Finance Corporation," *Reason* Magazine (July 1975).

30. See Walter E. Grinder and Alan Fairgate, "The Resurrection of the Reconstruction Finance Corporation," *Reason Magazine* (July 1975).

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THE POLITICAL ECONOMY OF CRISIS MANAGEMENT: SURPRISE, URGENCY, AND MISTAKES IN POLITICAL DECISION MAKING☆

Roger D. Congleton

1. INTRODUCTION: IGNORANCE AS A CHARACTERISTIC OF ALL CRISIS MANAGEMENT

A crisis typically has three characteristics. First, a crisis is unexpected, a complete surprise. Second, a crisis is normally unpleasant in that current plans are found to work less well than had been anticipated. Third, a crisis requires an urgent response of some kind. That is to say, an immediate change of plans is expected to reduce or avoid the worst consequences associated with the unpleasant surprise. These characteristics imply that not every public policy problem is a crisis, because many public policy problems are anticipated or long-standing. The present social security problem faced by most Organization of Economic Cooperation and Development (OECD)

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nations is not a crisis, although it is a serious problem. Other policy problems are clearly worsened rather than improved when current policies are abandoned. This may be said of constitutional law, in cases in which minor unexpected problems arise from longstanding political procedures. Other policy problems lack immediacy, even when they are unanticipated. This might be argued, for example, of global warming, which was unanticipated prior to 1990 yet is anticipated to take decades to emerge. Not every serious problem is a crisis.[1]

Crises are, nonetheless, common events for most people, most organizations, and most political systems. Recent public policy crises include terrorist attacks, unexpected environmental catastrophes, outbreaks of new deadly contagious diseases, and natural disasters such as major floods and earthquakes. Although not every problem or unpleasant surprise is a crisis, many are genuine emergencies. Moreover, even longstanding problems may become increasingly urgent as time passes.

This paper provides an overview of the politics of crisis management using a minor, but significant extension of the core rational choice models of political decision making. The focus of analysis is crisis management within democratic polities, although much of it will also apply to crisis management within private organizations and indeed to personal crises. The analysis has several general implications for the politics of crisis management and for designing routine procedures for crisis management. As demonstrated below, an important and unavoidable property of crisis management is an unusually high propensity for making policy errors. Standing procedures for dealing with crises should be designed with such mistakes in mind.

The political economy of crisis management has been neglected by the rational choice community. There is, for example, no reference to crisis management in Mueller's (2003) or in Persson and Tabellini (2000) extensive surveys of the public choice and political economy literatures, nor is there an entry for crisis management in Rowley and Schneider (2004) *Encyclopedia of Public Choice*. This lacuna is perhaps best understood as a limitation of contemporary rational choice models, although not of the rational choice approach itself. Neither urgency nor surprise can readily be included mainstream rational choice models.[2]

This paper demonstrates that a good deal of light can be shed on the fundamentals of crisis management when viewed through the lens of rational choice models that account for the effects of surprise and urgency. This paper also points out several neglected implications of crisis management, and also begins the task of filling a rather surprising void in rational choice-based contemporary political economy research.

1.1. Can there be a Rational Choice Model of Crisis Management?

To analyze crisis management using our standard tools, it is first necessary to overcome a significant methodological problem that may partially account for the lack of a rational choice literature on crisis management. There is a sense in which "crisis management" is *impossible* within the most commonly used economic models of rational decision making.

The usual model of rational decision making assumes that individuals possess sufficient information and imagination to evaluate every alternative course of action in every conceivable combination of circumstances. Preference orderings are complete and transitive for the full range of possible events and opportunities. Individuals know the full dimensionality of their opportunity sets and the conditional probability functions associated with them. Although random shocks of one kind or another may exist, there can be no surprises, no truly unanticipated circumstances calling for unanticipated decisions in conventional rational choice models. Decision makers may not know the result of a given roll of the dice, but they do know all the numbers that can turn up on top, and can therefore make plans contingent on each possible outcome.

Individuals in such models, consequently, always perfectly optimize. They choose the best possible plan of action, a plan that takes account of all possible alternatives in all possible circumstances. The standard assumptions thereby rule out crisis management, because they rule out unpleasant surprises calling for urgent responses. Unpleasant surprises may arise that must be dealt with rapidly, but these are in principle no different from other decisions that much be reached as time passes. All circumstances are "ordinary" in the standard rational choice model. There are no emergencies, no sudden requirements to adapt to new and unforeseen circumstances.

Given this, it might be reasonably concluded that crisis management is beyond the scope of rational choice models of decision making. Such a conclusion, however, would be incorrect. Analysis of crisis management from the rational choice perspective does, never the less, require us to move beyond the usual assumptions of economic models.

Several approaches can be used to escape from the limits of the standard model. For example, one could introduce planning costs or assume that individuals are rational only within narrow limits. The approach taken in this paper is to focus attention on a form of imperfect information that is neglected in most economic models of human decision making.

1.2. The Search and Ignorance Characterizations of Imperfect Information

Economists have assumed, for the most part, that imperfect information takes the form of *finite but complete data sets*. That is to say, information is assumed to consist of data points, and each data point includes information about all relevant dimensions of the phenomena of interest. Individual have information problems because they have only finite collection of data. Given finite but complete data, decision makers can make unbiased estimates of all the parameters of their choice settings, although the precision of those estimates can always be improved by increasing the sample size of their data sets (Stigler, 1961). Modern Bayesian analysis reaches similar conclusions from essentially similar assumptions about information, although Bayesian analysis also specifies the process by which learning takes place: priors are updated via Bayes Law as new data points (observations) become available (Hirshleifer & Riley, 1992). The "finite data set" approaches can be easily incorporated into the standard rational choice methodology, because decision makers remain perfect optimizers – *at least on average*.

The approach taken in the present paper is to acknowledge the existence of another form of imperfect information, namely, ignorance. Ignorance is not caused by having too few data points in one's sample, but rather by observing *too few dimensions* (characteristics) of the data points that are available. That is to say, the existence of ignorance implies that information about some dimensions of choice is simply unavailable to individuals at the time that they adopt their plans of action. In effect, individuals have a sample of size zero for such "missing" variables (Congleton 2001a, b).

The problem of ignorance has not been entirely neglected by economists, but for the most part has been limited to settings of asymmetric information in which one party does not know what the other knows. Here one may note Hayek's (1937, 1945) classic pieces on knowledge and Georgescu Roegen's (1971) insightful work on information and entropy, as well as a large contemporary literature on asymmetric information and public policy. For the most part, however, the latter retains the normal Baysian assumption that the full dimensionality of the universe is known, and that although one player may not know what the other knows, he knows what could be known. See for example, Milgrom and Roberts (1986), Laffont (1994), or McLean and Postlewaite (2002).

A good deal of ignorance, however, is not asymmetric but rather uniform in the sense that some missing dimensions or possibilities have never been imagined or confronted by the typical individual. We are born into the world knowing almost nothing. And, although our ignorance is gradually reduced by personal experience and as secondhand knowledge is imparted to us by our families, friends, teachers, and the mass media, a penumbra of ignorance always remains in practice.

Only part of the ignorance that remains is the result of individual decision making. Individuals are "rationally ignorant" when they realize that unknown dimensions or parameters exist, but decide not to learn anything about those unknown dimensions or parameters. Continued ignorance might be chosen for dimensions thought to be unimportant or too complex to be understood at a tolerable cost, as might be said of modern tax laws, trade regulations, most foreign languages, Chinese cooking, economics, and *many scenarios that lead to unpleasant policy surprises*. Most of our ignorance, however, remains unconsidered, a natural residual of our initial endowment.

1.3. Ignorance, Surprise, Urgency, and Mistakes

Although finite samples and ignorance have many similar behavioral implications, important differences between these two types of imperfect information also exist. Two of these are especially relevant for the analysis of crisis management.

First, unlikely events may occur in the search and Bayesian representations of imperfect information, but not complete surprises. Complete surprise is impossible, because there are no "unknown" possibilities. In contrast, *ignorance is allows the possibility of complete surprise, because some possibilities are unknown. Ignorance is therefore a sufficient condition for crises to emerge within a rational choice framework.* Ignorance implies that entirely unforeseen events may arise that call for immediate attention, which is what we normally mean by the term "crisis."

Second, the usual Bayesian characterizations of information allow the possibility of mistakes, but not systematic error. Random events may cause sensible choices to look foolish, ex post, but not systematically mistaken. Bayesian consumers may occasionally choose the wrong products, vote for the wrong candidates, and well-meaning elected representatives may adopt the wrong policies, but on average they select the right product, candidate, and policies, because the "error terms" associated with their beliefs have mean zero in the long run.

Ignorance, however, implies that "unknowns" are associated with every decision, and that "unbiased" decision making is possible only in areas in which ignorance does not lead to biased expectations. In areas in which missing variables are important, rational decision makers will make *systematic errors* insofar as they are ignorant of relevant variables and relationships.

Ignorance, however, does not rule out rational behavior. Rational choices remain possible in the sense that all the information available to decision makers is taken into account and the best of all known possibilities is chosen.[3] Ignorance simply implies that the list of possibilities considered may be very incomplete and that an individual's understanding of causal relationships (the conditional probability distributions between current actions and future events) may be erroneous in many respects. Together, these imply that systematic mistakes can be made by even the most careful and forward-looking decision makers.[4]

Ignorance, thus, allows the possibility of crisis and also implies that crisis managers are likely to make systematic mistakes. That is to say, crisis managers might honestly regret their past policy decisions in light of knowledge that becomes available after a crisis is over, but legitimately insist that their mistaken choices were the best that could be made, given what was known at the time they had to be made. Surprise and urgency are predicated on ignorance, and ignorance implies the possibility of honest mistakes.

2. AN ILLUSTRATION: OPTIMIZATION WITH MISSING VARIABLES

Several essential features of crisis management can be illuminated with the following model. Consider a setting in which individuals maximize a strictly concave utility function defined over their own private consumption, C, and personal health, H,

$$U = u(C, H) \tag{1}$$

Suppose that an individual's health, H, is a random variable that is affected by his or her own private expenditures on health care, E, and government public programs that reduce known health risk, R. In addition to these two readily observable control variables, suppose that an individual's health is also affected by risk factor Z, which is initially unobserved. Z could include such unknown factors as disease vectors, environmental toxins, terrorist plots, and geological pressures,

$$f(H) = h(H|E, R, Z) \tag{2}$$

Private income Y is assumed to decline as government regulations increase or as other health-improving programs increase at the margin because of increases in regulatory or tax burden.[5] An individual's personal opportunity set for private consumption and health care in this case can be written as $C = Y(R) - E$.

In their roles as private citizens, individuals select their health-care expenditures to maximize utility,[6] which can be written as

$$U^e = \int h(H \backslash E, R, Z) u(Y(R) - E, H)\, \mathrm{d}H \tag{3}$$

Differentiating Eq. (3) with respect to E and setting the result equal to zero allows the expected utility-maximizing level of risk-reducing public expenditures to be characterized as:

$$\int [h_{\mathrm{E}} U - h U_{\mathrm{c}}]\, \mathrm{d}H = 0 \tag{4}$$

Eq. (4) in conjunction with the implicit function theorem implies that the private demand for private health care can be written as

$$E* = e(R, Z) \tag{5.0}$$

with

$$E^*_{\mathrm{R}} = \left[\frac{\int [h_{\mathrm{ER}} U + h_{\mathrm{E}} U_{\mathrm{c}} Y_{\mathrm{R}} - h U_{\mathrm{cc}} Y_{\mathrm{R}}]\, \mathrm{d}H}{-\left[U^{\mathrm{e}}_{\mathrm{EE}}\right]} \right] < 0 \tag{5.1}$$

$$E^*_{\mathrm{Z}} = \left[\frac{\int [h_{\mathrm{EZ}} U]\, \mathrm{d}H}{-\left[U^{\mathrm{e}}_{\mathrm{EE}}\right]} \right] > 0$$

with

$$U^{\mathrm{e}}_{\mathrm{EE}} = \int [h_{\mathrm{EE}} U - 2 h_{\mathrm{E}} U_{\mathrm{c}} + h U_{\mathrm{cc}} Y_{\mathrm{R}}]\, \mathrm{d}H < 0 \tag{5.2}$$

The individual's demand for the regulation of health risks can also be determined from the same model. Given his or her private expenditures, a typical voter will favor the level of regulation that maximizes

$$U^{\mathrm{e}} = \int h(H | E^*, R, Z) u(Y(R) - E^*, H)\, \mathrm{d}H \tag{6}$$

which requires:

$$\int [h_{\mathrm{R}} U + h U_{\mathrm{c}} Y_{\mathrm{R}}]\, \mathrm{d}H = 0 \tag{7}$$

given the envelop theorem. Together with implicit function theorem, Eq. (7) implies that the political demand for regulation is a function of the unknown variable, Z,

$$R^* = r(Z) \tag{8}$$

The individuals of interest, however, are assumed to be ignorant about risk factor Z, so function $r(Z)$ cannot directly determine policy in this case.

Z can only indirectly affect the public demand for health care by its unrecognized effects on the marginal returns to private and public health expenditures, H_E and H_R. These returns may be known with certainty as long as Z remains at a steady state, $Z = Z^0$, in which case ideal policy $R^* = r(Z^0)$ can be adopted without any knowledge of Z. In such cases, ignorance does not reduce the effectiveness of private or public plans.

2.1. Policy Crises from Changes in Unknown or Neglected Variables

Ignorance of Z, however, can be a significant problem that leads to systematic errors in both public and private decision making if Z is not completely stable. For example, suppose that Z increases from Z^0 to Z' and produces an *unobserved* increase in the marginal returns from government policies to reduce health risks and to private risk-reducing expenditures. Such changes might go unnoticed if data on H_E and H_R are collected infrequently or if small changes are neglected. H is stochastic and thus minor fluctuations in the effectiveness of risk-reducing policies may be discounted as unexplainable random effects.

As long as the changes generated by the new level of Z are not recognized, the original policy remains "optimal" given the information available to decision makers, but no longer best advances their true interests. The unnoticed change in Z implies that Eqs (4) and (8) are no longer be satisfied at $R^0 = r(Z^0)$ and $E^0 = e(R*, Z^0)$. Losses accumulate, but there is no crisis because no attention is focused on policy reform. People are less healthy and/or comfortable than they would have been with more complete information, *but they do not yet realize this*.

The rate at which unnoticed losses accumulate under current public policies can be characterized as:

$$\Delta U^e = \int h(H|E^0, R^0, Z)u(Y(R^0) - E^0, H) \\ - (H|E', R', Z)u(Y(R') - E', H)\mathrm{d}H \tag{9}$$

where $R^0 = r(Z^0)$, $E^0 = e(R*, Z^0)$, $R' = rZ'$, and $E' = e(R', Z')$.

Consider now the consequences of a scientific breakthrough that allows data on Z and the relationship between Z and H to be collected for the first time. Three related crises can be generated by the discovery of Z as a risk factor. First, there is the immediate policy crisis. Previous private plans and public policies are now revealed to be suboptimal. New plans and new policies become necessary.

The "urgency" of the policy crisis varies with the perceived magnitude of the losses that accumulate. The higher the rate of perceived losses, the greater is the urgency of policy change.[7] Adopting an effective new policy, however, may be a nontrivial matter, both because major policy changes may be required and because it may take time before the effects of Z are completely understood.[8]

2.2. Knowledge Crises

An implication of the ignorance associated with unpleasant surprises, is that policy crises are often associated with a variety of "knowledge crises." Policy makers become more aware of their own ignorance and suddenly demand new policy-relevant information. The effect of Z on the marginal productivity of private and public expenditures will not immediately be understood, because previous experience involved only changes in E and R. New data and new analysis will be necessary to understand the effects of Z on health risks. The future time path of Z necessarily becomes a topic of research if capital investments are necessary to address risks associated with changes in Z. If Z simply moves to a new steady state, $Z = Z'$ and the new relationship between H and Z comes to be fully understood, the new optimal steady state patterns of public and private risk-reducing activities can be determined as above, $R' = r(Z')$, and $E' = e(R', Z')$. Unfortunately, neither scientists nor policy makers can initially be sure that Z has simply moved to a new steady state. Has Z temporally increased, moved to a new steady state, or begun a new process of increase? Perhaps Z is a stochastic variable. If so, how is it distributed?

The initial temptation will be to economize on research by ignoring the change in Z or simply extrapolating from the two available observations, $Z = 0$ and $Z = Z'$. Either approximation, however, may imply future levels of Z that are very wide of the mark. Having neither observed nor studied Z, little will be initially known about Z's behavior through time. Contemporary examples of such knowledge conundrums include urgent concerns over the future path of Islamic terrorism, global warming, and the acculturalization of recent immigrants within OECD countries.

Once the risks and time path of Z are understood, there may be subsequent efforts to control or influence the future course of Z. In such cases, completely new dimensions of policy may be added to the political agenda, which may, in turn, require new "crisis" research on Z policy to be produced and evaluated. Whether Z can be controlled or not, policy mistakes are likely to continue until both Z and policies for addressing Z are well understood, and this may take a long time.

Here, the reader might recall the wide range of public health problems that have plagued mankind for most of human history. Many solutions were tried over many centuries and much analysis was undertaken, but truly successful policies were adopted only in the past century or so as knowledge of bacteria, viruses, and other hazardous materials improved. Few plagues occur in developed countries these days, but this is a fairly recent state of affairs. Similarly efforts to control crime and fire, which are as old as civilization itself, have become increasingly effective as better routines, equipment, and materials became available.

2.3. Crisis Cascades

The ignorance associated with all true surprises also implies that mistaken policies are likely to be adopted, and that those mistakes may generate new crises insofar as mistakes have unanticipated effects. In the above model, secondary crises might arise in the period in which the relationships between R and Y or between Z and H are not fully understood. For example, increases in R beyond the range of experience might reduce Y by far more (or less) than initially believed, requiring a new round of emergency policy formation, hasty scientific research, and policy analysis. In this manner, urgency in combination with ignorance implies that one policy crisis may generate many others.

Urgency would not generate future policy problems without knowledge problems, but knowledge problems are an essential feature of all surprises and, therefore, all efforts at crisis management are prone to policy mistakes. In this manner, ignorance and urgency may generate crisis cascades that are not caused by the original crisis, but rather by errant responses to the original crisis. Some crises get out of hand simply because urgency prevents ignorance from being reduced sufficiently to permit accurate estimates of policy consequences.

3. THE POLITICS OF CRISIS MANAGEMENT IN A WELL-FUNCTIONING DEMOCRACY

In democracies, policy decisions are ultimately made by representatives elected by eligible voters. Because those elected to public office generally wish to stay in office and remaining in office requires broad electoral support, policy makers in democracies tend to favor polices that advance the interests of a broad cross-section of voters. In a ''first-past-the-post'' electoral system, electoral competition induces policy makers to adopt policies that maximize the welfare of the median voter (within the limits of their information).[9] Within a proportional representation (PR) system, electoral incentives are less sharp, but majority coalitions normally include the representatives favored by the median voter. Consequently, democratic policy formation within both first-past-the-post and PR electoral systems tends to move toward the middle of the distributions of voter demands for government services and regulation. In either case, electoral competition clearly constrains the policy options of elected officials who wish to be reelected.

3.1. Crisis and Democratic Policy Error

The existence of a crisis does not usually change fundamental political incentives, nor does political decision making avoid the information problems associated with surprise and urgency. That is to say, an ''ordinary'' crisis such as a new disease, major storm, accident, earthquake, or terrorist attack does not directly affect the balance of power within government, the incentives for choosing some policies over others, nor the difficulty of doing so in a setting in which decisions must be made rapidly without sufficient information.

Elected officials remain principally interested in broad policy issues that advance their electoral interests; consequently, democratic crisis management tends to focus on relatively severe and broad crises, because only those affect enough voters or attract enough sympathetic attention to influence future elections. Voters remain interested in maximizing their lifetime utility, whether in a crisis or not, and will vote for politicians and parties whose crisis management most advances their interests, given each voter's understanding of the policy alternatives and crisis at hand. The surprise and urgency of policy decisions during times of crisis implies that voters are more likely be mistaken in their assessments of their long-run interests.

An additional source of error is introduced in democracies, because surprise and urgency also imply that elected officials *do not have an electoral* *mandate* to address a crisis with specific policies, but rather have to discern hurriedly the future interests of their electoral supporters. Urgency rules out a careful analysis of long-term political interests by both voters and politicians. Policy responses to crisis will be based on less information than would have been available if policy decisions could be postponed until the next election. Democratic crisis management is, consequently, more error prone than normal democratic policy making is. It is based on less information, less analysis, and lacks a clear mandate from the electorate.

Although political decision makers remain interested in advancing the interests of pivotal voters, the urgency of crisis management implies that new policies are less likely to advance those interests than policies adopted in less urgent times, in part because the voters themselves are less able to determine their own interests. Policy mistakes will be more obvious after new policies are put into place than at the time they were adopted, because more information becomes available as experience and research accumulates. This implies that incumbents are more likely to *lose elections* following a crisis than in less urgent times, insofar as voters punish politicians for their past policy mistakes.

The policy decisions adopted during times of crisis, however, are not necessarily less legitimate than ordinary decisions if they are made using procedures that satisfy constitutional constraints. Government officials will simply appear to be less competent after periods of crisis than in ordinary times. Indeed, the logic of crisis management implies that this is necessarily the case.

3.2. Manufactured Crises: Agenda Control, Urgency, and Agency Problems

The above analysis assumes that voters have information that is comparable to elected policy makers, at least in terms of the dimensionality of the information available. Additional errors arise in settings in which policy makers and voters have substantially different information available to them. Informational asymmetries create a variety of agency problems, many of which have been analyzed by the rational choice literature on democratic politics. For example, informational asymmetries allow elected governments to adopt policies that are not in the general interest or those of electoral majorities, because some policies are largely unobserved, and, indeed, may be unobservable. A good deal of the special interest legislation that is passed, remains politically feasible because of such informational asymmetries. The beneficiaries of narrow policies have better reasons to be aware of such policies than those less affected.

What has not previously been analyzed is that informational asymmetries also allow crises to be manufactured – as when an agency announces that previously unrecognized problem Z has to be addressed immediately or else enormous losses will accumulate. By exercising agenda control during a period in which urgent action is required, crisis manufacturers can obtain more of what they want than possible during less urgent policy negotiations, because urgency implies that fewer alternatives to their initial proposal can be considered.[10]

Crisis manufacturing, thus, potentially allows governments to adopt policies that advance narrow ideological goals, favor their most supportive colleagues, contributors, and regions with little fear of electoral consequences. This effect of crisis is partly offset by increased voter demands for new policy-relevant information. However, voters tend to be less able to judge the quality of the information supplied, because they normally have little direct experience with the problems and solutions analyzed during times of crisis. Indeed, their relatively greater reliance on secondhand information makes them more susceptible to manipulation than in long-standing policy areas in which voter assessments of policy are partially rooted in their own independent observations and judgment.[11] Being aware of their own relatively greater ignorance, voters are also more willing to defer to governmental and other experts during times of crisis – after all, "something" has to be done!

These effects tend to alter the informal balance of power between voters and elected officials in a manner that reduces voter influence over public policy – at least in the short run. Times of crisis, thus, present interest groups inside and outside government with unusually great opportunities to profit by influencing the details of the policies adopted privately within the legislature and publicly through media campaigns. Bureaus may secure larger budgets and interest groups may be able to secure more favorable tax or regulatory treatments than possible during ordinary times, because voters and their elected representatives are more willing to accept the arguments and assertions of agency experts in times of crisis than in ordinary times and less able to monitor policy decisions.

All these informational asymmetries increase the likelihood of policy mistakes (suboptimalities from the perspective of the median voter) relative to ordinary policies under asymmetric information and relative to crisis management in the symmetric information case.[12]

3.2.1. Crisis Cascades can Lead to Constitutional Crises

In cases in which one policy error begets subsequent crises, voters may reasonably come to question the competence of their leaders and the performance of their fundamental political institutions. It is often difficult to distinguish among bad luck, incompetence, and institutional failure.

Consequently, crisis cascades can easily lead to constitutional crises as routine governmental procedures fail to produce satisfactory policy decisions for the crises at hand. A constitutional crisis may also arise because of internal or external attacks on constitutional procedures, as when elected officials willfully ignore constitutional limits, challenge long-standing constitutional practices, or a coup d'état is undertaken. Crisis cascades may encourage such attacks, as when hyperinflation undermines support for the existing constitutional regime. In either case, a major crisis can produce significant and mistaken reforms of the fundamental procedures by which governments make decisions.

Gasiorowski (1995) provides statistical evidence that changes in fundamental institutions are more likely to be adopted during times of economic crisis in large developing nations. Historical accounts provide additional evidence of changes in fundamental governmental procedures in response to crisis cascades.[13]

Constitutional responses to crisis are more problematic than ordinary political crisis management, because losses from mistakes can be very large. Changes in constitutional procedures generate losses that linger on after a crisis is over, because changes in the fundamental procedures and constraints of governance affect *all* subsequent policy decisions, rather than those associated with the crisis at hand. Losses associated with constitutional mistakes also tend to continue for longer periods than ordinary policy mistakes, because constitutional mistakes are inherently more difficult to correct than ordinary policies. Constitutional reforms often create a new balance of political power, which implies that the groups that adopted a constitutional reform cannot always repeal them if the new procedures or constraints perform less well than anticipated. The problem of irreversibility is increased by requirements of supermajority support in that reversion to previous rules can be blocked by a minority.[14]

The essential problem of constitutional crisis management, however, is not irreversibility, but rather the mistake-prone nature of rapid decision making in circumstances of limited information. All constitutional reforms are difficult to reverse; that is what allows ordinary amendments to function as new rules for the political game. The difficulty of lawful constitutional reform tends to increase the stability of constitutional rules and also tends to reduce the risk that one constitutional crisis will beget subsequent crises. The importance and irreversibility of constitutional amendments simply increases losses associated with mistakes.

4. STANDING PROCEDURES AND INSTITUTIONS FOR LIMITING DAMAGES FROM CRISIS MANAGEMENT

The above analysis has argued that the essential features of crisis settings – surprise and urgency – have a very general implication for policy outcomes. Namely, that policies adopted during times of crisis are more mistake prone than are policies adopted during normal times. Surprise and urgency, consequently, also have implications for designing effective and robust routines and institutions for crisis management.

The standard tools of welfare economics, social welfare functions and contractarian analysis, imply that institutions should attempt to limit downside risks associated with political and economic institutions. Although the extreme risk aversion assumed by Rawls is widely debated, the assumption that utility-maximizing men and women are risk averse is widely accepted by researchers using rational choice models. Utility functions are widely assumed to be differentiable and strictly concave, which implies both diminishing marginal utility of income and risk aversion.

Risk aversion has many implications for institutional design in peaceful and predictable circumstances, as noted, for example, in classic work by Buchanan and Tullock (1962) and Rawls (1971), and in more rent work by Mueller (1996), Buchanan and Congleton (1998), Brennan and Hamlin (2000), and Congleton (2003, part II). Risk aversion also has a number of implications for the design of routines and institutions to address crises of various kinds. Mistakes increase the downside risk associated with political decision making, and the logic of welfare analysis implies that the institutions should attempt to reduce those risks.

First, plan ahead. Urgency implies that there will be little time to explore alternative courses of action during a time of crisis. So, it is sensible to investigate and plan for crises before they happen to the extent that this is possible. Although surprise is a fundamental characteristic of all crises, ignorance of future crisis scenarios and policy responses to them can be reduced by creative analysis and planning. One can never fully anticipate the exact time and place of an earthquake, contagious disease, or terrorist attack, but many of the policy responses to these crises are similar regardless of specific details. A careful analysis of real and imagined crisis scenarios, thus, allows rapid policy responses to be chosen from a menu of well-understood policy options.

For example, an individual crime or fire remains a crisis in the sense that each case is a surprise and calls for an immediate response. However, responses to individual crimes and fires have been routinized, and, thus, particular crimes and fires are no longer regarded to be political crises, although they often have unique features and remain crises at the level of the persons directly affected. In this manner, analysis of past crises can reduce losses associated with mistakes during future periods of crisis; although it cannot entirely eliminate surprise, urgency, or mistakes.

Second, correct errors. Insofar as policy mistakes are unavoidable during times of crisis, the standing procedures for dealing with crisis should allow policy mistakes to be discovered and corrected at relatively low cost. This is, of course, one reason for having regular and routine popular elections rather than electing persons for lifetime terms of office. All emergency policies should have explicit "sunset" provisions so that policies are carefully reviewed after the immediate crisis has passed and better information becomes available.

Third, avoid big mistakes. A well-designed constitution should be crisis proof. It should be designed to handle the urgent unforeseen problems in a manner that does not threaten its fundamental decision procedures and constraints. Urgency implies that streamlined decision processes can be productive during times of crisis. However, emergency powers should not be used as a method of circumventing normal constitution practices. The standing procedures of crisis management should also allow persons other than those charged with crisis management to determine when the crisis has ended so that the normal decision processes are reinstated. (An example of such an architecture is provided by the US constitution, which gives Congress the power to declare war, but makes the President the commander in chief. The war can, however, only be continued with Congressional, approval insofar as Congress controls funding for the military on a year-to-year basis.)

Fourth, wait for the dust to clear. Constitutional amendments during times of crisis should be avoided to the extent possible, because changes in the fundamental procedures and constraints of governance are difficult to reverse and, consequently, constitutional mistakes tend to be far more costly than ordinary policy mistakes. To avoid such mistakes, procedures for dealing with crises should be designed, implemented, and revised during times that are relatively free of crisis. Consequently, amendment procedures should be somewhat more cumbersome than the requirements of ordinary legislation.

5. CONCLUSIONS: CRISIS MANAGEMENT AND RATIONAL CHOICE ANALYSIS

The fact that urgency and ignorance are essential features of crisis management has clear implications for policy making during times of crisis. Urgency, by definition, implies that a rapid policy response is advantageous. In combination with surprise, urgency implies that policy responses will be more error prone than are responses to less urgent or surprising policy problems, and this property of all crisis management should be taken account of.

Insofar as crises are fairly common events, the analysis predicts that every durable government will have developed standing procedures for dealing with urgent unexpected problems. Without such procedures, a city, region, or national government would be disadvantaged relative to those that have effective institutions for dealing with crisis. Although crises are by their nature unanticipated and unanticipatable, crisis management can be routinized within limits. The costs of policy mistakes can be minimized by conducting policy research that reduces ignorance about possible problems and responses, creating narrow, streamlined decision procedures for making emergency decisions with clear lines of responsibility and making emergency decisions temporary, and easily reversible as new knowledge becomes available. The costs of crisis management can also be reduced by avoiding major procedural and constitutional reforms during times of crisis.

However, insofar as a government's routines and institutions of crisis management reflect trial and error rather than analysis of the common properties of all crises, unusual crises will not be properly accounted for in existing routines. The likelihood and costs of errant decisions in such cases can be reduced by acknowledging the prospect of error and designing general routines and institutions for crisis management accordingly.

The advent of crisis does not change the nature of human decision making, although it does systematically reduce the quality of the decisions made at a point in time, and through time insofar as the errors of one round of crisis management may generate subsequent emergencies that have to be dealt with rapidly. In this manner, completely rational decisions in a crisis setting may lead to unexpected and undesirable consequences, and thus error detection and correction should play an important role in every response to crisis.

NOTES

1. This discussion distills essential features of the word "crisis" typical in ordinary usage of the term, and also parallels that used by political science research on crisis

management. Herman (1972, p. 13) is credited with the classic definition of crisis: "A crisis is a situation that threatens high priority goals of the decision making unit, restricts the amount of time available for response before the decision is transformed and surprises members of the decision making unit by its occurrence."

2. This is not to say that surprise or urgency have gone unanalyzed by the broader political science and economics communities. The importance of surprise events in ordinary life is a core assumption in Schackle's (1969) work in economics and there is a substantial literature on crisis management in political science and public administration, largely focused on urgent international military and financial crises. To the extent that general conclusions are drawn, they are drawn from a series of meticulous case studies. They are inductive rather than deductive. See, for example, Herman (1972) and Rosenthal and Kouzmin's (1997) for overviews of the more analytical subsets of those literatures.

3. The quality of individual decision making may also be affected by intense emotions, such as fear or anger, that reduce the quality of rational decision making, but these effects are neglected in the present analysis.

4. Such decisions might be said to be instances of "bounded rationality" in the sense that they are informationally bounded. However, they are not "bounded" because of lack of computational power or systematic failures of the mind, as is sometimes implied by the researchers who employ the bounded rationality concept (Conlisk, 1996), but rather because so much is unknown to decision makers at the moment that choices are made.

5. Across some range, personal income may increase as R increases, insofar as improved health improves productivity in the workforce. However, when R is set at approximately the level that maximizes median voter utility, R will be increased until it is in the range in which R decreases personal income (see below); thus, for expositional and analytical convenience, Y_R is assumed to be less than zero across the range of interest.

6. Sufficient conditions for strict concavity are $U_C > 0$, $U_H > 0$, $U_{HC} > 0$, $U_{CC} < 0$ and $U_{HH} < 0$. In addition to the strict concavity of U, it is assumed that the marginal return from private health care is reduced by effective regulations, $H_{ER} < 0$, and increased by risk factor Z, $H_{EZ} > 0$.

7. Urgency may exaggerated in cases in which panic or terror is generated by the sudden changes in perceived health risks associated with disease or attacks. In effect, Z' may be mistaken for Z'', with $Z'' >> Z$, or relationship $H_Z < 0$ may be misestimated because of the scarcity of information about current and past values of Z.

8. For example, Bayesian adjustment converges on the true underlying distribution of Z in the long run, but remains inaccurate, indeed biased, in the short run for cases such as the one postulated here – even after the dimensionality of the posterial probability function is corrected.

9. Many economists argue that public policies should address public goods and externality problems. Electoral competition only assures that relatively broad policies of interest to a large number of voters will be addressed. These may or may not involve public goods. (Narrower policies may also be adopted in cases in which politicians require resources to run their campaigns and significant asymmetries exist. Information asymmetries are addressed in Section 5.)

10. A good deal of the crisis literature in political science addresses international security problems as noted above. Many international security problems are manufactured (that is to say the result of deliberate choices), and many of these are genuine surprises to at least some of the affected parties. Military theorists often recommend "surprise attacks" in part because surprise makes it difficult for the opposition to respond effectively, (Liddell-Hart, 1967).

11. Of course, voters realize that secondhand information is not always accurate or unbiased and take this into account as much as possible. The lack of direct experience on the policy issues at hand, however, limit the extent to which this is possible. To the extent that disseminating information has any systematic effect on voter knowledge, it can be used to influence voter assessments of the relative merits of policy. Such effects are very evident in new areas of environmental regulation and in recent responses among nations to the threat of international terrorist attacks.

12. Among many other examples of rent seeking during a time of crisis, one can point to recent efforts in the United States to address its 9/11 crisis. Military expenditures rose rapidly after the terrorist attack, but as Wheeler (2004) and Rugy (2004) point out, a good deal of the increase in military expenditures justified as antiterrorism efforts, had little to do with terrorism. Moreover, per capita expenditures on "homeland security" were often highest in rural states where the probability of attack is relatively low (Wyoming, North Dakota, and Alaska) and lowest in more densely populated states where risks are relatively high (New York and California). Of course, such rural states voted disproportionately favor of the Republican presidential candidate (69%, 63%, and 62%) overseeing those expenditures than did the more urban states (40% and 45%), where terrorism is arguably a greater threat.

13. For example, the suspension of democracy in Italy during the interwar period was an unfortunate consequence of a crisis cascade. The break down of law in order following WWI created a crisis mentality throughout much of Italy, a sense of uncertainty and urgency. A small Fascist political party emerged partly because of this and successfully won 35 of the 535 seats in parliament in the 1921 elections. Among their members was an ambitious journalist named Mussolini. Fascist groups created a constitutional crisis in 1922 by marching on Rome. King Victor Emmanuel III responded to the crisis by appointing Mussolini prime minister, rather than calling out the army. The new right of center coalition government asked for and received emergency power and electoral reform in 1923 with the approval of parliament. The new election law, the Acerbo, assured "strong" government by giving two thirds of the seats in parliament to the party or coalition with the most votes. The Fascist coalition easily won the election of 1924, and the coalition of Fascists, Nationalists (Conservatives), and Liberals resumed office but now with essentially complete control of parliament. The left-of-center opposition parties created another constitutional crisis by walking out later in the same year after the murder of a prominent leader. They were prevented from resuming their seats, which further tipped the parliamentary balance toward the Fascist and Nationalist components of the government. In 1925 the laws on censorship were strengthened. The right-of-center coalition began to splinter in 1925, but it was already too late for the Liberals. In 1926 opposition parties were banned, thus, ending electoral competition for 20 years (Duggan, 1984). Without competitive elections, governance became unshackled from moderating pressures associated with majority rule and the error

correction associated with public debate and electoral feedback. Similar patterns of "emergency" constitutional reforms exist for Germany, Argentina, and many African countries during the past century.

14. Formal and informal procedures for revising constitutions are more demanding than are procedures for adopting ordinary legislation. A series of legislative decisions separated by an election may be required, a national referendum might be called for, or supermajority approval by several elective bodies may be necessary for adopting constitutional reforms. Such procedures are designed to reduce the likelihood of constitutional mistakes by subjecting proposed reforms to repeated analysis and decision points. Constitutional reforms adopted during times of crisis, however, pass rapidly through this process, eliminating the careful deliberation and debate of reforms adopted during less urgent times.

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THE CONFLICT ABOUT THE MIDDLE OF THE ROAD: THE AUSTRIANS VERSUS PUBLIC CHOICE

Erik Moberg

1. INTRODUCTION

This paper is about something which, at least superficially, looks like a conflict between public choice theory and Austrian social science, in particular as represented by Friedrich Hayek and Ludwig von Mises. What I am referring to is the conflict between the so-called Median Voter Theorem, on the one hand, and the Austrian contention that there is no "middle way", on the other. The Median Voter Theorem, as the reader knows, is often formulated within the framework of a left-right continuum, and it says that the decision taken will correspond to the position of the median voter. Thus, if the voters are distributed in a roughly symmetrical way along the left-right continuum, the decision will be a position somewhere close to the middle of the scale. The Austrians, on the contrary, claim that there is no such thing as a middle of the road outcome. Only socialism and liberalism are real alternatives.

The purpose of the paper is to clarify the nature of this conflict. In particular I want to find out the extent to which the conflict is real, and the extent to which it is just illusory.

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2. THE CONFLICT

2.1. The Median Voter Theorem

The left-right continuum, which I referred to above, is a special case of the so-called spatial model. The basic idea in this model is to describe people's political opinions by placing them at appropriate positions on a scale. Thus, the scale often represents positions from what is commonly understood as extreme left positions, through the middle field of politics, to the extreme right positions. Such a left-right scale is however only one of several possible scales.

The Median Voter Theorem is formulated within the framework of a one-dimensional, spatial model. The theorem says that, if the simple majority rule is used, the opinion held by the median voter will become the decision. The median voter is the voter having as many voters on her one side of the scale as on her other side. Thus, in Fig. 1, where the curve indicates the distribution of the voters along the scale, the voter M is the median voter. What makes the theorem true is that the median position will beat any other position in a vote. If, for instance, the positions M and P are put against each other, the position M will get all the votes to the left of O, and P will get all the votes to the right of O. Thus M wins. A condition for the truth of the theorem is that the voters' preferences are "single peaked", which means that each voter ranks political positions lower the farther away, in either direction, they are from her own position on the scale.

The rigorous formulation and proof of the Median Voter Theorem is due to the economist Duncan Black (1948, 1958), and his result has been hailed by the political scientist William Riker (1990, p. 178) as "certainly the greatest step forward in political theory in this century".

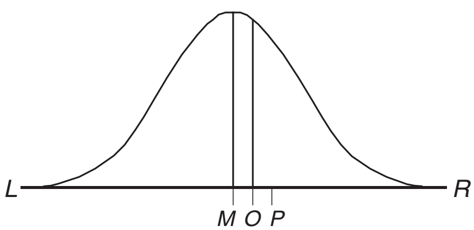

Fig. 1. Competition at the Middle of the Road.

2.2. Some Similar Results

But even if Black was the first one to make a real theorem of the matter, the idea had been formulated several times before Black by other scholars. There was, indeed, another proposition, which is very close to the Median Voter Theorem or really just a variety of it. According to this other proposition two political parties, which are competing for votes, have to position themselves close to the electorate's median in order to have a chance to win. The reason is again simple. If one of the parties deviates substantially from the median position, the other party will easily beat it by just taking that position. If there are more than two parties this result however does not hold.

The best known of the scholars advocating this proposition was, perhaps, the economist Harold Hotelling (1929). In his 1929 paper, while alluding to a political spectrum, he alleged that competing political parties, at least when there are just two of them, tend to take positions very close to each other in the middle of the spectrum. "The competition for votes", he wrote, "between the Republican and Democratic parties does not lead to a clear drawing of issues, and adoption of two strongly contrasted positions between which the voter may choose. Instead, each party strives to make its platform as much like the other's as possible."

Even some political scientists had very similar ideas. Thus Elmer Eric Schattschneider (1942), in his *Party Government* (p 85), claimed that:

> The second effect of the two-party system is the fact that it produces moderate parties. ... When one stops to consider the amount of thought and energy that has been devoted to the effort to protect people against oppression, it is difficult to imagine anything more important than the tendency of the parties to avoid extreme policies.

Furthermore, Schattschneider brings A. Lawrence Lowell,[1] who wrote as early as around 1900, into his own argument in this way:

> A generation ago President Lowell, writing about English major parties, said that the Liberal and Conservative tended to move toward the political center of gravity, i.e., they tended to be alike. Indeed, the most common criticism made of the American parties is not that they have been tyrannical but that they have been indistinguishable. (There is a strong) tendency of the parties to move toward the middle of the road.

Similarly V. O. Key (1964), in his extensive study *Politics, Parties, & Pressure Groups*, first published in 1942, stated, when describing the US political parties in election campaigns, that (p. 220):

> Each party leadership must maintain the loyalty of its own standpatters; it must also concern itself with the great blocks of voters uncommitted to either party as well as with

> those who may be weaned away from the opposition. These influences tend to pull the party leaderships from their contrasting anchorages toward the center. In that process, perhaps most visible in presidential campaigns, the party appeals often sound much alike and thereby contribute to the bewilderment of observers of American politics.

In 1951 Maurice Duverger (1964) draw a similar conclusion when discussing the British parties in his great study *Political Parties* (p. 387 f). He wrote:

> Let us take a precise example, that of contemporary Britain, neglecting the Liberal party, which is no longer important. Who decides whether the Conservative or the Labour party shall win the election? Not their fanatical partisans who, being unable to cast their vote for any party further to the Right or to the Left, will naturally vote for them whatever they do, but the two or three million moderate Englishmen, politically situated at the Centre, who vote sometimes Conservative, sometimes Labour. To win their votes the Conservative party is forced to attenuate its Conservatism and Labour its Socialism, both of them adopting a calm tone, a reassuring aspect. Both will have to to draw up policies clearly aimed at the Centre and therefore profoundly similar. We arrive at the paradoxical situation that the Centre influencies the whole of parliamentary life in the very country in which the electoral system prevents the formation of a Centre party.

Even if Duverger's work appeared three years after Black's essay it is quite possible that he did not know about Black's result, and anyway, which is the important thing here, he obviously supports the idea about the prevalence of middle of the road politics.

Mainstream political science thus stresses the tendency of political processes to avoid extreme positions and to end up in the political middle, at least in the British and American two-party systems. The Median Voter Theorem in public choice theory provides the theoretical underpinning for this tendency.

2.3. The Austrians' Positions

The Austrians, and here I am thinking in particular about Friedrich Hayek and Ludwig von Mises are however strikingly at odds with these ideas. Starting with Hayek (1944), he writes in The Road to Serfdom (p. 31), after having discussed socialism and liberalism, that:

> [M]ost people … believe that it must be possible to find some Middle Way between 'atomistic' competition and central direction. Nothing indeed seems at first more plausible, or is more likely to appeal to reasonable people, than the idea that our goal must be neither the extreme decentralisation of free competition, nor the complete centralisation of a single plan, but some judicious mixture of the two methods.

This idea of a mixture of the two systems is however refuted by Hayek (1944). He writes (p. 31) that:

> Both competition and central direction become poor and inefficient tools if they are incomplete; they are alternative principles used to solve the same problem, and a mixture of the two means that neither will really work and that the result will be worse than if either system had been consistently relied upon.

True, Hayek's position, as just described, is not logically incompatible with the contention that politics tends to move toward the middle, since Hayek only says that the median policy is inefficient. He argues however also, as we shall see later, that this inefficiency of the middle position will make it unstable and, indeed, pave a road to serfdom. And this, of course, is a far cry from, for instance, Schattschneider's contention about harmonious, nonoppressive, middle of the road politics.

Even Mises refutes the idea of a middle way, but his argument is different. The basis is his theory of interventionism, according to which an intervention always leads to further interventions, in wider and wider circles, until the whole of society has become socialist. Or, in Mises'(1949) own words in *Human Action* (p. 858):

> All varieties of interference with the market phenomena not only fail to achieve the ends aimed at by their authors and supporters, but bring about a state of affairs which – from the point of view of their authors' and advocates' valuations – is less desirable than the previous state of affairs which they were designed to alter. If one wants to correct their manifest unsuitableness and preposterousness by supplementing the first acts of intervention with more and more of such acts, one must go farther and farther until the market economy has been entirely destroyed and socialism has been substituted for it.

Hence, according to Mises (1949), there is no viable societal order between liberal capitalism and socialism, and therefore he concludes (p. 861) that:

> Men must choose between the market economy and socialism. They cannot evade deciding between these alternatives by adopting a "middle-of-the-road" position, whatever name they may give to it.

3. THE EXISTENCE AND NATURE OF THE IDEOLOGICAL LEFT-RIGHT SCALE

3.1. Introduction

In a formal sense the Median Voter Theorem is obviously correct if all the necessary assumptions are fulfilled. Thus, if there is a one-dimensional scale, which makes sense, and if the other assumptions are fulfilled as well, then the theorem holds. Still we may ask if a one-dimensional left-right scale makes sense in this context. Is there, indeed, such a thing as an ideological scale, and if so, what is its nature? Are the public choice theorists and the Austrians in agreement about these matters or not? I will start by investigating these matters since, if there is no agreement about the existence of the scale, then, quite conceivably, there need not be any agreement about the existence or nature of a middle point either.

3.2. The Public Choice Theorists

Starting with Black (1958) himself it is important to note that he, in his work *The Theory of Committees and Elections*, deals mainly with motions, or proposals, which can be described by a single number. Thus, he exemplifies (p. 9) with "a decision with regard to the price of a product to be marketed by a firm, or the output for a future period, or the wage rate of labour, or the height of a particular tax, or the legal school-leaving age, and so on." Then, after having discussed examples like that, he raises (p. 11) some rather philosophical, or epistemological, problems which may be associated with his symbolism. He does not, however, find those problems serious and summarizes his discussion as follows (p. 14):

> These are the main objections which may be brought against the symbolism we use. Certainly they raise difficult questions in the theory of knowledge, as indeed do all similar queries that may arise in any branch of mathematical science. But there seems to be no doubt that the symbolism we use is valid.

Then, much later in his book, and all of a sudden, there appears an example using a kind of left-right scale. He writes (p. 78 f):

> Let us suppose that in a constituency where there are 99 voters, Liberals, Conservatives and Labour have each put forward three candidates for the three seats available; that each of these parties has secured 33 first-preference votes; and that when the Labour candidates are placed at the left of the horizontal axis, the Liberals in the middle and the Conservatives at the right, the voters' preferences can be represented by single-peaked curves.

Accompanying this text there is also a figure showing the scale and the positions on that scale of Labor, the Liberals, and the Conservatives.

As for Black, we may thus conclude that, on the whole he discusses scales which are much simpler, and less problematic, than the ideological left-right scale. In just one case he happens to present an example including a left-right scale. In Black's book the place of the left-right scale is thus utterly marginal.

After this we may now turn to Anthony Downs (1957) who, in *An Economic Theory of Democracy*, was one of the first scholars to make an extensive use of an ideological left-right scale. He introduced the scale as follows (p. 115f):

> To carry out this analysis, we borrow and elaborate upon an apparatus invented by Harold Hotelling. … Our version of Hotelling's spatial market consists of a linear scale running from zero to 100 in the usual left-to-right fashion. To make this politically meaningful, we assume that political preferences can be ordered from left to right in a manner agreed upon by all voters. They need not agree on which point they personally prefer, only on the ordering of parties from one extreme to the other. … In addition, we assume that every voter's preferences are single-peaked and slope downward monotonically on either side of the peak (unless his peak lies at one extreme on the scale).

Then, making things more concrete, he goes on like this (p. 116):

> These assumptions can perhaps be made more plausible if we reduce all political questions to their bearing upon one crucial issue: how much government intervention in the economy should there be? If we assume that the left end of the scale represents full government control, and the right end means a completely free market, we can rank parties by their views on this issue in a way that might be nearly universally recognized as accurate. In order to coördinate this left-right orientation with our numerical scale, we will arbitrarily assume that the number denoting any party's position indicates the percentage of the economy it wants left in private hands (excluding those minimal state operations which even the most Hayekian economists favor). Thus the extreme left position is zero, and the extreme right is 100. Admittedly, this apparatus is unrealistic for two reasons: (1) actually each party is leftish on some issues and rightish on others, and (2) the parties designated as right wing extremists in the real world are for fascist control of the economy rather than free markets. However, we will ignore these limitations temporarily and see what conclusions of interest we can draw from this spatial analogy.

Downs thus works with a continuous, ideological left-right scale, which is clearly defined. At one end of the scale the whole of the economy is in government hands, which may be called socialism. At the other end of the scale the state is given a minimal role, which may be characterized as liberal capitalism. The points in between may be considered as mixtures of these two pure end-positions. True, Downs mentions some problems with his scale, but he also chooses to overlook these problems.

3.3. The Austrians

Of all the scholars discussed here Mises has the most elaborate and accurate treatment of the ideology concept. Furthermore, this treatment is of great relevance for the idea of an ideological scale. In his definition of the ideology concept Mises (1949) starts by defining the concept of world view as follows (p. 178):

> A world view is, as a theory, an interpretation of all things, and as a precept for action, an opinion concerning the best means for removing uneasiness as much as possible. A world view is thus, on the one hand, an explanation of all phenomena and, on the other hand, a technology, both these terms being taken in their broadest sense. Religion, metaphysics, and philosophy aim at providing a world view. They interpret the universe and they advise men how to act.

Then he proceeds to the ideology concept, explaining it like this (p. 178):

> The concept of an ideology is narrower than that of a world view. In speaking of ideology we have in view only human action and social cooperation and disregard the problems of metaphysics, religious dogma, the natural sciences, and the technologies derived from them. Ideology is the totality of our doctrines concerning individual conduct and social relations. Both, world view and ideology, go beyond the limits imposed upon a purely neutral and academic study of things as they are. They are not only scientific theories, but also doctrines about the ought, i.e., about the ultimate ends which man should aim at in his earthly concerns.

As for the specific contents of ideologies Mises'(1949) main point is that human beings, for their well-being, must cooperate. Hence he argues that (p. 184):

> Because man is a social animal that can thrive only within society, all ideologies are forced to acknowledge the preeminent importance of social cooperation. They must aim at the most satisfactory organization of society and must approve of man's concern for an improvement of his material well-being. Thus they all place themselves upon a common ground. They are separated from one another not by world views and transcendent issues not subject to reasonable discussion, but by problems of means and ways.

We thus see that, according to Mises, ideological differences basically are about "means and ways" not about goals. At the time of his writing Mises observed three types of ideologies, namely liberalism or capitalism, socialism, and interventionism. Thus he wrote (p. 183):

> In the field of society's economic organization there are the liberals advocating private ownership of the means of production, the socialists advocating public ownership of the means of production, and the interventionists advocating a third system which, they contend, is as far from socialism as it is from capitalism.

Mises thus mentions three ideologies, and at the same time, when he says that the third ideology, namely interventionism, according to its supporters, is as far from socialism as it is form capitalism, he at least indicates the possibility of a scale. It seems perfectly possible that Mises accepts the idea of an ideological scale, and that, so far, he has indicated three points on that scale. Furthermore, and remembering his saying in an earlier quotation, that a single first intervention leads "farther and farther until the market economy has been entirely destroyed and socialism has been substituted for it" he seems to consider, in fact, a complete and continuous scale, and thus not just three points. True, he considers the points between the two extremes as unstable, but that issue, which I will deal with below, is another one than the one about the existence of the points. Indeed, it is interesting to see how close Mises is to Downs here. Downs, as we have seen, explicitly talks about percentages of interventionism, and Mises seems to have something very similar in mind.

Even Hayek, as we have noted, though in a much less elaborate way than Mises, talks about the two pure ideologies of socialism and capitalism and mixtures of them. Thus even Hayek seems to have a continuous, ideological left-right scale in mind.

3.4. Summarizing Remarks

We can thus conclude that the public choice theorists and the Austrians, and also the main stream political scientists for that matter, all have a very similar continuous, ideological left-right scale in mind when discussing middle of the road politics. Basically this is a scale with pure ideologies at the ends – socialism at the one end and liberal capitalism, or perhaps conservatism, at the other end, and mixtures of these two pure ideologies in between. The differences between the Austrians and the public choice theorists are thus related to other things than the scale as such. I have already indicated that ideas about stability may be one possible reason for the differences, and that judgments of the value of the middle of the road position may be another such reason. I will discuss these matters in the following. Before that, as a preparation for the discussion, I will however present two important distinctions.

4. TWO DISTINCTIONS

4.1. The Distinction Between Incremental Changes and Accumulated Results

Even if there is an agreement about the scale as such it is not, so far, exactly clear what should be measured by the scale. In particular the distinction between incremental changes, or perhaps single individual decisions, on the one hand, and the accumulated effects of many such changes or decisions, on the other hand, is important. Sometimes this distinction seems to be disregarded, or, at least implicitly, considered unimportant. Remember, for example, Downs' definition of his scale as described above. The points on that scale indicate the percentage of the economy left in private hands. Now, in practical politics, it is easy to imagine that the voters never vote about that "total mixture" but rather about individual proposals, such as whether a particular enterprise should be private or public. And if so the "total" mixture is perhaps never decided about, but rather something which just happens to emerge in one way or the other. Hence the importance of the distinction between the incremental changes and their accumulated effects.

As an illustration of this distinction we may think about the descriptions of political competition in the quotations from Hotelling, Schattschneider, Key and Duverger above. All of these authors hold, we remember, that the two political parties take positions very close to each other in the middle of the ideological spectrum. We may think about this analysis as applying in particular to individual election campaigns. Thus, according to this interpretation, all the campaigns in a particular country, one following after the other, may be quite similar. Still it is quite conceivable that the accumulated effects of these campaigns, and the decisions following from them, change all the time. It is, for instance, quite possible that the public sector increases continuously or steadily as the election periods are passing by. Thus, even if all election campaigns are run in the middle, that does not mean, for instance, that the country's economy necessarily, and continuously, will remain a "fifty-fifty" mixed economy.

4.2. The Distinction Between the Decisions as such and Their Properties when Implemented

In order to explain this distinction, I will use an example, which I think is useful even if it also may seem extreme. Suppose that there is a group of people which shall decide where to place a stone on a perpendicular line from the stratosphere to the bottom of the ocean. The distribution of the group members' opinions on the issue is indicated by the curve in Fig. 2. The median opinion thus is that the stone should be placed at the sea level and that opinion, therefore, will become the decision. When, however, this decision is implemented, which means that the stone is placed at the sea level and left on it own, the stone will fall to the bottom of the ocean.

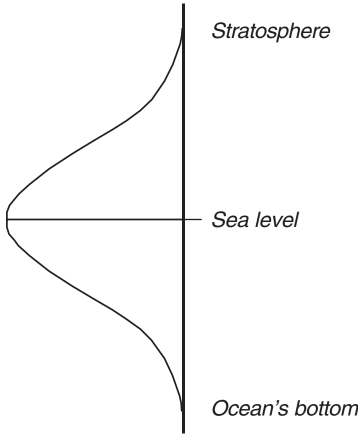

Fig. 2. The Falling Stone Metaphor.

The important thing here is the distinction between the decision-making procedure as such, on the one hand, and the properties of the implemented decision in its material context, on the other. What is shown is that the outcome of the decision-making procedure, taken in isolation, may very well be stable, or an equilibrium, whereas the implemented result, at the same time, may be utterly unstable. In the example, the median position is stable in the sense that it beats all other positions, but still the implemented result, that is the stone placed at the sea level, is unstable since the stone will sink to the bottom. In other words, this means that decision makers are not able to control reality simply by making decisions and implementing them – reality has a life of its own, and will react in its own way to the decisions taken.

5. THE NATURE AND STABILITY OF THE MIDDLE POSITION

5.1. The Public Choice Theorists and the Political Scientists

The reason which the public choice theorists, and also the political scientists, give for the preponderance of middle of the road politics is essentially strategic in nature, or even game-theoretical: If all parties act rationally the median, according to this reasoning, will become the solution of the game. This outcome, being the solution, is also an equilibrium point in the game theoretical sense, and thus stable. Hence the scholars we are considering here conclude that middle of the road politics is stable and durable.

5.2. The Austrians

Now, going from this example to the Austrians, they argue that middle of the road politics is unstable and hence not possible to realize. But even if Hayek and Mises agree in a very general sense about this, they have very different ideas about the exact nature, or about the mechanisms, of the instability.

Starting with Mises his opinion about middle of the road politics is based on his theory of interventionism. According to this theory an intervention will lead to further interventions "until the market economy has been entirely destroyed and socialism has been substituted for it". Hence "[m]en must choose between the market economy and socialism". They cannot adopt a "middle-of-the-road" position.

Mises' theory of interventionism can be characterized as an extreme domino theory. What he says, in principle, is that a single intervention leads to further and further interventions until a complete transformation of the whole society, from liberal capitalism to socialism, has taken place.

It is interesting to note that a single intervention in this context is a rather limited thing, or in Mises' (1949) own definition (p. 718):

> The intervention is a decree issued directly or indirectly, by the authority in charge of society's administrative apparatus of coercion and compulsion which forces the entrepreneurs and capitalists to employ some of the factors of production in a way different from what they would have resorted to if they were only obeying the dictates of the market.

Furthermore, he says (p. 718, his italics) about the interventions occurring in his theory that:

> [They] are *isolated* acts of intervention. It is not the aim of the government to combine them into an integrated system which determines all prices, wages and interest rates and thus places full control of production and consumption into the hands of the authorities.

But if the interventions are isolated in this sense, how come interventions always lead to new interventions? The basic reason is that the markets, as indicated in the definition above, react to each intervention, and thereby nullify or obstruct the intentions of the interventionists. Therefore, the interventionists feel compelled to react anew, in their turn, in order to realize their intentions. Hence, an initial intervention will lead to a long sequence of market reactions and new interventions until, finally, society is completely socialized.

Now, using the two distinctions presented in the former section, it is easy to characterize Mises' theory. First, when taking into account the market reactions following from an intervention, he includes in his argument something which is not controlled by the interventionists, or the decision makers. This, thus, corresponds to the metaphor of the falling stone. Second, he distinguishes between incremental changes, that is the individual interventions, and the accumulated final result. When he excludes the possibility of a middle of the road policy it is the final result he has in mind.

Mises' main argument against the possibility of a middle of the road policy thus has to do with its instability, or with the impossibility of realizing it. Hayek's (1944) main argument, as we will see in the next section, is rather that the policy in the middle is bad or inefficient. But he has a kind of instability argument as well. He claims that somewhere on the road from liberal capitalism to socialism, that is on our left-right scale, there is a point of no return such that, if that point is passed, serfdom is inevitable. The reason is that people, even if they agree about the necessity of planning, also, necessarily, disagree about the content of the plan. Thus he writes (p. 50):

> [A]greement that planning is necessary, together with the inability of democratic assemblies to produce a plan, will evoke stronger and stronger demands that the government or some single individual should be given powers to act on their own responsibility. The belief is becoming more and more widespread that, if things are to get done, the responsible authorities must be freed from the fetters of democratic procedure.

Hence, "[P]lanning leads to dictatorship because dictatorship is the most effective instrument of coercion and the enforcement of ideals, and as such essential if central planning on a large scale is to be possible." (p. 52). His main example is the rise of Hitler and he writes that, "Hitler did not have to destroy democracy; he merely took advantage of the decay of democracy and at the critical moment obtained the support of many to whom, though they detested Hitler, he yet seemed the only man strong enough to get things done." (p. 50).

Hayek's description of the mechanisms involved here is, I think, quite clear. What he describes is, essentially, one single, big step from democracy to dictatorship, and the ensuing result of that. He is however also quite vague about the position of the point of no return. Is that point located at the middle of the road, or, perhaps, to the right, or even far to the right, of the middle? About this there is no clear indication in Hayek's work. Still, since there is a point of no return somewhere on the scale, there is also a threatening instability. It may also be argued that the people, when they choose to install a dictator, lose all the control of what is happening thereafter. Hence the metaphor of the falling stone is relevant once again.

It is also obvious that Hayek, in the same way as Mises, is more interested in the accumulated final result than in the incremental changes. But even so the differences between Mises and Hayek are also striking. One difference is that Hayek's process includes just one single, big step, whereas Mises' process is composed of many small steps. Another difference is that Hayek's process is entirely political, whereas Mises' process is an interaction between politics and markets.

A few words may be said here about the realism of Mises and Hayek's theories. Mises' theory of interventionism is, as I have already indicated, quite extreme and, I would also say, hardly plausible. The idea that complete socialism will follow from a single intervention seems much too far-fetched. Indeed, it is quite easy to imagine interventions that do not lead to further interventions. In order to see this it is enough to consider what Mises (1949) says when he describes the purposes of interventionism. "The essence of the interventionist policy", he writes, "is to take from one group to give to another. It is confiscation and distribution. Every measure is ultimately justified by declaring that it is fair to curb the rich for the benefit of the poor" (p. 855).

Now, interventions of this kind will certainly stimulate various market reactions, but there is no reason why those market reactions, in turn, should lead to further political interventions. If, as Mises holds, the government's purpose is to redistribute income, and not to enhance economic efficiency, this purpose is achieved by the first intervention.

This does not, however, rule out the possibility that interventions sometimes give rise to further interventions, exactly as Mises also says. This possibility indicates the expediency of a distinction between interventions that are provoked by other interventions, and interventions which are not provoked in this way, and thus, in this sense new. And the combined effect of these two kinds of interventions may very well be a continuous and almost irreversible, rise of the public sector. In particular this is so since new nonprovoked interventions can be expected to occur all the time as a result of the political competition for votes. Thus, if Mises' theory is reformulated in that way, it seems quite realistic and compatible with the development in the Western democracies.[2]

Hayek's contention that people's failure to agree about a specific plan will lead to demands for a dictator is, I think, usually wrong, even if there may be exceptions. First, I think it is fair to say that the development in the world since Hayek published his book in 1944 contains few if any corroborating examples. When going into detail it also seems as if people, when they fail to agree about plans, at least sometimes, make the plans vague rather than asking for a dictator.

An example is the Swedish energy policy since the oil price hikes during 1973/1974. When that policy was first formulated and decided on in 1975 its reliance on socialist planning was striking. In so-called energy balances the quantities of various energy goods, for instance oil, to be supplied and consumed during the following years were specified in a rather exact, quantitative way. As time went on the lacking realism of these ambitions did however become evident, and therefore the plans were made vague and more vague. At first, rather broad intervals were substituted for the former more precise figures. Then also the intervals disappeared and the responsible minister even declared that it was "meaningless" to quantify the levels of future supply and consumption.

5.3. Summarizing Remarks

It is now easy to see the main differences between the Austrians and the public choice theorists including the political scientists.

It is clear that the Austrians, as made evident by their way of arguing, make a distinction between incremental changes and accumulated effects. Furthermore, they focus mainly on the accumulated effects, and it is concerning them that they claim that there is no middle way. A main reason for this is that there are elements in the relevant processes that lie outside the control of the decision makers.

Almost all of this is different for the public choice theorists and the political scientists. At first, they make no clear distinction between incremental changes and accumulated effects. A reasonable interpretation, however, is that they, in fact, deal mostly with individual decisions or incremental changes, not with accumulated effects. The political scientists' proposition, that the political parties in a two-party system tend to occupy positions close to each other at the middle of the political spectrum, seems, for instance, relevant for individual electoral campaigns. If interpreted like that it also seems, at least to me, quite realistic.

Furthermore, the public choice theorists and the political scientists make no concessions for elements outside the control of the decision makers in the way the Austrians do. They only consider the decision-making as such.

Since they, in contrast to the Austrians, not seem to be interested in long-term and accumulated effects, this is perhaps no serious fault. But it is part of the more limited perspective of the public choice theorists and the political scientists.

6. THE VALUE OR EFFICIENCY OF THE MIDDLE POSITION

As I have already said the middle position may also be ruled out on the ground that it is bad or inefficient, and the author who does so, in particular, is Hayek. He holds, as we have seen above, that there is no middle way between atomistic competition and central direction, since a mixture of the two will give a worse result than either system taken alone.

It is easy to illustrate Hayek's idea within the framework of the spatial model, and the result is represented by the solid curve in Fig. 3. Hayek's preference curve is, as we see, and surprisingly, not single peaked. Knowing what Hayek stands for, one would rather believe that his preference curve, in the left part of the figure, would follow the broken curve rather than the solid one. The idea that pure planning is better than a mixture of planning and liberalism is indeed strange. Consider, for instance, the comparatively well-run private land plots on the state farms (*kolkhozy* and *sovkhozy*) in the

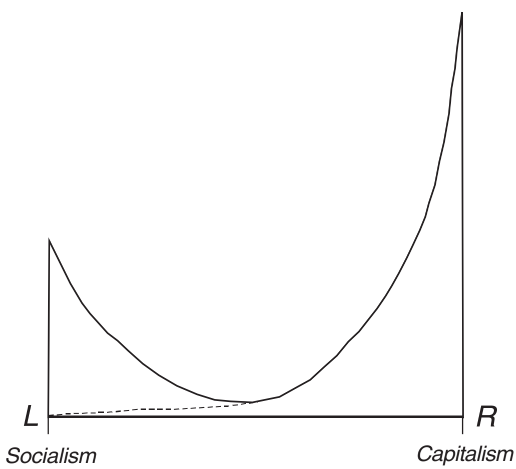

Fig. 3. Inefficiency of Middle of the Road Politics.

former Soviet Union. Is it reasonable to believe that the economic efficiency of the Soviet Union, as a whole, would be better if these private plots were socialized?

7. SUMMARY AND CONCLUSIONS

This paper seeks to clarify the nature of the conflict about middle of the road politics between public choice theorists and the Austrians. My conclusions are these:

First, there is no conflict about the scale as such. All scholars agree that there is something like a continuous, ideological, left-right scale. All of them also seem to consider all positions except the extreme ones as mixtures. Thus, their differences are not related to the scale.

The main differences are rather related to the distinction between single decisions or incremental changes, on the one hand, and long-term accumulated effects of the decisions, on the other. The public choice theorists and their fellow political scientists are mainly interested in the former, the Austrians mainly in the latter. Thus the seemingly conflicting results of the two groups may very well be compatible. Individual decisions or incremental changes may in fact be situated on the middle of the road – in particular the political scientists' contention, that the political parties in a two-party system tend to occupy positions close to each other at the middle of the political spectrum, seems quite plausible. But at the same time the Austrians' thesis that a middle of the road position is impossible for a long-term accumulated result, may also be true.

When accounting for this impossibility Hayek and Mises are, however, completely different. Hayek predicts a big, one-step transformation from democracy to dictatorship, whereas Mises predicts a process in many small steps, intervention by intervention, from capitalism to socialism. I have argued that Hayek's process is unrealistic, and that Mises' process, although unrealistic in its original form, can be made plausible by some small changes. In particular, interventions which are not provoked by other interventions, but which appear for other political reasons, should be added to the picture. When changed like that the theory may, in fact, contribute greatly to an understanding of the almost universally growing public sectors in the democratic world.

Mises' main reason for refuting the idea of middle of the road politics is thus that its results are unstable. For Hayek the main reason is rather the inefficiency of such politics. This may be right if middle of the road politics is compared with pure, liberal capitalism. Hayek's contention that pure central planning is also better than middle of the road politics is, however, hardly reasonable.

Finally I will just add that all politics is not about ideology, and about positions on an ideological scale, even if this paper has been confined to that kind of politics. There is also interest politics. Among the scholars treated here it is, again and in particular, Mises who writes about that kind of politics. In the quotations above we have seen some glimpses of that, but there is much more in Mises' works. That, however, falls outside the scope of this paper.[3]

NOTES

1. A. L. Lowell was President of Harvard University.
2. For a further discussion of these matters see Moberg (1999).
3. Moberg (2000) contains a discussion about ideological politics and interest politics.

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IF GOVERNMENT IS SO VILLAINOUS, HOW COME GOVERNMENT OFFICIALS DON'T SEEM LIKE VILLAINS? WITH A NEW POSTSCRIPT☆

Daniel B. Klein

> The general uncertainty about the prospects of medical treatment is socially handled by rigid entry requirements. These are designed to reduce the uncertainty in the mind of the consumer as to the quality insofar as this is possible. I think this explanation, which is perhaps the naive one, is much more tenable than any idea of a monopoly seeking to increase incomes.
>
> – Kenneth Arrow (1963, p. 966).

At lunch one day a colleague and I had a friendly argument over occupational licensing. I attacked it for being anticompetitive, arguing that licensing

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The Dynamics of Intervention: Regulation and Redistribution in the Mixed Economy
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boards raise occupational incomes by restricting entry, advertising, and commercialization. My colleague, while acknowledging anticompetitive aspects, affirmed the need for licensing on the grounds of protecting the consumer from frauds and quacks. In many areas of infrequent and specialized dealing, consumers are not able, ex ante or even ex post, to evaluate competence. I countered by suggesting voluntary means by which reputational problems might be handled, and by returning to the offensive. I said that in fact the impetus for licensing usually comes from the practitioners, not their customers, and that licensing boards seldom devote their time to ferreting out incompetence but rather simply to prosecuting unlicensed practitioners. I mentioned cross-sectional findings, such as those on state licensure, prices, and occupational incomes. Overall, I characterized the professional establishment as a group of villains, who set the standards, write the codes, and enforce behavior to enhance their own material well-being. The term economists often use for political operators who seek government-granted resources or privileges is "rent-seekers." The term connotes villainy.

Here, my colleague posed a question that I found very disarming: "Don't you think that the average doctor is honest?" "Don't you think," he said, "that we might get honest doctors on the state licensing board?"

This question is a disarming one in a great many areas of policy discourse. Anyone who believes that a status quo policy is grossly inefficient, unjust, and inequitable has to come to terms with it. Many feel that gross inefficiency, injustice, and inequity mark the status quo in numerous areas. Are the defenders of the status quo to be set down as liars? Are they all cynics, soullessly clutching their parasitic rents?

Another possibility is to say that our intellectual opponents are misinformed. They believe that what they want is good and what they say is true. But if so, why are they misinformed? Others stand ready to enlighten them, to show them that two plus two is not five. Why aren't they easily straightened out? If it is *we* who are misinformed, why aren't we straightened out? And if both they and we are misinformed, why can't we all at least believe the same error?

1. SELF-SORTING AND SCREENING

Individuals tend to seek out communities and organizations that appeal to their beliefs and values. They gravitate to positions and responsibilities that suit their personal aspirations and ambitions, and in such pursuits they succeed best. In *The United States of Ambition: Politicians, Power, and the*

Pursuit of Office, Alan Ehrenhalt (1992) argues that the political process tends to select for those who most believe in it and make a career of it. He suggests that one advantage held by the Democratic party (over the Republican party) is that the Democratic party is more thoroughly a party of active government, so it better attracts "people who think running for office is worth the considerable sacrifice it entails" (p. 224). Not only does the political process tend to attract those who believe in it, it also tends to prosper believers.

Sometimes the community holds a belief system, or culture, that does not dovetail with the individual's prior beliefs, in which case the individual must pursue one of the following courses: (a) depart from the community; (b) change the culture of the community to suit his beliefs; (c) play the cynic by getting on in the community and supporting its goals while privately rejecting the culture; (d) remain within the community but openly voice a dissenting view; or (e) embrace the culture of the community.

For the stark case of conflicting and firmly held beliefs course (a) – departing the community – is the most likely. Thus, self-sorting is a major component of the formation and persistence of organization culture. Economists such as Tiebout (1956) and Buchanan (1965) have offered models in which people self-sort into communities by "voting with their feet": people select the community with the local collective services, such as swimming pools and security services, that suit their tastes. In the present case, people also self-sort into communities – communities with suitable collective beliefs.

Course (b), remaking the culture to suit one's own taste, is uncommon. It may occur in young communities when a strong-minded individual finds a position of leadership. Course (c), playing the cynic, is also uncommon when beliefs are squarely in conflict. If the individual just keeps his mouth tight and his mind skeptical, he may feel compromised and frustrated. To play the cynic one must make his behavior neatly chameleon. Few can.

Course (d), open dissent, is not only trying for the individual, it is unsatisfactory to the community and often leads to sanctions or expulsion. Thomas Szasz (1992) explains the phenomenon of screening out heterodoxy in the matter of drug policy:

> Why do we now lack a right we possessed in the past? … Why … does the federal government control our access to some of mankind's most ancient and medically most valuable agricultural products and the drugs derived from them?
>
> These are some of the basic questions not discussed in debates on drugs. Why not? Because admission into the closed circle of officially recognized drug-law experts is contingent on shunning such rude behavior. Instead, the would-be debater of the drug

> problem is *expected to accept, as a premise,* that it is the duty of the federal government to limit the free trade in drugs. All that can be debated is which drugs should be controlled and how they should be controlled. (p. 96, italics added)

When beliefs are squarely in conflict, the final course of behavior, adapting one's own beliefs, is again uncommon. If the individual tries to surrender his old beliefs for the culture of the community, he may be surrendering precious parts of his selfhood. His old beliefs are like the deep roots of his behavior and habits of mind, so an effort to conform might uproot his moral and intellectual foundation.

When individual beliefs and values are well established prior to participation, therefore, the forces of self-sorting and screening tend to create organizations made up of people with fitting beliefs and values. And, perforce, expertise. Hayek (1960) commented on this tendency:

> The organizations we have created in these fields [labor, agriculture, housing, education, etc.] have grown so complex that it takes more or less the whole of a person's time to master them. The institutional expert ... is [frequently] the only one who understands [the institution's] organization fully and who therefore is indispensable .... [A]lmost invariably, this new kind of expert has one distinguishing characteristic: he is unhesitatingly in favor of the institutions on which he is expert. This is so not merely because only one who approves of the aims of the institution will have the interest and the patience to master the details, but even more because such an effort would hardly be worth the while of anybody else: the views of anybody who is not prepared to accept the principles of the existing institutions are not likely to be taken seriously and will carry no weight in the discussions determining current policy ... [A]s a result of this development, in more and more fields of policy nearly all the recognized 'experts' are, almost by definition, persons who are in favor of the principles underlying the policy .... The politician who, in recommending some further development of current policies, claims that 'all the experts favor it,' is often perfectly honest, because only those who favor the development have become experts in this institutional sense, and the uncommitted economists or lawyers who oppose are not counted as experts. Once the apparatus is established, its future development will be shaped by what those who have chosen to serve it regard as its needs. (p. 291)

2. BELIEF PLASTICITY

Firm prior beliefs give rise to self-sorting and screening. But very often a person comes to an organization without definite opinions on matters relating to the organization's purposes. In this case beliefs often adapt to the prevailing culture. The individual's lack of opinion usually reflects his innocence of theory about those matters. In the case of the U.S. Department of Agriculture, the theory is about how the agricultural sector works. In the case of the licensing board, the theory is about how licensing affects the practice of the trade.

An individual uses his belief system as an apparatus to cope with his circumstances. Like the steel producer who chooses his inputs to maximize profits, the individual tends to favor certain ideas and theories that render life more comfortable, more pleasant, and more convenient, given his circumstances. The individual's current hopes, information, opportunities, and constraints affect how readily he will take to various ideas and theories.

By "belief plasticity" I mean that individuals would believe different ideas if they were to pursue different goals or were to be inserted into a different cultural environment. The set of ideas that everyone is willing to admit as "the facts" does not always dictate unequivocally beliefs about how the facts relate to one another. This is especially so for social and political affairs. Belief structures are plastic: They are affected by the heat and pressure of everyday experience. People – all people – have different pressures and different yearnings, and these give rise to different beliefs. Were the pressures and yearnings otherwise, so would be the beliefs.

H. L. Mencken (1956) demonstrates a life-long fascination with belief plasticity as it manifested itself in a wide variety of human affairs. What follows is a sample from his *Minority Report*.

> The influenza epidemic of 1919, though it had an enormous mortality in the United States and was, in fact, the worst epidemic since the Middle Ages, is seldom mentioned, and most Americans have apparently forgotten it. This is not surprising. The human mind always tries to expunge the intolerable from memory, just as it tries to conceal it while current. (Mencken, 1956, p. 169)

> [C]onscription in both cases [World Wars I and II] involved the virtual enslavement of multitudes of young Americans who objected to it. But having been forced to succumb, most of them sought to recover their dignity by pretending that they succumbed willingly and even eagerly. Such is the psychology of the war veteran. He goes in under duress, and the harsh usage to which he is subjected invades and injures his ego, but once he is out he begins to think of himself as a patriot and a hero. The veterans of all American wars have resisted stoutly any effort to examine realistically either the circumstances of their service or the body of idea underlying the cause they were forced to serve. Man always seeks to rationalize his necessities – and, whenever possible, to glorify them. (*ibid.*, p. 176)

> I was once told by a Catholic bishop that whenever a priest comes to his ordinary with the news that he has begun to develop doubts about this or that point of doctrine, the ordinary always assumes as a matter of fact that a woman is involved. It is almost unheard of, however, for a priest to admit candidly that he is a party to a love affair: he always tries to conceal it by ascribing his deserting to theological reasons. The bishop said that the common method of dealing with such situations is to find out who the lady is, and then transfer the priest to some remote place, well out of her reach. (*ibid.*, p. 73)

> The really astounding thing about marriage is not that it so often goes to smash, but that it so often endures. All the chances run against it, and yet people manage to survive it, and even to like it. The capacity of the human mind for illusion is one of the causes here. Under duress it can very easily convert black into white. It can even convert children into blessings. (*ibid*., p. 3)

> Men always try to make virtues of their weaknesses. Fear of death and fear of life both become piety. (*ibid*., p. 47)

3. THE NETWORK EXTERNALITIES OF CULTURE

Belief systems exhibit network externalities, which is to say, what is best for an individual to believe depends crucially on what his day-to-day coworkers believe. If the individual works in a Christian Fundamentalist church, he will find it awkward to believe that man has evolved from apes. If he works in the U.S. Department of Agriculture, he will find it awkward to believe in the idea that current agricultural policy is absurdly inefficient, unjust, and inequitable. The individual would be out of sync with the actions, attitudes, and goals of the organization. His coworkers have certain underlying beliefs that form a web, and his opinions would upset that web. They would expect his head to nod when it would like to shake; when they chuckle, he may be inclined to grimace. Were he to defend his beliefs, his coworkers may respond with cold seclusion or hot animosity. The smooth workings of the organization would be upset by the cultural impasse. In fact, sheer novelty in behavior, regardless of its nature, can cause resentment. One can become unpopular simply by doing something other than the expected, regardless of what that something is.

Upon entry into the organization the individual is exposed to certain information, embedded within certain ideas. Hence, there is a strong element of information filtering. But in addition, as the individual comes into contact with these ideas, he faces strong incentives to subscribe to the organization line. As Adam Smith (1790) wrote in *The Theory of Moral Sentiments*

> Nature, when she formed man for society, endowed him with an original desire to please, and an original aversion to offend his brethren. She taught him to feel pleasure in their favourable, and pain in their unfavourable regard. She rendered their approbation most flattering and most agreeable to him for its own sake; and their disapprobation most mortifying and most offensive. (p. 116)

To be an effective coworker, to find goodwill among peers, to fetch promotions, the individual must act in accordance with the practices and expectations of the group, and to so act he must think the ideas of the group, and to so think he must, except in cases of dry cynicism, believe the group's beliefs. And coming to believe the community's ideas will be an uncontested choice if the individual is never exposed to competing ideas.

Social psychologist Robert Cialdini (1984) sets out several principles that help explain how people come to hold the beliefs they do. One he calls "social proof" or "Truths Are Us." The idea is that people rely on the example of those around them as a cue for appropriate behavior and proper thinking. He explains why television producers use canned laughter, why bartenders "salt" their tip jars with dollar bills (and church ushers their collection baskets), and why evangelical preachers seed their audience with enthusiasts. He explains how members of a cult can reinforce each other's beliefs, how a victim can suffer a drawn-out vicious assault with dozens of witnesses and not one calling for help, how newspaper reports of suicide can spawn further suicides, and how hundreds of people can line up in orderly and willful fashion to partake of lethal poison, as they did in Jonestown, Guyana in 1978. If the example of observance by others can decide and reinforce such dreadful beliefs and practices, certainly "social proof" can do much to reinforce the "normal" beliefs and practices of organizations such as duly created government agencies.

An example is the recruiting of individuals to the Unification Church of Reverend Sun Myung Moon. Here I crib from a discussion of obedience by George Akerlof (1991), who in turn cribs from social psychologist Marc Galanter (1989), and Galanter et al. (1979). The recruiting process is made up of four steps. As Akerlof (1991) explains, "[p]otential recruits are first contacted individually and invited to come to a 2-day, weekend workshop. These workshops are then followed by a 7-day workshop, a 12-day workshop, and membership" (p. 10). Each step of the program increases in cultural intensity. The structure works beautifully, in conjunction with the self-sorting process, to keep the potential recruit surrounded by other potential recruits who obey and reinforce the practices. The recruit who enters an advanced step of the program does *not* see the resistance that those who have dropped out *would have shown* to the cultural intensification. Nor does he see the resistance that those who *remained* would have shown had they been told in advance what they were to become. As Akerlof (1991) puts it, "[b]ecause those who disagree most exit, the dissent necessary for resistance to escalation of commitment does not develop" (p. 11).

Related here is another principle of belief formation set out by Cialdini: self-consistency and commitment. Since people fancy themselves wise and consistent beings, once a person has taken steps down a certain path, he is receptive to supplementary information and ideas that support the initial decision, and he tends to turn away from information that discredits it. As Adam Smith (1790) said:

> The opinion which we entertain of our own character depends entirely on our judgments concerning our past conduct. It is so disagreeable to think ill of ourselves, that we often purposely turn away our view from those circumstances which might render that judgment unfavourable. (p. 158)

Isn't it likely that "Truths Are Us" and self-consistency would be operating in the case of those rising to leadership in an organization? Consider the rise of an individual to the state medical licensing board. Most likely such a person must first be a prominent and not-too-innovative member of the profession – bold innovation is often a sign of irreverence. Then perhaps he would find a position in the professional association. After gaining the confidence of influential people in the establishment, he might finally join the state licensing board. Through these steps the individual would be increasingly enveloped by the inner culture of the profession. With each step outside viewpoints would be cleaved away. Dissenting pleas from powerless outsiders are politely dismissed and privately derogated. Herbert Simon (1976, p. xvi) says, a person "does not live for months or years in a particular position in an organization, exposed to some streams of communication, shielded from others, without the most profound effects upon what he knows, believes, attends to, hopes, wishes, emphasizes, fears, and proposes." The incentive to maintain and advance one's prior commitments to the profession would be enhanced; to challenge or innovate would cause disruptions both personally and in the day-to-day workings of the organization. As James Q. Wilson (1989, p. 110) says, "the perceptions supplied by an organizational culture sometimes can lead an official to behave not as the situation requires but as the culture expects." And only those amenable to the necessary commitments would climb the ladder.

The same reasoning is adaptable to any organization, whether communal, commercial, nonprofit, or governmental. But the most important application is to government organizations, since they have the most far-reaching and peremptory power. As Hayek (1944, p. 104) said, "the power which a multiple millionaire, who may be my neighbor and perhaps my employer, has over me is very much less than that which the smallest *fonctionnaire* possesses who wields the coercive power of the state and on whose discretion it depends whether and how I am to be allowed to live or to work." Government officials wield incomparably greater power than do businessmen, and they exercise it with much greater likelihood of calamitous consequence.

One need only consider petty officials at the FDA who routinely make decisions that prevent suffering individuals from being helped by new drugs.

The network of beliefs within a community may be related to the idea of "path dependence," or "lock in," discussed by Paul David (1985) (see also the important work of Liebowitz and Margolis (1990)). A path-dependent process is one that reinforces and steers itself once it has begun. Once members of a primitive society begin using copper as a medium of exchange, everyone joins in the use of copper. Once one particular textbook becomes customary for the Introductory Economics sequence, each professor has the incentive to stick with that textbook. Once the copper or textbook gets a foothold, it becomes "locked in;" that is, the arrangement is the reason for its own perpetuation. The moral of the story is that perhaps the original foothold was made in an adventitious or shortsighted way – gold actually would serve better than copper, or some textbook other than the one chosen – but once down the path a reversal is difficult to make. The result may be perpetual suboptimality. Hats off to the French rationalists who forced their countrymen to use the metric system – and chalk one up for *dirigisme*.

David explains that path dependence occurs when three features are present: technical interrelatedness, economies of scale, and quasi-irreversibility. Although David explores technological systems, the ideas can be applied to belief systems within communities or organizations. The first feature, technical interrelatedness, is the need for compatibility among members of the network. Again, network externalities are clearly exhibited by the belief system of a community. A common apprehension of ends, values, and opportunities is crucial to the efficiency of the community. A mind with the wrong beliefs can disrupt the smooth working of an organization in much the same way that a stretch of railroad track with the wrong gauge can disrupt the smooth passing of a locomotive train.

David's second aspect of path dependence, economies of scale, says that the more that system A is adopted within the community, the easier it will be to bring an additional individual into system A. Learning and using the system gets easier the more the system is used. This principle would seem to apply to belief systems. The more that one's coworkers share a common belief system, the more solidified and imposing that system will be. Beliefs that are very common come to be taken as "common sense." Basic notions become second nature, and, building on basic notions, community practices produce a mortar of supplementary beliefs, procedures, and rituals. Questioning the community's common sense is sure to gain one unpopularity. Often basic cultural premises are so uncontroversial that they go wholly unstated and unchallenged (see Kuran, 1995). Truths are us.

When most of the people working in an organization share a belief system, newcomers are quickly socialized and they then help solidify that system. In an organization, then, some system will come to dominate the thinking of the workers, just as in a "Polya urn scheme" some color will come to dominate the balls in the urn.[1] To change the metaphor, those who percolate through the cultural filter of an organization afterward might *become part of the filter* and enhance its purifying properties.

The third feature of path dependence is quasi-irreversibility of investments, which is to say, the costs of the original capital (whether animal, mineral, or intellectual) are at least partially sunk; switching to a new capital good would entail further investment. The first two features of path-dependent systems may present a sufficiently severe collective action problem to account for the persistence of suboptimal outcomes, but quasi-irreversibility reinforces the difficulty of jumping to a better path once the community has started down a suboptimal one. In the case of belief systems, Cialdini and Adam Smith have told us that individuals become attached to their beliefs. New experiences that compel one to change his mind can be both depressing, since his old intellectual investments will no longer serve him, and heartbreaking, since his old investments will have come to hold personal and sentimental value. Such new experiences can be tragic, much the way a conflagration can be. Hence the saying, "Ignorance is bliss." Like installing a smoke detector, sometimes we program ourselves to detect and avert new experiences and new arguments because they would jeopardize the peace of mind that our current beliefs afford us. And sometimes we refrain from challenging the beliefs of another, not out of fear of jeopardizing our own peace of mind, but out of a compassionate impulse to safeguard his.[2]

In an important work, Timur Kuran has modeled public opinion as a process of path dependence and multiple equilibria. In his main model, individuals are endowed with "private preferences" and then choose their "public preferences," or outwardly displayed preferences. Which preference one finds most profitable to display depends, due to the peer effect and social incentives, on what others are displaying.[3] Thus suboptimality can become locked in, or we may witness sudden revolutionary swings in outward preferences – in the manner of the French, Russian, Iranian, and East European revolutions. Kuran is interested especially in the attitudes of overall society, *where exit is very difficult*; hence his focus on preference *falsification*. I am more interested in beliefs within a subgroup, where exit is easier, and hence my focus on belief adaptation and self-sorting. But it should be noted that Kuran also gives much attention to the possibility of the *private* preferences being dependent on the path, thereby highlighting the idea that all belief formation is a contingent social process.

Much earlier William James (1963 [1907]) wrote of belief systems as a social process and acknowledged the possibility of lock in. He said:

> Our ancestors may at certain moments have struck into ways of thinking which they might conceivably not have found. But once they did so, and after the fact, the inheritance continues. When you begin a piece of music in a certain key, you must keep the key to the end. You may alter your house ad libitum, but the ground-plan of the first architect persists – you can make great changes, but you cannot change a Gothic church into a Doric temple. You may rinse and rinse the bottle, but you can't get the taste of the medicine or whiskey that first filled it wholly out. (p. 75)

James goes on to explain that what we call "common sense" is in fact the product of circumstances and, quite possibly, historical accidents. Occasionally, we find ourselves in conversations in which our "common sense" and the other guy's "common sense" cannot find much in common.

As for the individual who stumbles into a community and finds herself traveling a path involving elaborate new beliefs, the story is a case of what the pragmatist philosopher Richard Rorty calls "contingency." In *Contingency, Irony and Solidarity,* Rorty (1989) describes the broad terms of social life as set, not only by necessities or human deliberation, but also by blind contingency. Who we are is not essential, but accidental, the result of what family we were born into, what theories we were exposed to, what schools we went to, what jobs we landed, and the time and place of our existence. Not only could our physical doings have been otherwise, but the *way we describe* physical doings, including our own, could also have been otherwise. Culture not only generates incentives to believe in certain ideas rather than others, it provides the ideas among which we choose our beliefs. Rorty's view, like James's, is uncompromisingly anti-essentialist – there can be no metacultural description, only cultural ones – and hence he preaches concession to ironism.

There are, then, several distinct principles that help explain uniformity in behavior or belief: self-sorting and screening (noted by Akerlof, 1991), network externalities and belief adaptation (discussed in the context of technology, not cognition, by David), filtered information (noted by Simon), imitation based on uncertainty (congruent with Cialdini and developed by Bikhchandani, Hirshleifer, & Welch, 1992), preferences to conform (noted by Cialdini, Adam Smith, and Kuran), and sanctions on deviants (discussed by Kuran and noted by Mencken).

4. THE GENEALOGY OF ORGANIZATION CULTURE

If organization culture exhibits lock in, there remains the question of which path will come to pass. Path dependence tells us that the enduring equilibrium may have very adventitious origins, so in that sense there may be no way to generalize about what sort of equilibrium results. But the consideration of origins and of certain incentives that operate irrespective of cultural specifics may permit some generalization.

A relativist tradition beginning perhaps with Protagoras and including such thinkers as Machiavelli, La Rouchefoucauld, Vico, Mandeville, Hume, Marx, Spencer, Nietzsche, Sumner, Mencken, and Burke maintains that interest drives social mores, and social mores drive morality. Members of a community come to call "good" any behavior that promotes the interests of the community and "bad" any that damages it. By a process of legitimation, interest is transformed into propriety and justice. Thereafter, community members obey not only their interest but also their conscience. When a community is isolated the culture governs all and the society is tranquil in its practices. But if the community is embedded within a larger society, the way a government agency is, the cultural development of the agency is constrained by the interests and theories of the larger society. The interests of the society may in fact be bred into the members of the agency, so the agency may faithfully serve the greater good. But there will be some interests particular to the agency and its members.

Everyone wants more comfort and wealth. Almost everyone wants recognition, prestige, eminence, and power. We want a sense of significance, importance, and potency. We feel important when we can believe a story in which we get to play the hero. We want to take credit for both the good and the greatness achieved. We do not want to hurt colleagues and associates close to us. As Akerlof (1989, p. 13) says, people "choose beliefs which make them feel good about themselves." Call it the self-exaltation principle. It will sometimes conflict with the conscience, but the plasticity of belief will to some extent permit the conscience to accommodate self-exaltation even when onlookers perhaps feel it should not. Government officials, especially high-ranking ones, find comfort and prestige in their position. They will come to find legitimacy as well. They like to see their agency's actions as the cause of achievement, and themselves the cause of the agency's actions. The self-sorting and screening effects tend to prevent someone with strongly contrary views from entering the community; most of the others join the community and embrace the culture, which claims importance and legitimacy. The propensity for self-exaltation is universal enough that we can expect it to be one of the forces shaping cultural development – that means the pursuit of expanded power and a willful reluctance to surrender it.

We might also generalize on the basis of agency founding. The founding of the agency gives a cultural foothold to certain theories and goals that will to a great extent determine the belief system into the future. The push for occupational licensing was fueled by doctors seeking, often quite unabashedly, to limit competition; and justified by the theory that society needs protection from quacks. The Department of Agriculture grew out of the theory that farmers were getting a bad shake and the goal became arranging price supports and subsidies. The public school system was rationalized by the need for instruction, and the goal of public instruction persists. A mountain of literature has persuaded many people that the public school system is cause for great remorse, but few in the education establishment have been persuaded.[4] As the Viennese social critic Karl Kraus (1990) asks, "Who is going to cast out an error to which he has given birth and replace it with an adopted truth?" (p. 114). Those who favor laissez-faire and doubt the efficacy of government are likely to see badness persisting in the cultural systems of government agencies, since those agencies were founded to abridge laissez-faire.

The self-exaltation principle gives reason to believe that the culture of government agencies will favor expanded government power, and the founding principle gives another reason, reinforced by self-sorting and screening, to expect the culture to be highly statist. Although outside theories seep into the agency through its many holes and cracks, given belief plasticity and the network externalities within the agency, libertarians have reason for saying that government officials and allied parties often pursue bad policies but believe in their goodness.

Thomas Jefferson would agree that the irreproachable honesty of the members of the medical licensing board is no evidence of beneficence:

> It would be dangerous delusion were a confidence in the men of our choice to silence our fears for the safety of our rights; that confidence is everywhere the parent of despotism. Free government is founded in jealousy and not in confidence; it is jealousy, and not confidence which prescribes limited constitutions, to bind down those whom we are obliged to trust with power. (From the Kentucky Resolutions, November 16, 1798)

5. EXAMPLE: "THE CULTURE OF SPENDING"

James L. Payne has written a book about Congress that emphasizes belief plasticity and the presence of network externalities in cultural systems. He argues that the beliefs of congresspeople "will be affected by the information and opinions they are exposed to day after day.'' In fact, Congress ''is overwhelmed by the advocates of government programs.'' Payne (1991), who himself spent much time in the bowels of the persuasion process on Capitol Hill while researching his book, provides data showing that in the persuasion process the ratio of pro-spending voices to anti-spending voices is over 100:1 (p. 13). Even though from afar the congressperson might understand why only pro-spending interests seek the ear of Congress, in the barrage of pro-spending testimony the human mind simply succumbs to the senses and begins to accept what it hears. How unpleasantly and unremittingly jaundiced one must become otherwise! Like the poles that form the cone-shaped frame of a tepee, the lobbyists, agency staffers, media personnel, aides, and congresspeople all reinforce one another's beliefs. The principle of mutual reinforcement is nicely captured by an aphorism of Karl Kraus (1990 [ca. 1918]), who wrote bitterly against the First World War: ''How is the world ruled and led to war? Diplomats lie to journalists and believe these lies when they see them in print'' (p. 81).

The ''Culture of Spending'' on Capitol Hill, explains Payne, revolves around two central premises: (i) ''the philanthropic fallacy,'' or the virtual nonexistence of alternative uses for the citizen's tax dollar, and (ii) the efficacy of government programs. Regarding the ''philanthropic fallacy,'' Payne highlights how the will to self-exalt shapes beliefs:

> Everyone wants to have a high opinion of himself … . When the congressman comes to Washington, he is surrounded by beneficiaries and claimants who are pleading for his 'help.' He is strongly invited to accept the role of philanthropist, strongly encouraged to believe that he has assisted people and left the country better off by funding government programs … . This high self-opinion would be directly threatened if the donor of funds [that is, the taxpayers] were brought into the picture. As soon as one recognizes that in order to help some people you have to hurt others, much of the glow goes out of being a congressman. For this reason, congressmen are reluctant to face the opportunity-cost issue. (Payne, 1991, p. 53)

Regarding the presumption of government efficacy, Payne says, ''Congressmen tend to trust that government programs actually accomplish their intended purpose. They suppose that programs to 'help farmers,' or 'help science,' or 'help the poor' actually do what they are intended to do. One has to work long and hard pointing out defects in each scheme to overcome this basic credulity'' (*ibid.*, p. 163). Payne highlights the Truths-Are-Us nature of these beliefs: ''For most congressmen, spending programs are cultural 'givens,' an aspect of their environment that they accept without question''[5] (*ibid.*, p. 173). In discussing the source of program evaluation information, Payne remarks on the role of self-sorting and screening: ''personnel in government agencies will tend to believe that what their agency does is useful … An official who believed his program was useless or harmful would probably weed himself out of the agency even before the system expelled him'' (*ibid.*, p. 36).[6]

Payne (1991) explains that the congressperson's beliefs are, to a great extent, adopted only once the politician enters the culture of spending:

> When the innocent enters policy realms armed only with the general idea that 'spending is bad,' he is easily seduced, for this abstract homily is overpowered by visions of starving millions and eroding continents. The situation is not unlike sending a farm boy to town and telling him to 'keep out of trouble.' Because he is unaware of all the appealing and subtle forms 'trouble' can take in specific instances, this general advice is practically worthless. (p. 158)

Payne supports his theory with a wide variety of evidence, to show that congresspersons of both parties become substantially more pro-spending the longer they dwell in ''the culture of spending.'' (There is an unresolved scholarly debate on this question.[7])

Other theories of congressional spending, such as pork barrel politics, logrolling, and vote maximization, give the impression that politicians must be rather venal characters. Payne (1991) gives a different impression:

> The high-spending congressman does not feel he is a crook. He does not perceive that he is taking money away from some people to give it to others. He lives in a world of euphemism where the federal government 'generates' a 'general revenue' that well-intentioned 'public servants' can spend to 'promote the general welfare.' (p. 166)

Payne's persuasion hypothesis answers many questions that other theories do not, including the most immediate one of why politicians, even with all their platitude, seem more-or-less sincere in their efforts.[8]

6. CONCLUSION: INSTITUTIONAL KNAVERY OUT OF INDIVIDUAL HONESTY

> ... and they are not the less quacks when they happen to be quite honest.
> Mencken (1919, p. 80)

> The annual produce of the land and labour of England ... is certainly much greater than it was ... a century ago ... [Y]et during this period, five years have seldom passed away in which some book or pamphlet has not been published ... pretending to demonstrate that the wealth of the nation was fast declining, that the country was depopulated, agriculture neglected, manufacturers decaying, and trade undone. Nor have these publications been all party pamphlets, the wretched offspring of falsehood and venality. Many of them

> have been written by very candid and very intelligent people; who wrote nothing but what they believed, and for no other reason but because they believed it.
>
> Smith (1776, p. 327)

The conundrum of institutional knavery out of individual honesty was noted long ago by David Hume (1985):

> Political writers have established it as a maxim, that, in contriving any system of government, and fixing the several checks and controuls of the constitution, every man ought to be supposed a *knave*, and to have no other end, in all his actions, than private interest ... It is, therefore, a just *political* maxim, *that every man must be supposed a knave*: Though at the same time, it appears somewhat strange, that a maxim should be true in *politics*, which is false in *fact*. (pp. 42–43)

Bad government policy may be attributed to error or knavery. Following a taxonomy by Sanford Ikeda (1997b), we may distinguish the two explanations as the *error thesis* and the *deception thesis* (see Fig. 1).

The goal of this paper has been to resolve the conundrum posed by Hume. We may maintain the error thesis at the individual level and the deception thesis at the institutional level. Working inside the institution's culture, individuals of ordinary honesty affirm and advance that culture. Yet the culture itself, viewed from a larger and wiser culture, is selfish, dishonest, and knavish.

As investigators and concerned citizens we may toggle between the error thesis and the deception thesis. The two approaches are not necessarily beginning with different assumptions, but rather may be describing the same assumptions in two different ways (cf. Ikeda, 1997a, pp. 114, 119, 146, 149, 240). The appropriateness of each description depends in part on one's discourse situation and rhetorical purpose.

When we offer the deception thesis, based on assumptions of selfish or knavish behavior, we need to make clear that we offer one, simplified description of the matter, and *not* the one that the political participants themselves believe. When Milton Friedman (1953, p. 19) said we can describe the

	Honest, good-willed	Villainous, venal
Intelligent	State-as-Hero thesis	Deception thesis
Unintelligent	Error thesis	State-as-Disaster thesis

Fig. 1. Public Philosophies about Government.

growth of a plant as behavior aimed at maximizing sunlight exposure subject to constraints, he certainly was not saying that the plant saw it that way. Baldly cynical theories can give useful insights into the behavior of real people who are in fact not cynical. Malady does not imply malevolence, just as benevolence does not imply benefit.

The proximate spark igniting me to write the present paper was my friendly argument over occupational licensing. This paper is an extended response to my colleague's challenge invoking the honesty of the average doctor. I have said that I found his point disarming; also I found it a little naive. Wouldn't we expect the members of a state licensing board to be exceptional *and sincere* advocates of the cause? Are we surprised to learn that the A.M.A. opposes midwife birthing, the right to die, and the relaxation of prescription requirements on drugs? Are we surprised that the education establishment vociferously opposes school vouchers? Are we surprised that civil engineers champion rail transit projects, that university professors champion the value of higher education, or defense officials, the need for a strong military? Of course not, nor do we seriously doubt their sincerity. Although I firmly believe that occupational licensing serves existing practitioners and disserves the public at large, I do not suspect venality. It does not surprise me that a leading student of the subject reports that, "Despite the many opportunities that exist for bribery and corruption in the granting of licenses and deciding disciplinary cases, the record is amazingly clean."[9]

Sometimes it is appropriate to incriminate individual government officials, in the flesh. For the cynical and irresponsible ones, we might deem their behavior reprehensible. It will depend on how we delimit responsible beliefs given the individual's personal constraints. But I suggest that we strain to see how bad conclusions might have been reached by thought processes that were ordinarily honest and good-willed. Libertarians should meet and join institutions of power; they should cooperate and negotiate with those in power. To do that effectively, tell yourself that it is up to the wise to undo the damage done by the merely good.[10]

7. POSTSCRIPT 2004: FURTHER THOUGHTS

The foregoing essay was first written around 1992, first appeared in 1994, and has been revised considerably since. In this Postscript, written at the behest of the editor of the present volume, I speculate on whether the advancement of communication technologies might affect the cultural insularity of government agencies.

Improvements in communication technologies have typically brought challenges to cultural uniformity and insularity, by giving wings to criticism. In our time, talk radio, cable television, and especially the Internet are vastly expanding the opportunities for criticism. Anyone with something to say can publish criticism immediately by posting it on the Web, and readers can access it, all at virtually no cost other than the time and attention required. Also, electronic tools are vastly reducing the costs of print publishing, enriching the selection and availability of magazines and books.

Criticism of specific government agencies and policies is expanding in cyberspace. Take the website that Alexander Tabarrok and I developed on the U.S. Food and Drug Administration (FDA), called FDAReview.org, hosted by the Independent Institute. In simple discursive language and graphics we present the scholarly criticisms of restricting freedom in matters of medical products and medical communication. The site attracts a modest but steady stream of visitors with an average visit of about 10 min. This is just an example of the explosion of think tank literature, single-issue websites, and policy-oriented blogs that are making it easy to develop and access pointed criticism of agency policy.

But advancements are also bringing another sort of change. For generations in the U.S., the political news and commentary was largely confined to a few major organs in television and the press, dispensing an official line of opinion in a top-down fashion. But as new technologies (and some changes in communications policy) have enabled competitors to bring livelier forms of news to consumers, and enabled consumers to customize their political news, they have become less accustomed to being passive receptacles of official opinion. Thus, even the major newspapers and network television stations have become somewhat more oriented toward criticism and dialog.

Of course, an explosion of good, accessible criticism does not necessarily spell penetration into the culture of the government agency. But we may hope that improvements in discourse tend to favor the more enlightened ideas. There are at least three channels by which communications technologies could eventually lead to greater penetration and beneficial reform.

First, new technologies make it much easier for critics to develop educational campaigns and come knocking on the agency's door. The critics can mobilize opinion in a way that thrusts their ideas onto the agency's desk. Issue-focused websites and blogs can lead to the development of a line of criticism, which is then given a voice and platform in the major media. Critics can mobilize expert opinion, petitions, public testimony, and so on.

Second, although the current crew at the government agency might simply shrug off criticism, people in general – in particular, young people interested in the particular issues dealt with – become more cognizant of the criticisms. As these lines of criticism thicken, they often become a staple opinion at some of the new media, such as talk radio and cable television, thereby reaching a large popular audience. Maybe even a few college teachers will expose students to critical ideas. At the government agency, the current officials will eventually depart and we may hope that the new crew will be more attuned to libertarian lines of criticism.

Third, we may also hope that government officials themselves will consult subversive materials like FDAReview.org. Even if they approach such sources merely to anticipate their intellectual opponents, at least they will become more familiar with the criticisms. And as officialdom disbands, as fragmentation of opinion and interpretation expands, even people inside government are apt to become more ironic about their own station and its official purposes. We may hope that more government workers will become consumers of criticism. In the quiet of their own offices they may click with ease to pointed challenges to their official mandates. These developments might make it easier for government officials to pursue two options I downplayed in my essay, namely, "play the cynic by getting on in the community and supporting its goals while privately rejecting the culture" and "remain within the community but openly voice a dissenting view."

Government has at least one important and necessary function: undoing other governmental functions. Governmental reform must be, if not initiated by, at least validated by the government itself. If libertarians are concerned with actually reducing government coercion, they must embrace government authority as an essential tool of improvement and get inside the skin of the government official. That frame of mind might be necessary to step into their shoes.

NOTES

1. David (1985, p. 335) explains the Polya urn scheme: "an urn containing balls of various colors is sampled with replacement, and every drawing of a ball of a specified color results in a second ball of the same color being returned to the urn: the probabilities that balls of specified colors will be added are therefore increasing (linear) functions of the proportions in which the respective colors are represented

within the urn.'' It has been shown that ''the proportional share of one of the colors will, with probability one, converge to unity.''

2. ''The loss of faith, to many minds, involves a stupendous upset – indeed, that upset goes so far in some cases that it results in something hard to distinguish from temporary insanity. It takes a long while for a naturally trustful person to reconcile himself to the idea that after all God will not help him. He feels like a child thrown among wolves. For this reason I have always been chary about attempting to shake religious faith. It seems to me that the gain to truth that it involves is trivial when set beside the damage to the individual.'' (Mencken, 1956, p. 141)

3. ''[A]n individual, when he joins a crowd, whether of life-long Democrats, Methodists or professors, sacrifices his private judgment in order to partake of the power and security that membership gives him'' (Mencken, 1987 [1921], p. 154).

4. Chubb and Moe (1990, p. 46) say the following of those in the public school establishment: ''Although traditionally they have tried to portray themselves as non-political experts pursuing the greater good, they are in fact a powerful constellation of special interests dedicated to hierarchical control and the formalization of education.''

5. Hayek (1960, p. 112) makes the following related remark: ''For the practical politician concerned with particular issues, these beliefs are indeed unalterable facts to all intents and purposes. It is almost necessary that he be unoriginal, that he fashion his program from opinions held by large numbers of people. The successful politician owes his power to the fact that he moves within the accepted framework of thought that he thinks and talks conventionally. It would be almost a contradiction in terms for a politician to be a leader in the field of ideas.''

6. Although watchdog agencies like the Congressional Budget Office and the General Accounting Office are supposed to challenge the overly convenient beliefs of lawmakers, such agencies in fact are influenced by the lawmakers themselves and are rather ineffective (Payne, 1991, pp. 66–70).

7. One type of evidence used by Payne is longitudinal data, tracking over time congresspersons' voting record on spending bills, and he presents evidence of congresspeople becoming, beginning with their second year, increasingly in favor of spending. Aka, Reed, Schansberg, and Zhu (1996) also do a longitudinal study and find that the ''culture of spending'' results dissolve for a sample size larger than what Payne used. Payne has noted in correspondence, however, that the Aka et al. analysis does not properly control for several features of the problem, including prior government experience by congress people (in which they have been immersed in a culture of spending before their freshman term), the ''apprentice effect'' concerning the common peculiarity of first-year voting patterns, the phenomenon of a congressman like Ted Kennedy maxing out on the spending barometer and therefore not evidencing a tendency to become more in favor of spending over time, and the way national-defensive bills are handled. In private conversation with the author, Eric Schansberg has expressed recognition of the conceptual validity of these points in relation to his own study, and seems to feel that the question of a correlation is still an open one. It should be noted that the general validity of Payne's culture hypothesis really does not depend on there being a correlation between voting-for-spending and tenure-in-Congress (although such a correlation would be nice evidence for it). If the acculturation occurs prior to arrival in office (for example, in prior government service or during the campaign), the correlation will not be found,

but the culture theory might nonetheless help us understand why spending is as popular as it is among congresspeople. I hope researchers try to refine the empirical investigation of the culture hypothesis.

8. One can imagine methods of studying belief effects in organizations. For example, one might learn about self-sorting effects by interviewing those who depart from the organization and those who do not, or new arrivals versus veterans. One might learn from studying massive shifts in personnel, or in the creation of new subunits, staffed either by insiders or outsiders, or by a change in where the agency reports its activities.

9. Shimberg (1982, p. 9) There is much scholarly literature on occupational licensing, almost all of it critical to one degree or another. A good survey is Hogan (1983).

10. I find this saying in the good and wise book by Wildavsky (1988, p. 91).

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ULYSSES AND THE RENT-SEEKERS: THE BENEFITS AND CHALLENGES OF CONSTITUTIONAL CONSTRAINTS ON LEVIATHAN☆

Peter Kurrild-Klitgaard

> [A]fter this example of Ulysses, kings often instruct judges, to administer justice without respect of persons, not even of the king himself … For kings are not gods, but men, who are often led captive by the Sirens' song.
>
> Baruch de Spinoza, *Political Treatise* (1677).

1. INTRODUCTION

In recent decades, Homer's millennia old story of Ulysses and the Sirens has become a popular and frequently used metaphor for illustrating the importance of institutions, not least constitutional ones (cf., e.g., Elster, 1985;

☆The present paper is intimately related to and draws upon a set of other papers of mine (e.g., Kurrild-Klitgaard, 1998, 2001, 2002a, b); I am grateful to those who commented on these papers, in particular Niclas Berggren, Otto Brøns-Petersen, Lars Christensen and Stefan Voigt. All the usual reservations apply.

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Finn, 1991, 3ff; Elster, 2000; Zakaria, 2003, pp. 7 and 250). In one retelling the story goes like this:

> The Sirens were sea-nymphs who had the power of charming by their song all who heard them, so that the unhappy mariners were irresistibly impelled to cast themselves into the sea to their destruction. Circe directed Ulysses to fill the ears of his seamen with wax, so that they should not hear the strain; and to cause himself to be bound to the mast, and his people to be strictly enjoined, whatever he might say or do, by no means to release him till they should have passed the Sirens' island.
>
> Ulysses obeyed these directions. He filled the ears of his people with wax, and suffered them to bind him with cords firmly to the mast. As they approached the Sirens' island, the sea was calm, and over the waters came the notes of music so ravishing and attractive that Ulysses struggled to get loose, and by cries and signs to his people begged to be released; but they, obedient to his previous orders, sprang forward and bound him still faster. They held on their course, and the music grew fainter till it ceased to be heard, when with joy Ulysses gave his companions the signal to unseal their ears, and they relieved him from his bonds.[1]

When told by constitutional theorists, the story is typically used as an illustration of the general point that the adoption of institutional constraints that will limit what actions actors may take down the road, may guarantee that actors do not give into temptations they might otherwise come to regret. Specifically, that it may be preferable to give up some degrees of freedom of action (especially for individuals) in order to be able to realize long-term benefits for all.

When told as such, the story is charming, enlightening and fitting.[2] However, it may also be the case that it just is a little too easy. Why? To answer with another, quite abstract question: What if the solution proposed as the *necessary* solution simultaneously is one, which *cannot* be implemented? Or to phrase it more in the practical terms of the story: What if Circe had not been present to suggest the idea to Ulysses in the first place? Who provided the wax? Could Ulysses force the sailors into using the wax? What if the Sirens' song was so loud that the wax was not enough? What if the ropes were not strong enough to tie Ulysses? What if some of the sailors had responded to Ulysses' insistence that he be released? etc.

The present paper will try to address the underlying problem, which these questions illustrate. In the following we will, first, through the use of arguments from contractarian thought summarize what the proponents of constitutional liberalism generally see as being at least some of the advantages of the imposition of constitutional constraints on government (Section 2), then subsequently outline what some relevant examples of such constraints may be (Section 3) and further give a logical argument for why constitutional constraints may be difficult or impossible to implement (Section 4); doing so we shall incorporate insights from both public choice analysis and "Austrian" political economy. Finally, we will discuss whether some constitutional constraints may be easier to implement than others (Section 5).

2. THE ATTRACTIVENESS OF CONSTITUTIONAL LIBERALISM'S ORDER

One of the most outstanding constitutional thinkers ever, James Madison, formulated what has since been termed the *Madisonian Dilemma*, i.e., that constitutional framers are faced with a tough decision in so far as they, on the one hand, need to empower a government so as to be strong enough to take on the tasks deemed to be necessary, but that they also, on the other, simultaneously need to tie the hands of a government in such a way that it will not become tyrannical. Madison formulated it as such in a rightly famous passage:

> If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself. (Madison, *Federalist* no. 51, in Hamilton, Jay, & Madison [1787] 2001, p. 269)

The tough questions thus become (1) what tasks are considered to be essential to be undertaken by governments? and (2) how to tie the hands of government, including how tightly to tie them? While quite general, the Madisonian Dilemma thus is a challenge closely related to the more specific notion of *constitutional liberalism*.[3] In this tradition, the ideal constitutional order may, somewhat simplified, be seen to be one in which the government is effectively and relatively tightly constrained in what activities it may legitimately undertake. The emphasis, so to speak, is more on the second part of the Madisonian Dilemma than on the first. The underlying premise is that the more individuals – alone, through the market or the institutions of civil society – are left free to use their persons and property to pursue their own happiness within the constraints of the recognition of similar rights to others, the better the results for society as a whole. On the other hand, if the political system is one where interest groups are permitted to influence government decision making to such a degree that they are capable of directing decision making to their own narrow benefit rather than in the general interest, then it will be expected that the results will be harmful to society as a whole. In the following subsections this line of reasoning will be elaborated in greater detail so as to highlight the possibilities of constitutional design.

2.1. The Contractarian Analysis of Constitutional Costs and Benefits

A constitution is a comprehensive set of fundamental rules regulating the relations between individuals in a society through various institutions, and where these rules have consequences for the relative costs and benefits of making choices. Specifically, the design of a constitutional set-up involves choices concerning what may be called (1) *substantial rules*, i.e., rules for the allocation of resources, tasks, etc., and (2) *procedural rules*, i.e., rules of how decisions are to be made (e.g., including the general structure of government, separation of powers, electoral system, etc.).[4] When making constitutional choices, it is thus decided both what tasks can, must and may not be solved through government action, as well as how future decisions must be made. In fact, the very feature of constitutions restraining what government officials may do is probably *the* defining feature of a constitution (cf. Friedrich, 1950, Chapter 7; Hayek, 1960, Chapter 12).

One central insight of constitutional economics going back to at least the dilemma identified by Madison is that constitutional arrangements may either support solutions tending to be mutually advantageous or solutions tending to be advantageous for some and harmful to others (or for that sake arrangements which will be harmful to everyone). In order to analyze such welfare consequences of alternative constitutional arrangements, we may utilize a so-called ‘‘state-of-nature’’ for analytical purposes, such as it has been done since the classical contractarian philosophers such as Hugo Grotius, Samuel von Pufendorf, Thomas Hobbes and John Locke.[5]

A state-of-nature is a representation of a social condition where persons interact in the absence of rules, and subsequently compare this to the interaction where a constitution is in place, and the essence of such a contractarian analysis has been to show that a social condition without any central authority would be so undesirable in terms of some generally accepted standard that everybody would prefer the creation of a political authority. Of the classical contractarians Hobbes and Grotius, e.g., identified ‘‘peace,’’ understood as domestic social order, security of property rights and defense against external aggression, as what today would be termed a "public good" – and one of a quite fundamental kind, since without it most other "goods" would not be possible (at least in the long run). Pufendorf similarly identified the promotion of "sociality," understood as cooperation and mutual respect for rights, as the "fundamental natural law," since that was what would enable men to successfully pursue other ends. Finally, Locke identified "justice," understood as the lack of violations of the individual's natural right to freely pursue his self-preservation through the use of his property, as a "public good."[6] For more contemporary contractarians, the over-all public goods are usually identified with wealth or some conception of welfare.

But, these theorists have argued, in a "state-of-nature," where there is assumed to be nothing to make individuals pursue "peace," "sociality" or "justice," etc., other than their own self-interest, individuals will have a choice not between outcomes but between strategies for how to act. In Hobbes' state-of-nature, an individual would have a choice between a strategy of "peace" and one of "war," and in Locke's state-of-nature transformed into a state-of-war, he would have a choice between respecting the natural rights of others or of violating these. Let us for the present purposes assume that "peace" or "justice" are synonymous with the respect of established property rights of others; in that case, the possible choice sets of the individuals can be subsumed under two general strategies: respecting or violating property rights.[7]

This situation may, as it has often been done in recent decades, be illustrated by the use of some simple games.[8] The matrix in Fig. 1 depicts the strategic situation faced by two individuals in a state-of-nature, i_1 and i_2, and their available strategies, the possible outcomes and the relative preference orderings over these by the respective players. Specifically, the two each have the choice between two strategies: to steal from the other (s) or not to steal (s'). This produces four possible outcomes, depending on the combination of individual actions and corresponding to the cells (a–d) of the matrix, where

			i_2
		s'	s
i_1	s'	*a* 2 2	*b* 1 4
	s	*c* 4 1	*d* 3 3

Fig. 1. Interaction in a State-of-Nature/Rent-Seeking without an Efficient Constitution.

the numbers reflect the preference orderings of the individuals, with i_1's in the lower left corners and i_2's in the upper right corners, and with 1 being the most highly preferred outcome and 4 being the least preferred.

If the costs associated with stealing are less than the resulting benefits, the individual actor's most preferred outcome is where he himself steals, while the other remains passive, corresponding to the outcomes (s, s') and (s', s) for individuals i_1 and i_2, respectively. In contrast, an actor's least preferred outcome is where he himself remains passive while the other steals, i.e., corresponding to the outcomes (s', s) and (s, s') for i_1 and i_2, respectively. Since stealing also carries some costs with it, it is probable that both actors prefer an outcome in which they both remain passive and respect each other's rights (s', s') to one, where they both steal (s, s).

This portrayal of the interaction in a state-of-nature is fundamentally identical to the infamous "Prisoners' Dilemma" game, which in recent decades has become by far the most popular way to illustrate the problems facing individuals in a state-of-nature.[9] The strategy s strictly dominates the strategy s', and hence both actors will choose that action and thus produce the outcome (s, s) despite the fact that this outcome is less preferred by both actors than the outcome (s', s'). This is so since the structure of the preferences means that any individual, who in this situation unilaterally chooses to respect the property rights of others, will open himself up to – and be submitted to – predation. It also means that the rational strategy for each individual is to choose not to respect property rights, and to do so no matter what strategy other individuals might choose, and thus that the equilibrium is an outcome, where nobody respects property rights, namely (s, s) in cell d.

In other words, both individuals choose to steal from the other, and the consequence is a sub-optimal outcome for both parties, and this is an equilibrium where no actor will have an incentive to unilaterally change his behavior. We may compare such a situation to the Hobbesian vision of a state-of-nature, where nobody will engage in productive efforts but instead only in mutual exploitation, and where the familiar result is that "life of man" is "solitary, poor, nasty, brutish and short." (Hobbes [1651] 1991, §62, pp. 88–89).[10]

If the interaction between the two individuals is repeated over time, then some mutual recognition of and respect for property rights might evolve as a norm, but with symmetric preference orderings, no external sanctions imposed for violations, attempted utility maximization and shortsightedness, the interaction will have the character of a single-play game. Specifically, in the absence of any enforcement mechanism it will be irrational for any individual to perform his part of a contractual obligation first.[11]

This situation may be generalized into the generation of a "war of all against all" for at least two reasons. First, the situation is one common to *all* individuals faced with any human interaction in the state-of-nature, since all action necessarily involves the use of scarce resources and, hence, property rights in some form. It will in other words, not only characterize the interaction of some particular two individuals, but potentially all the interaction of all individuals. Second, any suggested solution to these forms of interpersonal conflicts will itself constitute a collective action problem, because the protection of rights itself is a public good. For while all members of society in principle may agree that they would all be better off if they respected each other's rights, there is a latent conflict between what is individually rational and collectively optimal when it comes to actually voluntarily providing the public goods of "peace" and "justice." If for example the securing of "peace" or "justice" is simply seen as the outcome of the individuals voluntarily changing their behavior from violating each other's rights to respecting these, and if there are no changes in the preferences of the individuals, then the choice set of the separate individual will nonetheless still be that of the bi-matrix of Fig. 1. That is, no individual has an incentive to unilaterally produce the public good, and nobody can trust anyone else's promises to do so.

2.2. The Constitutional Solution

In the contractarian literature, the standard approach is to contrast the predicted negative aspects of a state-of-nature with a constitutional solution stipulating certain rights in the form of what previously was called substantial rules, i.e., rules regulating who are permitted to perform specific action regarding the allocation of resources, and where these are enforced through the application of sanctions (or rewards) in order to encourage respect for the rights. This could, for example, be by specifying and enforcing property rights or relate to the supply of other, supposed public goods, and where the consequence is a situation such as in the matrix of Fig. 2. Here, the stipulation of rights and the threat of sanctions have raised the costs of stealing beyond the benefits, and the outcome is that both actors most of all prefer the possibility where none of them steals (s', s'), while they least prefer the outcome where they both steal (s, s). Between these two extremes are the outcomes (s, s') and (s', s); if the costs of stealing are sufficiently large, i_1 will prefer the latter to the former, while i_2 will have the opposite preference ordering. In this case, the outcome is (s', s'), which is the only equilibrium of this new game, i.e., both individuals will now abstain

		i_2	
		s’	s
i_1	s’	*a* 1 1	*b* 3 2
	s	*c* 2 3	*d* 4 4

Fig. 2. Interaction after a Constitution/Rent-Seeking with an Efficient Constitution.

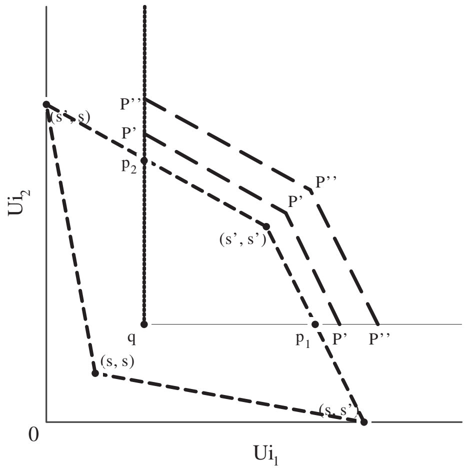

Fig. 3. The Potential Benefits of a Constitution.

from behavior producing sub-optimal outcomes. With such a solution, if successful, we may envision the possibility that a mutual recognition of property rights will have positive long-term consequences for all parties, etc.

The two situations described here have both been captured in the diagram in Fig. 3. Here, i_1’s and i_2’s utility have been displayed along the *x*- and *y*-axis, respectively, so that every outcome may be represented by a set of coordinates for the individual utilities of both actors, while the point *q* represents status quo. A broken line connects the four points representing the possible outcomes thus constructing the rhomb-shaped figure, which represents the range of possible outcomes of the present game.

The dotted lines extending from *q* represent the lower border for the Pareto set, i.e., that part of the set of possible outcomes, where no individual can be made better off without someone else being made worse off. As long as the two actors remain in a point outside this set, e.g., in the point q or at the point (s, s), they are in a sub-optimal situation, where they can both become better off.

The institutional challenge is thus to create an arrangement, which may bring the parties to a point on the Pareto frontier – or perhaps, in a longer perspective, to a point on the curves P' or even P'', which may be seen as representing two potential, more long-term Pareto frontiers. However, the problem is to establish just what institutional arrangements will guarantee what outcomes, and what the long-term consequences will be. For while (s', s') is an obvious goal, it is also the case, that – even if consideration is limited to the Pareto set – i_1 will prefer that the end result is as close as possible to his own most favored point (s, s'), while i_2 in contrast will prefer an outcome as close to his ideal point as possible (s', s). So even though both individuals will be better off at any point to the "north-east" of the lines extending from q, there is still potentially a redistributive conflict as to whether the constitution shall promote outcomes such as, e.g., p_1 or p_2. What the outcome of such a conflict will be, and whether it will be within the Pareto set at all, will depend crucially on the constitutional arrangement, and this is obviously itself an object of choice.

2.3. Rent-Seeking

The setting sketched here makes it possible to consider how alternative constitutional arrangements may have different consequences, depending on, e.g., the types of collective goods produced, the decision rules used and the types of rights assigned to individuals. However, for the present purposes we will only look at institutional arrangements that are inefficient when it comes to reaching a socially desirable outcome.

If an institutional solution is produced, which will be able to move a society from a sub-optimal condition to one or more preferable alternatives, it will represent the creation of a welfare gain benefiting all. However, this will also constitute a potential "rent," i.e., a profit derived from a transfer. If, for example, we consider Fig. 3 and assume that the actors find themselves at point q and have the possibility of moving "inside" the Pareto set, e.g., to point p_1 or p_2, there will exist potential benefits to be reaped corresponding to the distance between these points to q.

But where there are rents to be reaped, there will also be *rent-seeking* behavior, i.e., actors with an incentive to invest resources in transferring these rents to themselves (Tullock, 1967; cf. Tullock, 2005). An example is special interest groups who are willing to invest resources in engaging in organization building, lobbyism, bribes, etc., in order to convince legislators, bureaucrats, voters and other special interest groups that as much as possible of the created welfare gain should be distributed to them, e.g., so that the policy becomes p_1 rather than (s', s').

Such rent-seeking may not only occur when the actors collectively are faced with a potential or realized welfare gain to be reaped, i.e., when the realm of action is inside the Pareto set. No matter at what point to the left of the contract curve in Fig. 3 the status quo is, other than the outcomes (s', s) and (s, s'), at least one player could be made better off and, hence, would be willing to seek rents.

But the problem with rent-seeking is not only the distributive issue of who gets what, but rather also – as Tullock pointed out – that the process itself may result in welfare losses. Special interest groups will be willing to invest time and other resources in capturing the rents, and this is unproductive; such investments do not create new welfare gains but only transfer resources from one group to another while wasting something on the way.

A further point, when we move beyond the simplified two-person game, is that most likely there will be more than one group potentially interested in investing resources in such unproductive activities, and yet others who will be willing to do the same to prevent this from happening. Moreover, for each special interest group willing to invest in seeking rents, or preventing others from doing so, the welfare gains will be reduced, and for that reason the total losses may together be many times larger than the amount of resources redistributed. It is thus possible that any potential welfare gains produced not only will be lost but that the outcome actually will be far outside the Pareto set.

Rent-seeking may thus create a rather unattractive situation, which can be illustrated with the two games previously used to illustrate interaction in a state-of-nature and with a constitution, respectively (Figs. 1 and 2). Let us assume that Fig. 1 rather than a state-of-nature represents two special interest groups, i_1 and i_2, which each have the choice between either seeking rents (transfers, subsidies, privileges, etc.) through a political process (s), or alternatively not do so and instead invest the resources in, e.g., production and trade (s'). If the costs associated with rent-seeking are less than the rents to be reaped, the individual group will most of all prefer a situation, where it seeks rents itself and lets the costs be absorbed by others (taxpayers, consumers, etc.), while others remain passive, i.e., (s', s) and (s, s'), respectively, for two special interest groups. If the special interest group knows that the rent-seeking behavior by others will impose collective costs, it will likely prefer a situation where nobody seeks rents (s', s') to one, where everybody does so (s, s).[12] This is a situation fundamentally identical to that of the Prisoners' Dilemma, i.e., where the outcome is the collectively unattractive (s, s).

The likelihood that special interest groups will be mobilized and seek rents and will be successful is, ceteris paribus, likely to be greater the more asymmetric the rents are, i.e., the more concentrated the benefits and the more dispersed the costs (cf. Olson [1965] 1971). The more they are able to do so, the larger we should expect the resulting welfare losses to be. This then suggests that societies with constitutional orders that do not constrain governments so as to efficiently prevent rent-seeking may end up going down a road of welfare losses.

2.4. The Madisonian Balance

The insights sketched in the previous subsections are not, in themselves, new at all. James Madison early on recognized that behavior, where different groups fight it out for a concentrated political power, in the absence of constitutional restraints in fact may come to resemble a warlike state-of-nature.[13] In other words, he recognized that there were potential, collective benefits from enforcing order, but also that the creation of that order in itself also makes it possible to produce policies resulting in sub-optimal decisions.

One way of illustrating the reasoning of this Madisonian perspective is through a reformulation of what has been more widely known as the *Laffer curve*, i.e., the notion, named after Chicago economist Arthur Laffer, that government income will not be increasing steadily with increases in taxation levels, but that beyond a certain point higher taxes will lead to avoidance of taxation and reduced activities to such an extent that government revenue actually will begin to decline; in this perspective government revenues may actually peak at lower levels of taxation rather than higher.[14] Inspired by this, the economist and politician Dick Armey formulated what has subsequently been called the *Armey curve*, extending this kind of reasoning to the relationship between government spending (e.g., as percent of total production) and its consequences for income per capita. The reasoning here is that higher levels of government spending in the long run will lead to reduced incentives for production, crowding-out effects, etc. (Armey, 1995; Vedder & Gallaway, 1999, pp. 102–103). We may formulate this even more generally in terms of government intervention as such (including any kind of both regulation and redistribution), i.e., as the hypothesis that some enforcement of property rights, etc., and the production of some public goods, conceivably may lead to increased economic activities, increased incomes, etc., but only up to a certain point. If rent-seeking special interest groups manage to influence government decision making in such a way that it extends beyond that and becomes more extensive, it will lead to growth retarding policies, etc. Indeed, if all decisions in a society were completely collectivized, individuals would stop having any incentive whatsoever to be productive, and there would – as Thomas Hobbes characterized a quite different social condition – be "no place for Industry; because the fruit thereof is uncertain: and consequently no Culture of the Earth; no Navigation, nor use of the commodities that may be imported by Sea; no commodious Building; no Instruments of moving, and removing such things as require much force; no Knowledge of the face of the Earth; no account of Time; no Arts; no Letters; no Society…" (Hobbes [1651] 1991, §62, pp. 88–89).

This logic has been illustrated in Fig. 4, where the overall extent of government intervention (taxes, regulation, etc.) is displayed along the horizontal axis (G), whereas the average income of the citizens (e.g., measured in dollars) is given by the vertical axis (I). If the purpose of collective decision making is to maximize prosperity, then in this scenario the challenge will be to develop a constitutional structure that will bring about collective choices inducing conditions to come as close as possible to the point on the curve matching G^*/I^*.

This raises a number of interesting questions, when seen in the perspective of a constitutional liberalism. The first and most important of these are, of course,

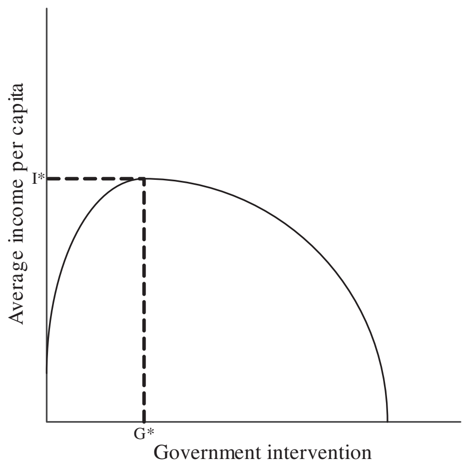

Fig. 4. A Variation of the Laffer/Armey Curves: Hypothesized Relationship between Levels of Government Intervention and Average Income Per Capita.

whether the relationship at all is as hypothesized, and if so how the curve slopes and where it peaks. This is, of course, by no means clear a priori but must ultimately remain a question to be estimated empirically. A second interesting question is what *types* of constitutional structures will be able to induce the level of government intervention to reach a point as close as possible to G^*, i.e., what types of constitutional arrangements will be able to effectively constrain governments to such an extent that the most positive consequences will follow. In the following, we will briefly consider these two sets of questions.

3. TAMING LEVIATHAN?

The previous analysis indicates that if one wants to induce growth and prosperity in a society and to keep taxes low, then a wise strategy would be to seek to constrain governments and anchor liberties severely in the constitutional order. But how to do this? Given the previous points, the obvious question would then be how to construct a constitutional arrangement, which supports a situation between individuals in a society which is more reminiscent of that in Fig. 2 than that of Fig. 1, and which will permit a society to reach a condition matching the point (s', s') in Fig. 3, or the point on the curve in Fig. 4 corresponding to I^*.

In order to consider this, let us again consider Fig. 3 and keep in mind the previously made distinction between procedural rules and substantive rules; given this we may distinguish between two types of constraints on a government aiming at limiting the power of those acting on behalf of governments to exercise power arbitrarily: *procedural* constraints and *substantive* constraints.

3.1. Procedural Constraints

Procedural constitutional constraints are rules that aim at restraining governments and their agents (or does so as a consequence), not by prohibiting or mandating particular actions as such, but by stipulating particular procedures for how to make decisions and doing so in a way which will tend to limit how many or what types of actions that are taken (relative to what would be the case without such procedural constraints). Procedural constraints thus function by operating directly on the way of making decisions, but only indirectly on their content.

Procedural rules generally speaking, as well as procedural constraints in the sense just outlined, are plentiful in most constitutional orders, and in fact it is difficult to imagine any constitution worth its name that does not impose procedural constraints of some kind. Even an absolutist constitution granting all ultimate decision-making power to one person or one body will typically have some rules that stipulate who can make what decisions when; for example, autocrats will often be indirectly limited through rules governing their succession, just as an almost unlimited parliament such as the British has numerous rules of procedure regulating its procedures.[15]

However, the types of constraints typically associated with a constitutional liberalism are those constraints, which introduce various forms of *veto players* into a constitutional structure. A veto player is an individual or collective actor whose agreement is necessary for changes in the status quo, i.e., an actor who can veto collective decisions under certain circumstances (cf. Tsebelis, 2002). If we consider Fig. 3, such a procedural rule may be seen as being one that requires that the preferences of some agent (or agents) are taken into consideration when making a decision, thereby making that agent a veto player; for example, that q is the status quo and that i_2 is the decision-maker but that she will need to get consent from i_1 in order for decisions to come into effect. In that case, policies outside the Pareto set will be prevented from being adopted, even if closer to (s', s) than q. The consequence of introducing more such veto players into a constitutional set-up is, first and foremost, that the set of feasible outcomes becomes limited to Pareto-improving moves. In practical terms, such constitutional veto players may, for example, be more chambers in a parliament, a supreme court or constitutional court with the power of judicial review, a president with veto powers, a requirement that certain types of decisions must be submitted to a referendum, etc.[16] It is widely accepted that a larger number of institutionalized veto players will serve to induce stability and promote Pareto-improving outcomes (Hammond & Miller, 1987).

Another type of procedural constraints is where a *separation of powers* takes place, and where authority is granted to some individuals with regard to making decisions within certain spheres of collective decision making. Examples of such are, e.g., a horizontal separation of powers within a government (e.g., between a legislature and an executive) or a federal structure with a vertical separation of powers between units in a hierarchy. In this case, the constraint does not come in the form of inducing exclusively Pareto-improving relationships but rather by dividing the realm of social choice into separate domains.

In addition, there are a vast number of other types of procedural constraints, which do not fit neatly into categories, e.g., "sunset" provisions for when existing legislation will expire, legislative term limits regulating the number of terms that politicians may be elected to serve, requirements of super majorities in parliamentary decisions or referendums, etc..

3.2. Substantive Constraints

Substantive constitutional constraints on governments are rules that seek to limit what governments may legally do by explicitly stipulating what they may not do. Substantive constraints thus work more specifically on the content of the policies, rather than simply on the procedures; as such they are more explicit and perhaps less open to reinterpretation, but they also require external backing to a degree, which, say, a more or less self-enforcing separation of powers will not need.

Most constitutions developed since the 18th century contain substantive constraints of some sort and to some extent. Substantive constraints may operate either at the micro-level or macro-level. Examples of the former are rules stipulating that certain actions cannot be done with regard to individuals; these are, e.g., "negative" rights such as traditional liberties (e.g., private property rights, freedom of contract, freedom of exchange, freedom of thought, etc.). Examples of substantive constraints at the macro-level are rules that stipulate that certain conditions at group level must or cannot be fulfilled. These too may be very wide in scope and include legislative output (e.g., restrictions on the amount of laws passed in a year), fiscal policies (e.g., limits on taxes, spending or in increases in these, balanced budget requirements), etc.

3.3. Some Empirical Observations

In recent years a number of studies have investigated the potential relationships between on one hand the extent of the presence of one or more political institutions (e.g., the extent of democracy) and on the other hand such macro-phenomena as prosperity, distributions of income, etc. The almost universal and unanimous verdict has been that governments that respect the liberties of its citizens tend to do better on almost all accounts. This seems to be the case both at the level of the fundamental political institutions (e.g., property rights, rule of law, separation of powers, etc.) and at the more intermediate level of the policies adopted within such a framework and further influencing welfare and prosperity (e.g., monetary policies, trade policies, etc.) (for surveys, see, e.g., Lane & Ersson, 2000; Holcombe, 2001; Scully, 2001; Berggren, 2003; Kurrild-Klitgaard & Berggren, 2004).

But if that indeed is the case, then why do so few societies seem to choose the optimal arrangements when it comes to promoting prosperity? That is, why are not more states adopting more tightly constrained governments? It would in fact seem to be the case that much experience indicates a general trend the *other* way, i.e., that constitutional constraints on governments are generally loosened over time rather than tightened, while in contrast constitutions in the 20th century have come to be used still further to mandate the use of government power. In fact, systematic studies show that it is a general tendency that more recent constitutions are longer than older constitutions, not because they are more restrictive but because they loosen up and expand the tasks of government (Montenegro, 1995; Kurrild-Klitgaard, 2001).

It seems as if governments, and the people living under them, only want to listen to the Sirens – or at least only read Madison as suggesting the empowering of government while forgetting that men are not angels.

4. THE CONSTITUTIONAL PROBLEM OF GUARDING THE GUARDIANS

The answer to the question of why so few constitutions contain features that otherwise seem so generally attractive may lie in what could be termed "the contractarian paradox," which, in essence, is that the very features which may seem attractive about constitutional constraints are what also make them unlikely to be implemented.[17] We shall consider this first at a general and abstract level and second with some more specific examples.

4.1. The Contractarian Paradox

In recent decades a renaissance has occurred for the political theory of contractarianism, such as outlined in Section 2, first and foremost due to the works of John Rawls, James Buchanan and Gordon Tullock, David Gauthier et al. (Buchanan & Tullock [1962] 1999; Rawls, 1971; Buchanan, 1975; Gauthier, 1986). In this movement, contemporary theorists have given new life to the old tradition by employing modern analytical tools, e.g., those of micro-economics and game theory, such as it has been done explicitly in the case of the theories of Thomas Hobbes,[18] and such as summarized here.

In our outline of the contractarian reasoning it was shown that a situation where rules are enforced will be preferable to one, where they are not, but in fact the argument of political contractarianism usually goes much further than that. A general version of the argument might go like this: rational individuals in the state-of-nature will realize that significant public goods will only be produced if they simultaneously give up their ability to violate the rights of others and do so by empowering an institution with a monopoly on the use of coercive force so as to make it possible to enforce solutions.

Hobbes, for example, argued, that every individual in "the natural condition of mankind" guided by reason will come to realize the "fundamental law of nature," which is, "to seek peace, and follow it," and accordingly, as the second law, "be willing, when others are so too, as farre-forth as for Peace, and defence of himself he shall think it necessary, to lay down this right to all things" (Hobbes [1651] 1991, §65, p. 92). Accordingly, each individual in the state-of-nature must make a covenant with every other individual, in which it is mutually promised to give up the right of self-defense by relinquishing that and all other rights to a political authority to be created, either stipulated in each covenant or chosen by a majority. The political authority thus created has the obligation to secure internal and external peace and is unconstrained.[19] In a related, but somewhat different way, Locke argued that political authority is justified as a remedy for an efficient and just enforcement of property rights by the restraining of violence. But since injustice may also occur under an unconstrained and sovereign political authority, this can only be created by consent and only and solely by giving up those rights, which are necessary for the achievement of this goal.[20] Pufendorf similarly saw the institution of political authority as necessary for securing and further increasing the already created socially beneficial institutions; if "sociality" is not so secured, there is a risk, that the seeking of self-preservation by individuals will endanger it. Pufendorf therefore envisioned that individuals in the state-of-nature voluntarily will form a two-stage social contract, whereby it is decided to institute political authority and what form it shall have.[21]

Of contemporary political contractarians, Buchanan (1975) has similarly outlined a strictly logical social contract process also consisting of two stages (or levels), whereby individuals, out of consideration for their own utility maximization, are seen as unanimously agreeing on the assignment of property rights and provision of public goods, first and foremost the protection of rights.[22] While this is not intended as an accurate description of what goes on, Buchanan at least implies that such an analysis captures sufficiently much of what goes on in reality so as not merely to be a normative theory of how rules are to be evaluated.

So, what unites these contractarian theories is, despite their differences, that the purpose of the social contract is to create political authority, since it is assumed that the institution of a organization with the ability to enforce solutions will mean a more efficient provision of some otherwise problematic public goods (as "peace," "justice," "welfare," etc.), and this is what was attempted to be illustrated by the bi-matrix in Fig. 2. Here, the political authority created by the social contract has succeeded in imposing sanctions upon those, who do not respect the property rights of others, and thus successfully changed the preference orderings of the individuals so as to induce them to cooperate. Accordingly, there now is a unique equilibrium, which is identical to the collectively preferred outcome in the Prisoners' Dilemma-like state-of-nature, i.e., (s', s') in cell a. Accordingly, the argument of political contractarianism broadly conceived, may be summarized as done by the propositions in Table 1.[23]

The argument contained in these propositions is, at least in essence, very typical of what is at least implicitly central in contemporary versions of political contractarianism, be they explanatory or justificatory, and assuming that the consent is hypothetical or actual (whether explicit or tacit). In explanatory versions of political contractarianism, the inference will be that the historical origin of existing states can – at least in some sense – be explained as the outcome of such a process, i.e., the move from a state-of-nature without government to a condition with government can be explained through the contractual creation of political authority.[24] Similarly, in justificatory versions of political contractarianism the inference will typically be that political authority is justified, because it can be seen as being the outcome of what rational individuals freely *would* consent to.

However, there are several problems inherent in using the Prisoners' Dilemma analogy outlined here in a political contractarian context. We shall not treat these problems here, but neither shall we claim that the Prisoners' Dilemma is the only way to model the interaction of the state-of-nature, or even necessarily the best.[25] For while several theorists have had important

Table 1

(P1) If political authority is necessary to enforce a supply of solutions to public good problems, then rational individuals will consent to the creation of political authority.

(P2) Rational individuals in a state-of-nature will not cooperatively supply solutions to public good problems.

(P3) Political authority is necessary to enforce a supply of solutions to public good problems in a state-of-nature.

Therefore

(P4) Rational individuals in a state-of-nature will consent to create political authority to enforce a supply of solutions to public good problems.

things to say about these questions, and while these are highly relevant for the question of the general applicability of the Prisoners' Dilemma, it is not the problem we want to address. Rather than to try to show that political contractarianism is wrong in modeling the interaction of the state-of-nature as something similar to a generalized version of a two-person single-play Prisoners' Dilemma, we shall simply take the assumption that this *is* a valid procedure for granted and then proceed to show that this, nonetheless, *itself* poses a much deeper problem for political contractarianism. For while political contractarians have labored hard to explain the disadvantages of the lack of cooperation in the state-of-nature and the advantages of cooperation made possible by the creation of political authority, they have spent little or no time addressing the very important question of how it can be possible to reach the cooperation necessary for the creation of political authority itself. Yet, political contractarianism, when it is based in a modeling of the Prisoners' Dilemma, will necessarily fail in what must be its most important pursuit, namely to *simultaneously* explain how the state-of-nature can be so problematic as to make the creation of political authority necessary but *not* so problematic as to make this impossible.[26]

The potential existence of such a problem has already under various labels and to varying extents been identified by some theorists, particularly as it may apply to arguments in favor of government enforced solutions to public good problems and similar situations resembling other two- or *n*-person Prisoners' Dilemmas.[27] But while the possibility of such a problem has been identified, it has in my opinion neither been given the attention it deserves, nor been explicitly related to its full potential implications for political contractarianism.[28] However, a political contractarianism based on the use of Prisoners' Dilemma reasoning is faced with what could be called the "Prisoners' Dilemma of the Prisoners' Dilemma," but which here is perhaps best described as a *contractarian paradox*.[29]

The problem can potentially take two forms, which, however, seem to be but different sides of the same underlying problem and both stemming from the same line of reasoning, namely the assumption in the Prisoners' Dilemma-like version of the contractarian argument where the players are not just handicapped in their communication but *incapable* of communicating, imposing mutual sanctions, etc. To see this, one may consider the argument given by the propositions (P1), (P2), (P3) and (P4), as well as their logical alternatives (P1′), (P2′), (P3′) and (P4′) of Table 2.[30]

The problems of this line of reasoning come into effect, once two implicit assumptions – which indeed quite often are claimed explicitly in political contractarianism – are realized. That political authority itself, according to

Table 2

Proposition		Negation	
(P1)	If political authority is necessary to enforce a supply of solutions to public good problems, then rational individuals will consent to the creation of political authority.	(P1′)	If political authority is necessary to enforce a supply of solutions to public good problems, then rational individuals will not consent to the creation of political authority.
(P2)	Rational individuals in a state-of-nature will not cooperatively supply solutions to public good problems.	(P2′)	Rational individuals in a state-of-nature will cooperatively supply solutions to public good problems.
(P3)	Political authority is necessary to enforce a supply of solutions to public good problems in a state-of-nature.	(P3′)	Political authority is not necessary to enforce a supply of solutions to public good problems in a state-of-nature.
Therefore			
(P4)	Rational individuals in a state-of-nature will consent to create political authority to enforce a supply of solutions to public good problems.	(P4′)	Rational individuals in a state-of-nature will not consent to create political authority to enforce a supply of solutions to public good problems.

the argument, must be a public good, and that the cooperative supply of the public good (the consent to create it) hence itself may constitute a collective action dilemma. This must necessarily be so, since it is both assumed that the existence of an enforcing political authority is a necessary prerequisite to overcoming public good problems (P3), yet also that this can be created cooperatively (P4). Given that this is the case, then the first version of the problem comes into action, when it is argued that rational individuals in the state-of-nature *cannot* overcome public good problems (P2). If that is the case, then they cannot, as concluded in (P4), cooperatively create political authority either, which is – at least implicitly – assumed to be a public good itself (P3). This is what we might call *the possibility problem* of the social contract.

The second version of the problem occurs, if on the other hand it is argued that rational individuals in the state-of-nature actually *can* create political authority (P4). If that is the case, then public good problems can be overcome cooperatively without being enforced, i.e., (P2′), and hence there is no need for political authority. This we might, on the other hand, call *the necessity problem* of the social contract.

The essence of these two problems is thus that since, on the one hand, (P2) $\rightarrow$ (P4′), then (P4) cannot be true, while, on the other hand, since

(P4) → (P2′), then (P2) cannot be true. There are, at least, two important implications, which follow as corollaries to the two sides of the contractarian paradox. First, if political authority *can* be created cooperatively (P4), then it cannot itself be a public good, as assumed (P3), i.e., (P3′). Rather it must be the case that it is something different, namely some form of a private good, although possibly of a bundled character. But, secondly, if political authority really is a public good, then it cannot be created cooperatively for the purpose of supplying solutions to public good problems but must be created non-cooperatively. The contractarian paradox may now, in short, be summarized as: if a social contract is necessary, then it is not possible; but if a social contract is possible, then it is not necessary.

4.2. An Extension: From Social Contract to Constitutional Design

The argument offered in the previous subsections in favor of the existence of a paradox in contractarian reasoning might be seen as simply armchair philosophizing, i.e., as something irrelevant for what goes on in the real world. However, it should require little reflection to appreciate that this is not so, and that this indeed is the reason why there are so few of those good solutions. After all, what is quite often done in the discourses and processes of constitutional design is exactly to reason in a manner following the contractarian logic summarized in Table 1 and on the left side of Table 2: first a problem of a collective good nature is identified, and then an institutional solution is posited, while little effort is directed toward identifying whether the solution proposed (1) is the optimal one or (2) is possible at all.

An illustrative historical example of such reasoning being used in actual constitutional design is that of the US founding fathers. Specifically, in the rightly famous *Federalist* no. 51 Madison writes so brilliantly about the necessity of separation of powers, but then falls into the trap – or uses the strategic trick – to infer that this will be desired by rational actors:

> Justice is the end of government. It is the end of civil society. It ever has been and ever will be pursued until it be obtained, or until liberty be lost in the pursuit. In a society under the forms of which the stronger faction can readily unite and oppress the weaker, anarchy may as truly be said to reign as *in a state of nature*, where the weaker individual is not secured against the violence of the stronger; and as, in the latter state, *even the stronger individuals are prompted, by the uncertainty of their condition, to submit to a government* which may protect the weak as well as themselves; so, in the former state, will the more powerful factions or parties be gradually *induced, by a like motive, to wish for a government which will protect all parties*, the weaker as well as the more powerful. (Madison, *Federalist* no. 51, in Hamilton et al. [1787] 2001, p. 271; emphasis added)

What Madison does here is exactly to commit the logical fallacy identified in the previous discussion. But perhaps the important point to note is that the situation he and his co-founders were in was not exactly one resembling a Prisoners' Dilemma. They found themselves in a situation, where they could communicate; where actions were not simultaneous; where certain rules were in place; etc.

4.3. A Parallel: The "Austrian" Analysis of Interventionism

The preceding analysis of the contractarian paradox may be seen as potentially having some interesting relevance for the analysis of government intervention formulated by the Austrian School of Economics (Mises [1929] 1996, [1940] 1998; Hayek [1944] 1976; Ikeda, 1997). In the Austrian analysis, all government decisions are analyzed as being essentially redistributive in their consequences (cf. Rothbard [1970] 1977), and as such the analysis bears a significant resemblance to at least some versions of public choice analysis (e.g., Tullock [1967] 2004; Aranson & Ordeshook, 1981). The political economy analysis of the Austrians suggests that government interventions in the interactions between individuals invariably will lead to both disturbances in the market process and welfare losses, and that these – when decision-makers are confronted with the consequences – may lead to still further interventions. As such a society with a "mixed economy" characterized by "middle-of-the-road" policies will not be a stable condition; decision-makers will ultimately have to choose between either free market capitalism or outright socialism (cf. Mises [1950] 1991).

We must presume that this Mises–Hayek analysis of interventionism would apply even to what is often seen as the public goods rationale of the supposed "core functions" of government (law enforcement, defense, etc.), since interventions aimed at such cannot be seen as being a priori any less vulnerable to the negative effects of intervention than other types of intervention. However, this was not the way which Mises himself saw the issue (and probably not Hayek either): for Mises government protection of property did not itself constitute an intervention, and for him a minimal state would therefore – in contrast to a mixed economy – be able to be a stable condition (Mises [1929] 1996; cf. Ikeda, 1997: 196ff). Among other things, Mises put his trust in the ability of the constitutional framers and legislators to set the long-term general benefits of a liberal order high on the agenda:

> The framers of the modern constitutions did not overlook the fact that in the short run the particular interests of individual groups may conflict with those of the overwhelming

> majority. But they had full confidence in the intelligence of their fellow citizens would be wise enough to realize that selfish group interests must be sacrificed when they run counter to the welfare of the majority. They were convinced that every group would recognize that privileges cannot be maintained in the long run. Privileges are only of value if they benefit a minority; they lose value as they become more general. When every individual group of citizens is granted privileges, the privileges as such become meaningless; everybody suffers, nobody gains. (Mises [1940] 1998, p. 80).

However, the analysis as suggested by Mises and Hayek would seem to have some flaws somewhat similar to those discussed in relation to the contractarian reasoning. First of all, Ikeda has carefully and convincingly argued that Mises is wrong on at least one point: even a minimal state would not be able to remain a stable, among other reasons because even a minimal state would need to engage in some form of interventionist policies (Ikeda, 1997, Chapter 6); a rent-seeking analysis such as Tullock's would certainly seem to support such a conclusion, since even the protective activities of a minimal state might produce potential rents that interest groups might seek to reap.[31] Secondly, the optimistic view of institutional design set forth by Mises in the previously quoted paragraph seems as flawed as Madison's point of view when it comes to solving the underlying problem: if welfare-decreasing interventionist policies take place in, say, parliaments because of short-run concerns, why should this problem not be universal, including at the more fundamental, constitutional level?

Together these points leave a significant question mark at the issue of whether it would ever be possible to effectively constrain Leviathan. If the "size" of government – in the sense of the extent of its intervention into the actions and transactions of individuals – will never be stable, but with the forces pulling toward more government intervention being omnipresent, then it is likely that after sufficient pressure the "levees" will begin to crack. The logic then suggests that when the levees have cracked, the cracks might easily be followed by floods. The same would likely be the case for constitutional constraints and perhaps even more so: if a particular rule is intended to prevent, e.g., violation of property rights, regulation of trade or excessive taxation, but where the interpretation of that rule will be open to interpretation (as virtually all rules are at some level), then at some point it will be likely that it will be interpreted in a way consistent with an interventionist program – and the moment that this has been done once, more similar decisions are likely to follow, when pressure and precedent combine. The most illustrative examples of this are, of course, the revisionist interpretation of the interstate Commerce Clause and the New Deal and post New Deal erosions of limited government in the US.

4.4. An Example: Legislative Term Limits

The points made in the two previous subsections may be illustrated by a specific case, namely the attempts at institutionalizing so-called "term limits" in the US political process, i.e., to introduce limits on the number of (usually consecutive) terms that politicians may serve in office.

The term-limit phenomenon has roots deep in US political history, but it burst into modern prominence in the early 1990s, when a very broad-based campaign pushed the proposal high on the political agenda – in fact, so high that it was supported by a majority of the voters and became one of the key elements of the Republican Party's "Contract With America" in 1994. Since the early 1990s, a number of organizations have with considerable success worked for the introduction of term limits for local and state offices. The same has been sought at the federal level: through restrictions imposed at the state level for representatives elected for the federal level (which however was struck down by the Supreme Court as unconstitutional, since it is not for the states to impose limits on the term lengths of federal politicians), and through a proposed constitutional amendment. Furthermore, a number of politicians signed pledges to voluntarily limit themselves to only two terms in office.

The basic reasoning of the term-limits movement has been one clearly reminiscent of a Ulysses-style contractarian solution to a perceived collective action problem, as illustrated by these passages written by two proponents:

> [Members of Congress] frequently engage in pork-barrel politics. Many bring home pet projects that benefit their constituents and, as a consequence, their own chances for reelection. In addition, representatives use myriad taxpayer-funded perquisites to spread their messages and enhance their visibility. Incumbents also are able to help their constituents with various problems that they may encounter with the federal bureaucracy. Such help, known as constituent service, is made necessary by the increasing size of government and can significantly increase an incumbent's approval rating. … [Imposing] term limits on members of Congress would ensure that party leaders and committee chairmen would not become part of a permanent ruling class…
>
> Term limits would dramatically change the incentives of the political system. If the seniority system was eliminated, more potential citizen-legislators would be inclined to seek office. There are many people who care about their government and would be willing to spend a few years in Washington fixing it, if they believed that career legislators – party leaders and committee chairmen – did not completely control the agenda.
>
> Once in office, it is likely that citizen-legislators would behave much differently than those currently in power. Since they would have little desire and, indeed, no opportunity to spend their lives in Congress, citizen-legislators would have no incentive to pursue activities – such as pork-barrel spending, constituent service, and regulating campaign finance – that, as one of their principal effects, entrench legislators in office. Moreover,

> term limits would do much to overturn Washington's "culture of spending," as James Payne has put it, and thus shrink the federal bureaucracy. The benefits of such a change are clear (O'Keefe & Steelman, 1997, pp. 1 and 19).

There are some theoretical arguments and some empirical evidence to support such a view – more junior legislators do tend to vote in a more fiscally responsible way[32] – and the momentum was so significant that it was believed in the mid-1990s that term limits might be implemented at the federal level, especially after the Republicans took over control of Congress. However, nothing really came of it: a bill proposing limits of six terms for members of the House and two terms for members of the Senate (i.e., in both cases 12 years) came to a vote in the House of Representatives 29 March 1995, after the Republicans had gained a majority in the 1994 mid-term elections. But due to vehement opposition from Democrats and lukewarm support from leading and senior Republicans, the bill went down to defeat. What is significant is that it was almost exactly the legislators who would have been restricted, who were opposed; senior representatives voted almost 2:1 against term limits, while junior representatives were in favor (Steelman, 1998). Even more illustrative is that many of those who had pledged to retire from their elected offices suddenly felt that they had good reasons to stay on. For example, following the 1998 mid-term elections, many of those who had been elected in 1992 and 1994 as term-limit backers, and who had promised to serve only six or eight years, subsequently reneged on their promises.[33]

5. SO WHEN AND HOW (IF AT ALL)?

The problem outlined here has not gone completely unnoticed in the literature; it has indeed, as indicated, often been acknowledged as being a logical problem. However, very little work has been undertaken with regard to the problem's possible implications for constitutional design. In the contractarian-inspired tradition of constitutional economics it does indeed often seem to remain the case that the analysis takes the road of first presenting an analysis of what is conceived as being a problem, then posits a possible constitutional solution to that problem, but largely ignores a discussion of what the potential problems in regard to actually implementing that solution would be. But doing so would – given the previous points – seem to indicate that whatever is proposed as a solution either is insufficient at constraining Leviathan or stands little or no chance of being realized. The fate of the term-limits campaign is one illustration, while another is that of budget deficits; the latter are seen as problematic and come into being because legislators are unwilling to commit themselves to fiscally responsible policies; yet for that very reason it is unlikely that the same legislators should agree to limit spending by, say, adopting a constitutional amendment enforcing balanced budgets.

However, the real challenge – at least when seen in the perspective of constitutional liberalism – seems to be to find constitutional constraints, which simultaneously are effective in restraining governments *and* possible to have implemented. So do such solutions exist? And are there times and occasions where they seem to be more easy to implement than others? In the following we shall very briefly add a few cursory observations on these issues, based more in anecdotal reflections than in systematic studies but which nevertheless hopefully may serve to highlight the subject.

First of all, it would seem that many of the most path breaking instances of constitutional reforms, where decisive steps were taken to constitutionally limit governments, were taken subsequent to experiences of tyrannical governments and in times of crisis, whereas constitutional reforms taking place in "ordinary" times seem more often than not to work in the direction of loosening the constraints on government. This certainly seems to have been characteristic of all the "great" constitutions usually praised by constitutionalist liberals, e.g., the British Glorious Revolution (1688), the American Revolution (1776), the European "Bourgeois" Revolutions (1848), etc., and it also seems to apply to some of the minor constitutional changes often heralded as limiting governments, e.g., the passing of Proposition 13 in California. In such cases, it would seem that (a) negative experiences with a perceived excessive degree of government, and (b) the severity of a crisis made it possible to get a sufficient number of decision-makers to be perceptive to new ideas. Similarly, Mancur Olson has pointed out that there are good reasons to believe that major crises, such as caused by defeat in a war, may shake up the political system to such an extent that consolidated interest groups are destabilized in their rent-seeking pursuits that it may open up for more general interest promoting policies (Olson, 1982). It seems, in other words, that there is something about crisis situations, where a country is inflicted with severe financial, political or social problems that make it relatively easier to get the public and the decision-makers to accept drastic reforms. Of course this is not to say that *all* constitutional reforms implemented in times of crisis serve to constrain governments; that, obviously, is not the case (cf., e.g., the Russian Revolution of 1917, the German Nazi takeover in 1933–1934, etc.), and in fact crisis situations have often been used to expand government activity (Higgs, 1987). However, it would seem to possibly be the case that some form of crisis is at least a crucial facet of an environment in which constitutional constraints are implemented, albeit certainly not a sufficient cause.

Second, it seems occasionally to be the case that constitutional reforms aiming at restraining governments may succeed in being implemented if there are special interest groups whose narrow, strongly asymmetric interests *coincide with the general interest*. In such cases, the special interest groups, who might benefit from the policy change, may be willing to invest time and resources in funding and otherwise supporting efforts to have the institutional changes made (cf. Buchanan, 1979). Historically, it has often been business interests, who have been instrumental in the support for implementing institutionalized policies of free trade, lower taxes, etc. Indeed, the entire US Constitution – as liberal, constitutionalist and general interest oriented as it is often seen as being – may very well be explained with reference to the relatively narrow economic interests of those who were present at the time of decision (McGuire & Ohsfeldt, 1989; cf. Beard [1913] 1935).

Finally, it seems to be the case that constitutional reforms limiting governments require some degree of *political entrepreneurship*, i.e., some individuals who are willing to take it on themselves to invest time and resources in organizing collective action, be it intellectual (in the form of articulating the ideas) or political (by promoting the articulated ideas).[34] Constitutional changes require that some individuals are willing and able to act as the new John Lockes and Thomas Paines, but also as the new Earls of Shaftesbury and James Madisons.

So, let us return to the example of Ulysses and the Sirens. The situation itself was a crisis, which made Ulysses and the sailors receptive to the knowledge and ideas suggested by Circe, and Ulysses, who owned and commanded the ship, had an asymmetric high interest in solving the institutional problem – and did so in an entrepreneurial way. Also, there were not so many men on the ship that they could not communicate beforehand or that the transaction costs of doing so were prohibitively high. However, it was a particular situation, and had the circumstances been different, a solution to the song of the Sirens might have been too difficult to come up with.

6. CONCLUSION

There are good reasons to believe that constitutional liberalism, i.e., the constitutional imposition of constraints on governments, may play an important role in supporting policies that will result in generally attractive consequences, first and foremost economic growth and freedom. But we have also shown here that the very general attractiveness of such a constitutional order makes it unlikely to be achieved. Special interest groups, whose influence over governments is supposed to be tied by constitutions, are unlikely to support the continuation or implementation of constitutional constraints on government, which would limit their own potential for seeking benefits for themselves.

So is all hope lost? That could easily seem to be the conclusion. After all, the grand constitutional revolutions of history only seem to occur ever so rarely, and many constitutional revolution would seem to have loosened rather than tamed Leviathan. On the other hand, it would seem odd for the constitutionalist liberals to conclude that super-human forces are driving change in one and only one direction, and that there is nothing we can do about it.

One lesson would, as indicated, also seem to be that constitutional changes might occur, which can move institutions in a direction consistent with a constitutional liberalism, *if* ideas can be articulated that will seem to be able to resonate with sufficiently powerful interest groups. The greatest challenge for the constitutionalist liberals is, thus, to ensure that when Pandora's Box of constitutional reform is opened up, there will be some useful ideas available for inspiration.

NOTES

1. Thomas Bulfinch, *The Age of Fable or Stories of Gods and Heroes*, here quoted after Zakaria (2003, p. 7).

2. It was indeed quite natural for the journal *Constitutional Political Economy* to adopt a logo depicting Ulysses tied to the mast, when the journal was launched in 1990 (cf. Brennan & Kliemt, 1990). One of the first to connect the story of Ulysses and constitutional design may have been Spinoza.

3. For works in this tradition, see, e.g., Buchanan ([1975] 1999), Hayek (1960), Epstein (1995), Barnett (1998); and cf. Zakaria (2003). For some more specific works in the public choice tradition, see also, e.g., Weingast (1993, 1995).

4. For this distinction, see, e.g., Buchanan (2000), cf. Hayek (1960, p. 178). Substantial rules operate directly on the content of decisions; for example, a constitution may specify that certain decisions may not be made (e.g., capital punishment), or that certain decisions must be made in particular situations. Procedural rules operate directly on the way of making decisions, but only indirectly on their content; an example is a requirement of qualified majority in collective decision-making, e.g., among legislators and/or votes when changing a constitution.

5. More contemporary philosophers working in the contractarian tradition include, e.g., Buchanan and Tullock ([1962] 1999), Buchanan ([1975] 1999), Gauthier (1986), Binmore (1994), etc.

6. On these points, see, e.g., Hobbes ([1651] 1991, Chapters 13–15, pp. 86–111), Pufendorf ([1673] 1991, I, Chapter 3, §§7–9, pp. 35–36) and Locke ([1690] 1988, II, §17, p. 279).

7. Cf., e.g., Pufendorf ([1672] 1934, VI, Chapter 4) and Locke ([1690] 1988, II, Chapters 2–3).

8. The first of the games is familiar and widely used in constitutional economics, cf., e.g., Buchanan (1975, pp. 26–28, 64–68), Buchanan and Congleton ([1998] 2003, p. 23) and Kurrild-Klitgaard and Berggren (2004). For similar uses of the Prisoners' Dilemma game to illustrate the fundamental character of the interaction of the state-of-nature, see, e.g., Hampton (1986, pp. 61–63) and Kavka (1986, pp. 109–112). Both games used here appear in Kurrild-Klitgaard (2001).

9. See, e.g., Barry ([1965] 1990, pp. 253–254), Tullock (1974, pp. 2, 11–16), Buchanan (1975, pp. 26–28, 64–68, 130–146), Hampton (1986, pp. 61–62, 75–93, 132–39, 225–232), Kavka (1986, pp. 109–113, 124–40, 146–147, 154–156, 245–146) and Schmidtz (1991, pp, 57–85). Rawls also uses the Prisoners' Dilemma in order to illustrate the argument for government provision of public goods (Rawls, 1971, p. 269). Moreover, it is often used in reviews of contractarian arguments in order to illustrate these, cf., e.g., Green (1988) and Kraus (1993).

10. See, e.g., Tullock (1974) and Buchanan (1975) for some modern statements of this analysis in a public choice perspective. For some reservations as to the universal usefulness of the Prisoners' Dilemma as a portrayal of a state-of-nature, see, e.g., Kurrild-Klitgaard (2002b).

11. See, e.g., Hobbes ([1651] 1991, §68, pp. 96–97). See also Hampton (1986, pp. 62–63).

12. This is, however, not a necessary assumption: If $i1$'s costs from $i2$'s rent-seeking are infinitely small due to a radical asymmetry between collective costs and private benefits, then the payoffs from the two outcomes may plausibly be such that $(s, s) > (s', s')$ rather than the reverse. However, this does not change the outcome; indeed, it only makes rent-seeking even more dominant as an individual strategy and extensive rent-seeking and redistribution more likely as the outcome.

13. See Madison, Federalist no. 51, in Hamilton et al. ([1787] 2001).

14. For a recent restatement and application of the Laffer curve, see, e.g., Laffer (2004); this relationship between taxes and revenue was recognized as early as by Adam Smith (Smith, [1776] 1981; cf. Kurrild-Klitgaard, 2004).

15. Cf. Kurrild-Klitgaard (2000, 2003).

16. Not all veto players in a political system are necessarily constitutional veto players. For example, in a parliamentary system, a coalition partner in a government coalition may be a veto player, but will not be a constitutional veto player since the party's position is not stipulated by the constitution.

17. See Kurrild-Klitgaard (1998), where parts of the present section derives from; cf. also Kurrild-Klitgaard (2002b).

18. This has been done, though with slightly different emphasis and somewhat different conclusions, by, e.g., Kavka (1986, Chapters 3–6), Hampton (1986, Chapters 2–3, 5–6) and Taylor (1987, pp. 125–163).

19. See Hobbes ([1651] 1991), especially Chapters 14–15. Grotius' position was close to Hobbes', but much less developed, see, e.g., Grotius ([1625] 1901, pp. 63–68).

20. Cf. Locke: The "great and chief end … of Men uniting into Commonwealths, and putting of themselves under Government, is the Preservation of their Property." (Locke [1690] 1988, II, §124, pp. 350–51). For other central passages, see Locke ([1690] 1988, II, §15, p. 278; §95, pp. 330–31; §99, p. 333).

21. On these points, see especially Pufendorf ([1672] 1934, VII, Chapter 2, [1673] 1991, I, Chapter 3, §7, p. 35).

22. For Buchanan's somewhat abstract and complex scheme, see Buchanan (1975, pp. 17–73).

23. This presentation owes much to Schmidtz (1990, p. 95, 1991, p. 8).

24. See, e.g., North (1981, Chapter 3). Whether the consent in question has been actual (be it expressive or tacit) or hypothetical is not necessarily assumed to be important; what is posited as important is that the origin of states may be modeled "as if" consent had been given.

25. There may indeed be good reasons why it should not be seen as being adequate, and why the provision of public goods in a state-of-nature should rather be seen as constituting such milder collective action dilemmas as, e.g., the games called "Chicken," "Assurance," or "Battle of the Sexes". See, e.g., Taylor (1987, pp. 18–19 and 31), Hampton (1987) and cf. also Ellickson (1991). If the character of the state-of-nature is not quite as bad as envisioned in the Prisoners' Dilemma-like scenarios, then the creation of the centralized political authority may not necessarily be the optimal solution. Cf., e.g., Moselle and Polak (2001), Grossman (2002) and Kurrild-Klitgaard (2002b).

26. Cf., e.g., Schmidtz (1990, pp. 93–94), Hampton (1986, pp. 74–79, 136–137), Green (1988, pp. 147–148) and Kraus (1993, pp. 11, 17–18, 38).

27. Of contemporary theorists some speak of a "paradox" of the "public goods theory of the state" (Kalt, 1981, pp. 577–584), while others describe the "problem of supply" of public goods and the possible existence of "second-order collective dilemmas" (Bates, 1988, pp. 394–395; Ostrom, 1990, pp. 42–43). The treatments of the problem closest to the present are those of Hampton (1986), Green (1988) and Cowen and Kavka (1991), of which the first and the last try to solve the paradox. In an elaborate treatment Green (1988, pp. 122–157), in contrast, uses the paradox to reject political contractarianism. Green presents the paradox in a way quite similar to the present, i.e., he identifies implicitly what is here termed the "necessity problem" and the "possibility problem" and speaks of a "Prisoners' Dilemma Dilemma" and of a potential "string of higher-order PDs." Hampton has, in her reconstruction of Hobbes' argument, pointed toward a similar problem in Hobbes' account of the character of the state-of-nature and the institution of absolute sovereignty (Hampton, 1986, pp. 69–79). Cowen and Kavka (1991, pp. 1–2) speak of a possible "circularity problem" in the public goods argument for government intervention and supply of public goods. For somewhat related discussions, see also, e.g., Taylor (1987), Hampton (1987), Narveson (1988, pp. 139–140), Schmidtz (1988, 1990). I have myself treated the paradox briefly in Kurrild-Klitgaard (1994, 1997, 1998).

28. Buchanan is one of the few to explicitly discuss a similar problem in relation to constitutional design, see Buchanan (1980).

29. I have elsewhere called this the "Prisoners' Dilemma of the Prisoners' Dilemma" (Kurrild-Klitgaard, 1994, 1997).

30. Notice that (P1), (P2) and (P3) → (P4) is what is usually argued in political contractarian arguments, such as already outlined. It is, however, not claimed here that (P1′), (P2′) and (P3′) → (P4′); these do not constitute an argument, but are merely considered to be the corresponding logical negations of the propositions (P1), (P2), (P3) and (P4).

31. For some different, yet related discussions, see, e.g., Tullock (1974), Nozick (1974), Cowen (1992) and Friedman (1994).

32. See Steelman (1998). However, empirical evidence for the consequences of legislative term limits is not unequivocal, cf. López (2003).

33. See, e.g., "Some Term-Limits Backers Want to Stay," USA Today 3 December 1998.

34. On the relevance of political entrepreneurs for organizing collective action, in politics and elsewhere, see, e.g., Frohlich, Oppenheimer, and Young (1971), Frohlich and Oppenheimer (1974) and Kurrild-Klitgaard (1997).

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THE ONGOING GROWTH OF GOVERNMENT IN THE ECONOMICALLY ADVANCED COUNTRIES

Robert Higgs

I maintain that in the economically advanced countries, the government continues to grow, as it has grown for more than a century, although the growth now takes a somewhat different mix of forms than it did in earlier times. Some leading analysts, in contrast, have concluded that the growth of government has slowed or even stopped in the past 20 years. In this paper, I first show how those analysts have erred because of their excessive reliance on conventional measures of the size and growth of government. I then discuss the logic of the growth of government in the economically advanced countries. Finally, I contrast my own interpretation with the interpretation developed by Ludwig von Mises (and elaborated by Sanford Ikeda), which concludes that the mixed economy is inherently unstable and must transform itself into either laissez-faire or complete socialism. In my own view, neither of these two extreme forms of politico-economic organization is now realizable, although the reasons for their unrealizability differ. As a feasible political economy, pure socialism is dead; so is laissez-faire. In the real world of the near and intermediate terms – at least for the next several decades – the likely prospect is for moderate movements back and forth along the

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middle segment of the spectrum occupied by different degrees of mixed economy, some of them more severely hampered by government than others.

1. MISLEADING MEASURES OF THE GROWTH OF GOVERNMENT

Many of us who believe that governments continue to grow relentlessly, at least in the economically advanced countries, have been criticized by analysts who claim that in fact the growth of government has petered out or slowed substantially. Those who advance such claims perceive us to be needlessly alarmed, and they fault us for a failure to acknowledge the decisive turn of events associated with the so-called Reagan and Thatcher revolutions of the 1980s. Not to worry, they exhort us; the statists are on the run, and a brave new world of market-oriented liberalism shimmers on the horizon (Boaz, 2003).

I maintain that the seemingly level-headed realists are the ones who have failed to perceive correctly the ongoing growth of government.[1] A major reason for their failure is their reliance on certain conventional measures of the size and growth of government. Some of these measures have a built-in tendency to exhibit deceleration even when a more compelling representation indicates a continuing steady growth. In other cases, the conventional measures simply miss the growth of government that has been diverted into channels beyond the scope of their measurement. To some extent, governments have been growing in important but unmeasured or poorly measured ways all along, and they continue to grow in these ways, perhaps more menacingly than ever before. Off-budget spending, for example, is a well-known resort of political scoundrels, but it is only one example among many of how governments employ hard-to-measure means to achieve their usual ends, especially when tax resistance or formal spending limits frustrate their chronic desire to tax and spend at a greater rate.

1.1. Government's Share of Gross Domestic Product

The most common measure of the size of government is the amount of government spending relative to gross domestic product (GDP). In Vito Tanzi and Ludger Schuknecht's recent monograph on the growth of government, for example, the authors present much of their data in the form of government-spending variables relative to GDP. A major theme of the book is: "Government spending [measured in this way] increased most rapidly until about 1980. Since the early 1980s, it has been growing more slowly and in some instances has even declined" (2000, p. 3).

Now, the first thing to notice is that a sure-fire way to make nearly any economic magnitude appear small is to divide it by GDP, because the latter, which purports to be the total value at market prices of all final goods and services produced within a country in a year, is always an enormous dollar (or euro or peso or other currency unit) amount. Government spending of $2,855,200,000,000, as in the United States in the fiscal year 2001, seems to be an astronomical amount, but just divide it by the value of concurrent GDP and, *voilà*, it's a mere 28 percent – surely nothing to be alarmed about, especially in comparison with corresponding figures for many European countries that exceed 50 percent.[2]

(It is worthwhile to notice in passing that GDP, a measure that includes a large component for capital consumption allowances [13.3 percent of the total in 2002 for the United States], makes an inherently ill-suited aggregate for use as a benchmark in assessing the size of government. Certainly, net national product [NNP] or national income [NI] would be a more defensible aggregate. The difference is not trivial. Thus, again for the United States in 2002, for example, the current receipts of all governments amounted to $2,875 billions, or 27.5 percent of GDP, 31.8 percent of NNP, and 34.4 percent of NI.)[3]

The next thing to notice is that because government spending for currently produced final goods and services is itself a component of GDP, the ratio of the former to the latter is immediately compromised. Any addition to such government spending increases the denominator as well as the numerator of the ratio. Suppose that in year 1 the government spends $100 for currently produced final goods and services, and the GDP in that year is $500. Now suppose that in year 2 the government spends twice as much – that is, it increases its purchase amount by 100 percent – but nothing else changes. In year 2, the government's share of GDP will be 33.33 percent (or $200/$600), as compared to 20 percent in year 1. An analyst focusing on the government's spending *share*, then concludes that government has grown not by 100 percent, as it plainly has, by construction, but only by 66.66 percent (i.e., $[(33.33/20)-1] \times 100$). The greater the government's initial share, the greater the bias in moving from its absolute spending to the share concept to measure its growth. If government had begun with spending of $100 out of a GDP of $200, then doubled its purchase amount, other things being unchanged, it would have increased its spending share from 50 percent to 66.66 percent – a mere 33.33 percent growth.

Granted, many economically advanced countries have maintained a fairly steady government "exhaustive" share of GDP during the past couple of decades (Tanzi & Schuknecht, 2000, p. 25), but this steadiness merely attests that the government's purchases of currently produced final goods and services have grown fully as fast as the sum of nongovernmental purchases of such goods and services during that period of substantial economic expansion, not that the government has grown quiescent or stuck in the mud. In the United States, for example, the total government share of GDP was 22.1 percent in 1975 and 17.6 percent in 1999. Lest anyone think that the government ran out of steam during that quarter-century, however, one ought to notice that government increased its purchases of currently produced final goods and services from \$361.1 billion in 1975 to \$1,634.4 billion in 1999, which is to say, it increased the annual rate of such spending by \$1,273.3 billion during that period (US Council of Economic Advisers, 2001, pp. 274–275). To be sure, inflation accounts for some of that increase, but even in constant (1996) dollars, the increase was from \$942.5 billion to \$1,536.1 billion (*ibid.*, p. 277), or 63 percent – hardly a retrenchment. Population growth cannot justify the increased spending: the US population grew by just 26 percent during the period (*ibid.*, p. 315).

Of course, most recently, the really gigantic increases in government spending have taken the form of transfers (including subsidies), which are not components of GDP and therefore do not give rise to exactly the same numerator–denominator bias that arises when government increases its purchases of currently produced final goods and services ("exhaustive" spending). Transfer spending also, however, is commonly placed for purposes of analysis in relation to GDP, which then serves as a sort of "normalizer" or standard of comparison, and whenever this ratio is used, some of the same problems identified earlier arise again. Even if one grants that some such benchmarking is appropriate, one still might ask why government's transfer spending should be placed in a ratio to GDP, rather than, say, in a ratio to population or some other base. And if the ratio to GDP remains constant, one might ask why such constancy should prevail. That is, why should government's transfer spending increase whenever the economy's output of final goods and services increases? Indeed, such constancy would seem to betoken a kind of relative growth of government in its own right, inasmuch as people in a higher-income society presumably can get by more readily without government assistance, and hence the ratio of transfers to GDP might be expected as a rule to fall in a growing economy, rather than rising or even remaining constant.

However this matter might be viewed, in reality the ratio has risen enormously in all the economically advanced countries during the past several decades, and it now stands at more than 20 percent on average for a group of 17 important industrial countries studied by Tanzi and Schuknecht (2000, p. 31), up from less than 10 percent as recently as 1960.[4] Increasingly, transfer spending is becoming recognized as the Godzilla that threatens to consume New York, Tokyo, Berlin, and nearly every other city on the planet. A few countries, such as Chile, have taken effective measures to deal with this looming threat to government fiscal viability, but so far most politicians in most countries have kept their heads planted firmly in the sand, ignoring everything beyond the next election, while the government's transfer spending has grown ever more bloated and the severity of the adjustments that will have to be made when the day of reckoning can no longer be postponed has grown ever greater.

1.2. Government's Share of Employment

Government employment as a percentage of total employment often has served as an index of the size of government. This measure, too, has a built-in bias toward suggesting that the rate at which government is growing is decelerating over time even when government increases its share of employment by, say, one percentage point every year. Thus, for example, when government's employment share increases from 2 percent to 4 percent, the government grows by 100 percent, but when the share increases from 20 percent to 22 percent, gobbling up the same incremental proportion of total employment, the government grows by just 10 percent.

In the group of 17 advanced countries analyzed recently by Tanzi and Schuknecht (2000, p. 26), the government's average employment share increased from 5.2 percent in 1937 to 12.3 percent in 1960 to 18.4 percent in 1994. The rate of increase of this ratio has declined during the past couple of decades in most countries, but one ought not to make too much of that deceleration. In the United States, increases in the amount of "contracting out" of government functions have led to a replacement of formal government employees by a growing "shadow army" of many millions of seemingly private employees – grantees, contractors, and consultants – who are doing what they are doing only because the government arranges it and pays for it to be done (Blumenthal, 1979; Hanrahan, 1983; Light, 1999a,b). According to Paul Light's (1999a) estimates, the US federal workforce is not the fewer than 2 million persons officially reported (as of 1996) but nearly 17 million persons – "and the count does not even include the full-time equivalent employment of the people who work on a part-time or temporary basis for Uncle Sam – for example, the 884,000 members of the military reserves,'' though it does include some 4.7 million already counted as employees of state and local governments (p. 1).

Moreover, governments increasingly have established regulations that in effect require bona fide private parties to work for the government. Tanzi and Schuknecht themselves take note of such ''quasi-fiscal policies,'' which they describe as regulations that ''become alternatives to taxing and spending'' (p. 203). In this recognition, they follow in a long line of analysts stretching back at least to Richard A. Posner (1971) in his capacity as the author of an oft-cited article ''Taxation by Regulation.''

The relevant class of regulations, though, is much wider than it is usually recognized to be in the standard literature of economics and public choice. To be sure, all sorts of economic, environmental, health and safety, and social regulations continue to spew out of Washington and Brussels, among many other places (Grow, 2003). In addition, however, the US government especially requires ever more uncompensated information collection and reporting by its subjects in order to slake the Surveillance State's insatiable craving for the most minute details of everyone's conduct (Bennett & Johnson, 1979, Twight, 1999). These Big Brotherish demands are justified by the despicable slogan that only those with something to hide will object, but in truth this vile rain falls on the righteous and the wicked alike, and one would have to be pretty dimwitted to expect the latter to report truthfully in any event.

According to Clyde Wayne Crew's recent summary of US federal regulation:

- The 2001 *Federal Register* contained 64,431 pages....
- In 2001, 4,132 final rules were issued by agencies.
- Of the 4,509 regulations now in the works, 149 are ''economically significant'' rules that will have at least $100 million in economic impact. Those rules will impose at least $14.9 billion yearly in future off-budget costs....
- The costs of meeting the demands of off-budget social regulations were as high as $229 billion according to the Office of Management and Budget. A more broadly constructed competing estimate that includes economic regulatory costs and paperwork costs pegs regulatory expenditures at $854 billion in 2001, or 46 percent of all FY01 [fiscal year 2001] outlays (Crews, 2002, pp. 1–2).

The foregoing, shocking as it is, describes the regulatory burden being imposed at only the federal level of government. Simultaneously, the state and local governments, as well as various international bodies, continue to pour out endless streams of their own regulations, all of which entail resource costs and sacrifices of citizens' liberties.

Because the public has less awareness of the burdens imposed by these regulations, many of which remain obscure and indirect in their operation and effects, governments encounter less resistance to their ongoing imposition of regulatory burdens than they encounter in their quest to collect greater revenue from explicit taxes laid on incomes, sales transactions, and property values. So far, there seems to be no political limit to the number of regulations that governments can and will impose. Hence, we are fast approaching a condition in which everything that is not forbidden is required, even as Americans, acting for all the world like faux-patriotic zombies, continue to reassure themselves incessantly that "it's a free country."

For present purposes, the point is that people occupied with regulatory compliance are not truly privately employed. Instead, they are in effect stealth government servants, working not for their own ends but doing the bidding of their political masters. In the present Western world, then, nearly everybody is actually a government employee, but rather than getting a government paycheck for our efforts, most of us are required to pay the government for the privilege of our own serfdom and to bear the risk of prosecution and imprisonment should our unpaid work on the government's behalf prove unsatisfactory to our de facto "employer."

2. THE LOGIC OF THE GROWTH OF GOVERNMENT IN THE ECONOMICALLY ADVANCED COUNTRIES

The growth of government has had many sources. In a sense, nothing less than a comprehensive social, political, legal, and economic history can tell the story fully. Within the vast empirical complexity, however, we can perceive patterns and identify crucial types of changes that have promoted the rise of the leviathan state in many countries since the mid-nineteenth century, a time when everywhere government was still ordinarily very small by comparison with its subsequent dimensions. By appreciating the major patterns, we can begin to understand better not only why governments have grown historically but also why they continue to grow currently and most likely will continue to grow for a long time to come in the economically advanced countries.

For understanding the dynamic process of the growth of government, I find it useful, at least at the start of the analysis, to separate causal factors into two categories. One category includes what I designate here as structural/ideological/political (SIP) changes; the other category includes crisis/ideological/political (CIP) changes. To some extent, these two classes of factors correspond to what John J. Wallis (1985) has called "trend" and "trigger" events. Later, I will insist that the two classes of factors are not independent, but interact with each other in important ways.

2.1. Structural/Ideological/Political (SIP) Changes

In the nineteenth century, earlier in some countries than in others, a number of interrelated changes began to accelerate. All had something to do with the processes that have come to be known collectively as modernization; they included industrialization, urbanization, the relative decline of agricultural output and employment, and a variety of significant improvements in transportation and communication. As these events proceeded, masses of people experienced tremendous changes in their way of life. In response, they turned to government to seek its assistance in order to gain from, or at least to minimize the losses attendant upon, the social and economic transformations in which they found themselves swept along.

The structural changes associated with modernization altered the perceived costs and benefits of collective action for all sorts of latent special-interest groups. Thus, for example, the gathering of large workforces in urban factories, mills, and commercial facilities created greater potential for the successful organization of labor unions and working-class political parties. New means of transportation and communication reduced the costs of organizing agrarian protest movements and agrarian populist political parties. Urbanization created new demands for government provision of infrastructure, such as paved streets, lighting, sewerage, and pure water supply. All such events tended to alter the configuration of political power, encouraging, enlarging, or strengthening certain special-interest groups, discouraging, diminishing, or weakening others. At nearly every step, opposing factions clashed, on more than a few occasions violently.

Simultaneously, the structural transformations altered the perceived costs and benefits of government response to various demands. For example, it became cheaper for governments to collect income taxes when more people received their income in the form of pecuniary payments traceable in business accounts, as opposed to unrecorded farm income in kind. The modern welfare state is often seen as originating in Imperial Germany in the 1880s, when the Iron Chancellor Otto von Bismarck, established compulsory accident, sickness, and old-age insurance for workers. Bismarck was no altruist. He intended his social programs to divert workers from revolutionary socialism and to purchase their loyalty to the Kaiser's regime, and to a large extent he seems to have achieved his objectives. The lesson was not lost on governments elsewhere. By 1914, similar programs had gained enactment in most other western European countries, and even the United States – a laggard in this regard – was moving in the same direction, albeit at first only at the state or local levels of government and in federal programs restricted to war veterans and their dependents (Higgs, 1996).

This development calls to mind another important aspect of the SIP events, namely, ideological change. From the mid-nineteenth century onward, collectivist ideologies of various stripes, especially certain forms of socialism, gained greater intellectual and popular followings, while traditional conservatism and classical liberalism increasingly fell out of favor and, with a lag, suffered losses in their political influence. By the early twentieth century, the intellectual cutting edge in all the economically advanced countries had become more or less socialistic (in the United States, in greater part, "Progressive"), and the masses also had become more favorably inclined toward support for various socialist or Progressive schemes, from regulation of railway rates to municipal operation of utilities to outright takeovers of industry on a national scale (Hayek, 1949; Higgs, 1987, pp. 113–116).

Political developments mirrored the changes in the economy and the dominant ideology. Throughout the nineteenth century, democracy tended to gain ground. The franchise was widened, and more popular parties, including frankly socialist parties and labor parties closely allied with the unions, gained greater representation in legislative assemblies at all levels of government, more so, however, in Europe than in the United States. Everywhere the trend toward universal manhood suffrage and even women's voting became seemingly irresistible. People insisted on casting a ballot in periodic contests to select their political leaders. Even Adolf Hitler came to power via the ballot box.

Whether structural, ideological, or political, the foregoing changes proceeded gradually. With the passage of time, various such changes reached a threshold at which the balance of forces tipped in favor of a new outcome with regard to government action. Modernizing economic transformation, collectivist ideological drift, and democratic political reconfiguration tended to bring about a changing balance of forces that favored, not always but as a rule, increases in the size, scope, and power of government. Such trends now have continued for more than a century and a half in the economically advanced countries.

2.2. Crisis/Ideological/Political (CIP) Changes

Superimposed on the gradually unfolding SIP transformations has been a series of discrete crises, of which the most significant were wars and economic depressions, especially the two world wars and the Great Depression. These crises also tended to promote the growth of government, although in certain cases, such as those of Germany and Japan after World War II, the consequences of the crisis took a different form because of the wartime regimes' defeat and the countries' occupation by victorious powers intent on reforming the vanquished societies' basic politico-economic institutions.

War is the preeminent government undertaking, and great wars, such as those of 1914–1918 and 1939–1945, have elicited the fullest expression of government power over economy and society. In World War I, all the major belligerents adopted some form of "war socialism" in order to mobilize resources and place them under government control for the prosecution of the war (Mises [1919] 1983, pp. 133–176; Higgs, 1987, pp. 123–158). Price, wage, and rent controls, inflationary increases in the money stock, physical allocations of raw materials and commodities, conscription of labor, industrial takeovers, rationing of consumer goods and transportation services, financial and exchange controls, vast increases in government spending and employment, increased tax rates and the imposition of new kinds of taxation, and many other measures all figured prominently in the warring governments' economic management (Porter, 1994, pp. 161–167). Mises ([1919] 1983) called attention to "the stupidities of the economic policy of the Central Powers during the war," noting that "measures and countermeasures crossed each other until the whole structure of economic activity was in ruins" (p. 146), and similar problems plagued the war socialism in other countries as well. Yet, everywhere the war left institutional and ideological legacies that promoted the subsequent resort to similar measures, not only in wartime but in peacetime crises as well. World War II, an even bigger exercise in mass human slaughter and massive property destruction, prompted similar measures and had similar results in most places (Porter, 1994, pp. 167–169; Klausen, 1998). As Bruce Porter (1994) has written, "The mass state, the regulatory state, the welfare state – in short, the collectivist state that reigns in Europe today – is an offspring of the total warfare of the industrial age" (p. 192). Likewise, in the United States, World War II left the society permanently shackled with what the Americans aptly call "big government" (Higgs, 1987, pp. 196–236).

In addition, especially in the United States, the economic crisis of the Great Depression brought forth similar government responses and left similar legacies of swollen state power and permanently lost liberties (Wallis, 1985; Higgs, 1987, pp. 159–195, 1996, pp. 261–263). Three decades later, the crisis events that crowded into the troubled years from 1964 to 1974 – turmoil that for Americans sprang initially from US involvement in the Vietnam War and from urgently contested race relations – had similar, if somewhat less sweeping, consequences (Higgs, 1987, pp. 246–254, 1996, pp. 264–265; Matusow, 1984; Shultz & Dam, 1977).

2.3. SIP–CIP Interactions

Analysts have not been blind to the operation of both SIP and CIP events in bringing about the growth of government in the economically advanced countries, but they have tended to consider the two classes of factors as if they were independent. Often, if only implicitly, they have viewed the SIP factors as systematic and the CIP factors as stochastic – some have gone so far as to exclude wartime periods from their empirical analysis of long-term changes in the size of government (for citations of examples, see Higgs, 1987, p. 288, n. 3). To proceed in this manner is a mistake, because SIP and CIP events are interrelated in important ways.

On the one hand, SIP events precondition how societies will respond to the outbreak of crisis. During the process of gradual structural, ideological, and political change, the various special-interest groups and ambitious political actors maneuver to position themselves so that when the opportunity arises, they will be better placed to realize their objectives. For the time being, they may be stymied by opposition, but they understand that in a crisis, the ordinary checks and balances of social and political life will be attenuated, and new possibilities will arise. Therefore, they prepare themselves for that day, and on occasion they may even take actions to precipitate the very crisis they long for – more than one "burning of the Reichstag" has occurred in the past century.

This routine ideological and political activity creates a configuration of forces that to some extent predetermines how crises will be dealt with and therefore what consequences they will have for the operation of the society in the period of post-crisis (altered) normality. Mises ([1919] 1983) described an important instance of this phenomenon when he discussed the causes and consequences of wartime socialism during World War I:

> War socialism was only the continuation at an accelerated tempo of the state-socialist policy that had already been introduced long before the war. From the beginning the intention prevailed in all socialist groups of dropping none of the measures adopted

> during the war after the war but rather of advancing on the way toward the completion of socialism. If one heard differently in public, and if government offices, above all, always spoke only of exceptional provisions for the duration of the war, this had only the purpose of dissipating possible doubts about the rapid tempo of socialization and about individual measures and of stifling opposition to them. The slogan had already been found, however, under which further socializing measures should sail; it was called *transitional economy*.
>
> The militarism of General Staff officers fell apart; other powers took the transitional economy in hand. (p. 176)

Similar events took place in the United States, where socialist "liberals" and Progressives viewed the war as their long-awaited opportunity to put permanently in place many of the expanded government powers they favored, and which they and their political friends hoped to wield then and later (Rothbard, 1989).

If SIP events precondition how crises will be handled and what consequences they will have, it is no less true that CIP events determine the character and operation of the political economy during post-crisis periods of normality and therefore they condition the unfolding of SIP events, sometimes for many decades after the relevant crisis. Countless examples of such interdependence might be given (see Higgs, 1987, pp. 150–156, 189–193, 225–234 for discussions of the "legacies, institutional and ideological" of World War I, the Great Depression, and World War II, respectively, for the United States). I continue to adhere to the general understanding of such CIP–SIP interdependency that I described a number of years ago as follows:

> The expansion of the scope of governmental power was path-dependent; where the political economy was likely to go depended on where it had been. Those who brought about the growth of government were motivated and constrained at each moment by their beliefs about the potentialities and dangers, the benefits and costs of alternative policies under current consideration. Their beliefs derived in turn from past events as they understood them. A genuine "return to normalcy" was unlikely after a crisis had provoked an expansion of the scope of governmental powers.
>
> The irreversibility obtained not only because of the "hard residues" of crisis-spawned institutions (for example, administrative agencies and legal precedents), few of which necessarily show up in conventional measures of the size of government. More importantly, the underlying behavioral structure could not revert to its prior condition because the events of the crisis created new understandings of and new attitudes toward governmental action; that is, each crisis altered the ideological climate. Though the postcrisis economy and society might, at least for a while, appear to have returned to their precrisis conditions, the appearance disguised the reality. In the minds and hearts of the people who had passed through the crisis and experienced the expanded governmental powers (that is, at the ultimate source of behavioral response to future exigencies), the underlying structure had indeed changed. (Higgs, 1987, pp. 58–59)

Thus, what seem to be "trends" are as they are, at least in part, because of the "triggers" associated with great national emergencies. A complete understanding of the dynamic process of the growth of government requires not only that analysts take both into account but also that they give careful consideration to the interactions between them.

3. MISES AND IKEDA ON THE INSTABILITY OF THE MIXED ECONOMY

In several papers published during the 1920s and included in a collection titled *Critique of Interventionism* ([1929] 1996), Mises argued that the mixed economy (he called it "the hampered market order"), which by definition is subject to chronic, pervasive government intervention, is an unstable form of political economy. Over the following years, he returned from time to time to the same theme, most notably perhaps in his magnum opus, *Human Action* (1966), in which Part Six is called "The hampered market economy" and includes 10 chapters, the last of which deals with "The crisis of interventionism."

Mises ([1929] 1996) maintained that with respect to the politico-economic order, no "middle way" is possible: "There is no other choice: government either abstains from limited interference with the market forces, or it assumes total control over production and distribution. Either capitalism or socialism; there is no middle of the road" (p. 9; see also pp. 18, 27, 28, 54).

Mises's ([1929] 1996) argument for the "impossibility" of the mixed economy rests on three interrelated claims: (1) the government's interventions in the free market cannot achieve the aims that the interventionists seek; (2) because of the adverse effects of the interventions, ever more interventions will be required, which will produce even more adverse effects, and so forth; and therefore (3) ultimately the government will be driven to abandon the market system completely and to adopt full-fledged socialism with its total government control of the means of production, unless, on the contrary, the government has the wit to recognize that socialism also is unworkable and so instead the government gives up all its interventions and reverts to a full-fledged free-market order (p. 54 and passim). In *Human Action*, Mises (1966) added a fourth factor: "Interventionism aims at confiscating the 'surplus' of one part of the population and at giving it to the other part. Once this surplus is exhausted by total confiscation, a further continuation of this policy is impossible" (p. 858).

In his probing and thorough reconsideration and elaboration of Mises's analysis of interventionism, Ikeda (1997) calls attention to "the paradox of interventionism," namely, that despite the mixed economy's alleged instability, "among existing politico-economic systems, the interventionist mixed economy, all of its contradictions notwithstanding, is by far the most popular, widespread, and persistent of them all" (p. 46). Indeed, Mises ([1929] 1983) himself explicitly recognized this seeming paradox, remarking that "interventionist norms survived for hundreds of years, and since the decline of liberalism, the world is ruled again by interventionism. All this is said to be sufficient proof that the system is realizable and successful, and not at all illogical" (p. 21).

In response to his own recognition of the paradox, Mises ([1929] 1996) declared: "The fact that measures have been taken, and continue to be taken, does not prove that they are suitable. It only proves that their sponsors did not recognize their unsuitability" (p. 21). Mises then proceeded to blame the "the empiricists" for failing to apply economic theory properly and hence for failing to understand what the actual consequences of various interventions had and had not been. Whatever the analytical shortcomings of the Historical School and other empiricists or of the sponsors of interventionist measures, however, Mises's response fails to resolve the paradox. The point is not whether certain analysts or sponsors of interventionism failed to see the failure of the middle way, but whether that failure constitutes a fatal flaw that necessarily renders the system unstable and thus guarantees its replacement by either all-out socialism or the free-market order.

Ikeda (1997) provides a much more satisfactory resolution of the paradox. In his view, "the key to resolving this paradox is to realize that to claim the mixed economy is unstable is not the same thing as asserting that it is *transitory* … . By introducing contradictions into the system, interventions generate a process that causes the mixed economy continually to adjust and to evolve into novel and diverse forms over time" (p. 215). Still, it need not become unviable quickly: "the roads between the minimal and maximal states can thus be very long and winding, and state expansion very gradual" (p. 215). Indeed, it turns out that because socialism itself is unworkable in the long run (for reasons that Mises and Hayek explained persuasively) and because, in Ikeda's views, laissez-faire is also unstable (owing to "governmental error" and "shocks in ideological preferences" [p. 216]), *all* politico-economic orders are unstable, and the mixed economy is the least unstable among them: "paradoxically, therefore, it appears that the product of interventionism, the mixed economy, though unstable, is likely to be more enduring than the pure forms of either collectivism or capitalism, offering as it does a much wider range of (ultimately futile) adaptive forms than either of its rival systems'' (p. 216). Hence, the first of Ikeda's eight pattern predictions: ''At any given time, nearly all economic systems will be mixed economies'' (p. 216).

Much more might be said about the endogenous logic of interventionism as explicated by Mises and elaborated by Ikeda, but because Ikeda himself has plowed this ground so thoroughly, I make no attempt to do so here. Before leaving the topic, however, I offer a few additional observations. In doing so, my intention is to appraise not so much the structure of the arguments already advanced as their applicability to the present-day reality of the economically advanced countries.

First, in much of their writing on interventionism and even on socialism, Mises, Hayek, and Ikeda assume good will on the part of the interventionists, that is, they assume that the interventionists seek to promote the broad public interest, not merely to achieve their personal ends or those of special-interest groups. Thus, the recurrent assertion that the interventionist measures cannot ''achieve what their advocates expect of them'' (Mises [1929] 1996, p. 5; see also pp. 20, 28, 36) and the expressed need to explain ''the failure of [intelligent, well intentioned, and public-spirited] public authorities to learn from their mistakes'' (Ikeda, 1997, p. 49; see also pp. 104, 110–112, 121, 137; but compare pp. 145–151 on ''relaxing the assumption of benevolent public interest''). Although one may defend this assumption as a methodological device not intended to be descriptively accurate, I see only a minor purpose at best being served by proceeding with analysis on this basis. As Hayek (1944, pp. 134–152) himself argued compellingly, the worst get on top in political life, and the ''ruthless and unscrupulous'' thrive in positions of government power (p. 151; see also Bailey, 1988). Although Hayek was writing with socialism in mind, the same tendency prevails in the mixed economy, though perhaps in a slightly lesser degree (Higgs, 1997). In addition, public affairs are rampant with rent seeking by one and all. As Ikeda (1997) properly notes, although ''it is possible initially to abstract to a large extent from political self-interest and exogenous ideological change in order to isolate analytically a unique Austrian method of political economy … completely removing these two factors is … neither possible nor desirable in a realistic theory of political economy'' (p. 53), that is, in a political economy of genuine applicability in the interpretation of current public affairs.

The idea that well-intentioned authorities make mistakes is closely connected to the concept of ''failed policies'' that has come to play such a frequent part in popular discussion of government intervention in the market order. As I have argued elsewhere (Higgs, 1995), however, notwithstanding the fair-mindedness of Austrian political economists to the interventionists they analyze, very few if any genuine failed policies last long. The all-too-numerous seemingly failed policies fail to achieve only their *ostensible* objectives; their *actual* objectives they achieve with remarkable success. In brief, the world of government affairs is the world of humbuggery; things are almost never what they are represented to be. All sides consider that they stand to gain by disguising their self-serving programs with a public-spirited rationale, and invariably they do so. Only rarely, however, is political talk anything but spin and counter-spin, and we will sooner find chastity in a brothel than truth or honest pursuit of the public interest in a political setting. As analysts, we do well never to lose sight of this pervasive smoke-and-mirrors aspect of politics. Our task in this respect is to understand the operation, effects, and limits of the humbuggery.

In much of their work on politico-economic systems, both Mises and Hayek wrote as though the nature of the system itself were the object of choice. Thus, for example, in the preface of *Critique of Interventionism*, Mises wrote: "Nearly all writers on economic policy and nearly all statesmen and party leaders are seeking *an ideal system* which, in their belief, is neither capitalistic nor socialistic … " (p. xi). Rarely, however, is the object of political choice the system itself; as a rule, this stark choice presents itself only in consequence of the violent revolutionary overthrow of a regime or its total defeat in war (e.g., in Russia in 1917 or in Germany and Japan after World War II). In general, political choices pertain only to programs that make piecemeal ad hoc changes within the context of an existing politico-economic framework, whatever its overall character may be. Of course, by making many partial changes, the overall character of a system eventually may be transformed, as it was in the United States between, say, 1885 and 1945. Even then, however, the nature of the resulting system is an artifact – the product of human action but not of human design.

This aspect of the workings of politics bears on the Austrian idea that the mixed economy may reach a point at which, the public choosers having piled intervention on intervention and the society having come to suffer all the resulting ill effects, "the recognition at some level of a systemic failure become *inevitable*" (Ikeda, 1997, p. 123). Although such a recognition may occur – perhaps New Zealand in the late 1980s provides a case in point – it is highly unlikely. Rather than recognizing that the system has reached a point at which, "interventionism having lost its legitimacy, there is no longer a middle ground" (p. 137), the political decision-makers are much more likely to respond in the classic manner of Franklin Delano Roosevelt, who proposed in the midst of the Great Depression to "try something" and, if it did not work, to "try something else," not to abandon the whole system of interventionism. So long as an interventionist system retains any viability at all, its kingpins will cling to it, as the history of nearly all times and places bears witness. So long as the public will tolerate the countless burdens and insults of interventionism – a toleration that hinges almost entirely on their dominant ideology rather than on the system's objective conduct and performance – then the response to even severe systemic difficulties is likely to be more muddling through, a moderation of the worst abuses perhaps, but not an overthrow of the system or a drastic retrenchment within it. In short, as Robert Bradley (2003) has observed, in the mixed economy even a crisis may lead only to "halfway measures of a new form" (Ikeda's, 1997 pattern prediction number 2 [p. 217] also accords with this conclusion).

Finally, we must recognize the severe limitations of the Misesian model of the dynamics of the mixed economy (even as expanded by Ikeda) that arise from its inability to incorporate the effects of war on the course of the politico-economic order. As Ikeda acknowledges, "perhaps the most important omission, especially from the standpoint of empirical observation, is the effect of *war and domestic conflict* on the interventionist process. This means that the rapid growth of government in the United States during the twentieth century owing to war and similar national crises lies outside [the] scope" of the model (Ikeda, 1997, p. 226). Directly and indirectly, however, war and preparation for war have been by far the most significant wellsprings of the growth of government during the past century – and they are again in the United States at the present time, owing to the so-called war on terrorism and the boost it has given to US imperialism abroad and the Police State at home. A model of the dynamics of the mixed economy that excludes this aspect of the historical process, however useful it might be for revealing the endogenous forces at work, must be judged severely deficient for purposes of aiding the interpretation of actual ("complex") events.

4. DOUBLE-ENDED CONSTRAINT: THE ACTUAL DYNAMICS OF THE MODERN GROWTH OF GOVERNMENT

In the light of the foregoing discussion, I can be brief in presenting my own scheme for understanding the past and likely future course of the growth of government in the economically advanced countries. I maintain that in the short and intermediate terms – at least for the next few decades – reversion to laissez-faire or anything close to such a system is impossible, but resort to a full-fledged centrally planned socialism is scarcely more likely. As Jeffrey Rogers Hummel (2001) has remarked, "Rather than being inherently unstable, interventionism is the gravity well toward which both market and socialist societies sink" (p. 530). Mixed economy, social democracy, democratic socialism, participatory fascism – whatever one's preferred name for it – this system clearly has demonstrated its superior survival power under present conditions against all feasible alternatives. The politico-economic orders of the advanced countries will remain within the broad middle of the spectrum because they are effectively constrained at both ends from transforming themselves into one of the alternative, extreme systems.

Mises, Hayek, and Ikeda, among others, have diagnosed correctly the ills of interventionism and explicated its characteristic mode of operation and change. Such a system does generate tremendous burdens and opportunity costs, and over time the absurdities do compound themselves. However, the chief political decision-makers have come to recognize that so long as private enterprises are allowed to retain a modicum of room to maneuver, then continued high levels of productivity and even some economic growth can be expected. As Mises ([1929] 1996, pp. 12–13) noted, the corruptibility of public officials helps to mitigate some of the most idiotic elements of interventionism, allowing a certain amount of important business to get done despite taxes and regulations that, if fully enforced, would preclude all progress. More important, however, "the adaptability of the capitalist economy has negated many obstacles placed in the way of entrepreneurial activity. We constantly observe that entrepreneurs are succeeding in supplying the markets with more and better products and services despite all difficulties put in their way by law and administration" (p. 14). This remark, so reminiscent of Adam Smith's observation that there is a lot of ruin in a nation, deserves much weight. So long as entrepreneurs are not crushed utterly, they will prove astonishingly creative in finding ways to satisfy market demands, whether the market be legal or "black," and "interventionism is seen as a tribute that must be paid to democracy in order to preserve [the remnants of] the capitalistic system" (Mises [1929] 1996, p. 13).

In no event will public choosers opt for full-fledged socialism. The economic disasters wreaked by central planning in the Soviet Union, China, and other countries during the twentieth century have been taken to heart everywhere. No substantial support exists anywhere for the maintenance of such a politico-economic system, and where its remnants remain, as they do in Russia, China, Vietnam, and Cuba, they are gradually being phased out. The verdict is in – socialism does not work – and the world has accepted it. People want a system that can "deliver the goods" for a modern standard of living. Therefore, the extreme collectivist end of the spectrum is no longer regarded as a viable option.

Nor is the political dictatorship that accompanied the economic central planning any longer a promising option. As noted earlier, all over the world, for better or worse, people want to cast meaningful ballots to select their political leaders. Democracy, ugly duckling that it is, bids fair eventually to become and to remain the only acceptable political system everywhere.

Laissez-faire is unrealizable, too. Not because it could not "deliver the goods." Indeed, it could deliver them in undreamt of abundance if it were allowed to operate. But no population anywhere will allow it to operate. In today's world, no substantial group of people is prepared to accept the personal responsibilities and to shoulder the personal risks inherent in genuine capitalism – which is, after all, as Joseph Schumpeter emphasized, a system of creative *destruction*. Certainly throughout the economically advanced world, people have come to demand that governments relieve them of nearly every personal responsibility, from caring for their own health to preparing for retirement to teaching their children about sex. In more ways than anyone can count, people now expect the government to take care of them, in the classic phrase, from the cradle to the grave. Thus, in the European Union, whose peoples exemplify this syndrome at its worst, "the European social-welfare system is thriving despite a decade long call for change," even as "a report from the European Commission shows Europe faces a looming crisis unless it enacts changes" (Grow, 2003). Personal responsibility has become too painful for the citizens of the economically advanced countries even to contemplate. Locked in this ideology of dependency on and belief in the capacity and rectitude of state provision, they have no interest in living in a free society. (It goes without saying that a government cannot provide even a semblance of the demanded personal security unless it regulates and controls the people in countless ways and taxes them heavily to pay for its many "services.") Thus, the dominant ideology of modern populations has rendered them uninterested in and incapable of living in a full-fledged market system, and by their participation in modern democratic-political processes, they can make sure that no such system ever comes close to realization.

Thus constrained on both ends, the politico-economic systems of all the economically advanced countries stand condemned to fluctuate within the great middle of the spectrum. Should matters become too unbearably botched by high taxes or by intervention compounding intervention, then small retrenchments are possible, but in no event will such retrenchments move the system close to laissez-faire, and in every case, once the retrenchments have served their purpose for a while, new pressures will be brought to bear on the system, compounding once again the absurdities of the existing mixed economy. A decade ago, Bruce Porter (1994) wrote that "a shrinkage of the American state appears about as remote as a drying up of the oceans" (p. 294). Nothing has happened since to change that prospect, and with good reason we might express the same expectation for all the other economically advanced countries.

NOTES

1. For my earlier defenses of this thesis, some of which deal with matters not touched on here, see Higgs 1983, 1987, pp. 20–34; 1991a, pp. 5–8; and 1991b, pp. 66–68.
2. U.S. ratio computed from figures reported in U.S. Office of Management and Budget (2002, pp. 292–293); ratios for various European countries from Tanzi and Schuknecht (2000, pp. 6–7).
3. Calculated from data in Bureau of Economic Analysis, National Income and Product Accounts Tables, Tables 1.9 and 3.1, at http://www.bea.doc.gov/bea/dn/nipaweb/TableViewFixed.asp.
4. The group includes Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

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INTERVENTIONIST DYNAMICS IN THE U.S. ENERGY INDUSTRY

Robert L. Bradley Jr.

The dynamics of government intervention in the economy (interventionism) has a long history in the United States. Founding Father James Madison (1788, p. 291) observed over two centuries ago:

> The sober people of America are weary of ... sudden changes and legislative interferences [that] ... become jobs in the hands of enterprising and influential speculators, and snares to the more-industrious and less-informed part of the community. They have seen, too, that one legislative interference is but the first link of a long chain of repetitions, every subsequent interference being naturally produced by the effects of the preceding. They very rightly infer, therefore, that some thorough reform is wanting, which will banish speculations on public measures, inspire a general produce and industry, and give a regular course to the business of society.

Madison's 18th century lament captured several salient features of interventionism:

- The counterproductive, and even unintended, effects of intervention
- The non-neutral effects of intervention (creating winners and losers)
- The propensity of intervention to expand from its own shortcomings
- The shifting political sands underlying intervention
- The opportunity for fundamental reform

These insights are captured within a modern "Austrian" or "process" theory of interventionism (Ikeda, 1997; Bradley, 2006). This essay outlines

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an *interventionist typology*, which is then applied to five case studies in the U.S. energy market.[1] These episodes are:

- Public-utility regulation of manufactured/natural gas (1885 to present)
- Public-utility regulation of electricity (1887 to present)
- Water power intervention (20th century)
- Wellhead petroleum conservation regulation (1920s–1960s)
- Petroleum price and allocation regulation in the 1970s

1. A THEORY OF INTERVENTIONIST DYNAMICS

A typology of interventionism can categorize regulations, taxes, and subsidies both theoretically and as they sequentially unfold in practice. This typology is inspired by, but broader than, the *Mises interventionist thesis*, which, similar to Madison's lament, recognizes the propensity of intervention to expand from its own shortcomings in the elusive quest to achieve economic rationality (Lavoie, 1982, p. 180; Ikeda, 1997, pp. 41–46; Bradley, 2006).

Three classifications compose our interventionist typology, each of which is more fully developed and illustrated elsewhere (Bradley, 2006). The first distinction divides intervention between *dormant* and *causal. Dormant intervention* does not meaningfully affect market activity because it is either a dead letter (an irrelevant law that remains on the books), superfluous (not market impacting but enforceable), or not respected and enforced. *Causal intervention* affects market activity – or more precisely the motivations and actions of market participants. The great majority of intervention is causal because legislators and regulators take action that is intended to have certain effects, or the intervention has unintended effects that change market outcomes from what they would have been in the absence of the regulation, subsidy, or tax.

A second categorization differentiates between *initiating* and *non-initiating* intervention. Initiating intervention leads to further government involvement. It is active and generative, creating an *interventionist process* as described below. Non-initiating intervention, on the other hand, is causal but sterile – an end in itself. In a historical sense, for that moment in time, it is inconsequential for later intervention. However, a non-initiating intervention can become initiating should a new interpretation of the statute or regulation trigger an interventionist dynamic.

A third distinction concerns the *cumulative process* in which an *initiating* intervention produces *consequent* intervention. The interventionist process can sequentially unfold into different phases that the social scientist can segregate and describe. Fig. 1 shows the three categories of interventionism and the potential phased cumulative process.

Changes in the cumulative interventionist process can be *expansionary*, *contractionary*, or *neutrally amendatory*.[2] An expansionary path is the most common, although the historical record contains some examples of a contractionary process short of total deregulation.[3] An amendatory change is one that is not distinctly expansionary or contractionary but still represents a revision or phased change – as subjectively perceived by the social scientist.

The Mises interventionist thesis stresses the propensity of intervention to expand from its own shortcomings (Lavoie, 1982). Government authorities attempt to "rescue" intervention rather than uproot it; more involvement is chosen instead of a changed strategy of market reliance. Public-choice economics explains how subsequent government involvement is propelled from the self-interested actions of interveners themselves who have personal motivations that might well be outside of the public weal (Tullock, 1998, pp. 1042–1043). The U.S. energy experience is replete with strings of interventions unfolding over time from a variety of reasons and with a variety of results – but many with unsatisfactory outcomes, even from the viewpoint of their original proponents.[4]

A particular legislative action can house a family of interventions, some of which are expansive and others contractionary. The common denominator

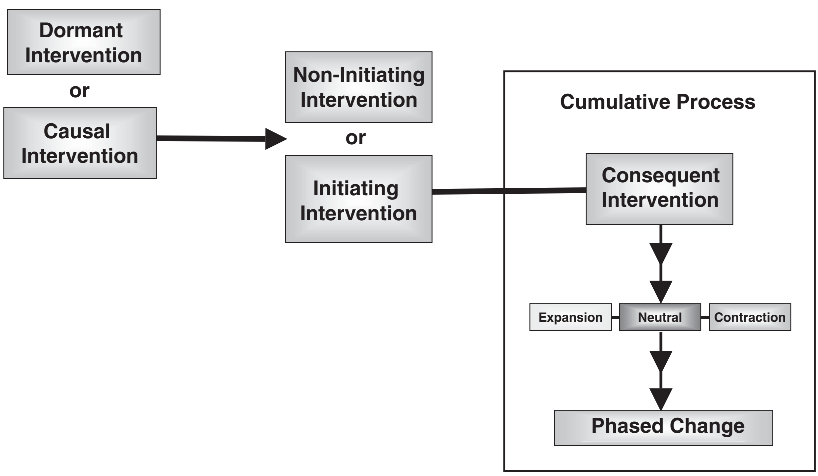

Fig. 1. An Interventionist Typology.

may be "energy," for example, but the potpourri must be analyzed in its parts as well as the whole before its dynamics and consequences can be understood.

An interventionist dynamic can span political jurisdictions and geographical regions. The process can be intermittent (non-sequential) with prior intervention relating to later intervention after an elapsed period. The microeconomic process of major intervention can have such great effects as to register macroeconomic impacts.

Any particular intervention can originally contain what otherwise might have been a future intervention in a cumulative process. A maximum-price edict can include allocation mandates if shortages are anticipated, for example. In general, *interventionist learning* can make the initial regulation, tax, or subsidy edict more complex than it otherwise would be – all in the expectation of preventing future distortions, pre-plugging "regulatory gaps," or avoiding entrepreneurial "gaming."

A methodological note is in order. The interventionist process is wholly driven by *purposeful human action*. The motivations of participants from the public and private sides are crucial, and the effect of interventions on market and government parties – altering thought and action – is causal. The subjectivist nature of economic and political action requires that an interventionist typology be *qualitative*, not quantitative. Historians, however, can quantify data to describe how different interventionist episodes played out relative to each other in terms of elapsed time, the number of participants, the economic magnitudes affected, or intended versus unintended impacts. Social scientists may also employ the typology to *predict* the future course of interventionism, which then can be compared to actual results.

2. CASE STUDY #1: PUBLIC-UTILITY REGULATION OF MANUFACTURED/NATURAL GAS

Public-utility regulation of the manufactured gas industry in the 19th century and natural gas industry in the 20th represents the longest cumulative interventionist process in U.S. energy history. Gas-industry historians Arlon Tussing and Connie Barlow noted (1982, p. 15):

> A fascinating theme that runs through the long, convoluted history of natural gas regulation is the seemingly inexorable expansion of government intervention. Regulation seems to have spawned further regulation; soon after one regulatory gap was filled, another appeared.

Investor-owned firms in the early gas industry, integrated between coal-gas manufacture and piped-gas distribution to end users, worked in a quasi-governmental environment. Corporate charters, which sometimes provided franchise protection to induce entry by the initial firm, put city fathers in an oversight role. Municipal lighting contracts with private companies, typically anchoring the whole project, gave local government officials power over firms. Municipal (government-owned and operated) enterprises acted as ''yardstick'' enterprises whose rates and general operation could be compared to that of private firms. The specter of municipalization was a club-in-the-closet for local officials should the firm reach an impasse with customers – prominently including city fathers in charge of street lighting contracts. There was never really a *laissez-faire* era of the industry, although private firms in important respects were less regulated than they would be later – and still are today.

Firms in the early gas industry were not regulated as a ''public utility'' where maximum rates and exclusive franchises were coupled into law. Rates were seldom regulated outside of municipal contracts, and new entry was possible in many locales. ''There was no demand for regulation,'' observed John Gray (1900, pp. 514–515) in his essay series on the gas industry published in the *Quarterly Journal of Economics*. ''Both the public and companies were inclined to let well enough alone and to jog along as they have been doing for so long a time.''

This changed in the 1880s when the industry began to lobby for protection against new entrants, entrants utilizing superior technologies for manufacturing gas. Price wars and financial uncertainty, exacerbated by growing competition from the fuel substitutes electricity and kerosene, became commonplace. ''The question before had been how to prevent state interference,'' stated Gray (1900, p. 515). ''It now became how to stimulate, direct, and control state interference so as to protect investments.'' He explained (pp. 515–516):

> The more far-seeing members of the [gas] associations recognized that the days of high charges and high profits … were gone forever, and that … they must … claim protection for ''honest investments.'' They realized, also, that a request for protection would raise the cry of monopoly, which could be safely met only by an acknowledgement of the state's right to regulate the monopoly in the public interest. … The question now became simply how much of their previous claims the companies could afford to give up for the sake of state protection against rivals.

The 1890 presidential address by Emerson McMillin before the American Gas Light Association (now American Gas Association) captured the changing mood of the industry. McMillin stated (quoted in Bradley, 1996b, p. 4):

> Raiders are still abroad in the land. The men with processes that can make gas for almost nothing, and still have a valuable residual, do not seem to despair in their efforts to get a standing in cities already well supplied. If they were only modest enough to go to small towns not now supplied with gas, and demonstrate the value of the process there, they would merit the everlasting gratitude of existing companies.

McMillin and other industry leaders sought the *public-utility covenant* whereby cost-based rate regulation was accepted as the quid-pro-quo of franchise protection. Prescribed *rate maximums* would allow each company, in theory at least, to recover its prudently incurred costs and earn a reasonable rate of return on invested capital. A *certificate of public convenience and necessity* would reserve a service territory for the incumbent and placed the burden of proof on the new entrant in a formal hearings process to show cause to receive permission to enter into a serviced market.

McMillin saw the future in one state, Massachusetts, and wanted to universalize it. Massachusetts had enacted the first statewide law regulating the gas industry in 1885. The *Act to Create a Board of Gas Commissioners*, authored by the Boston Gas Company, was followed by legislation establishing "continuous control" state public-utility commissions in New York (1905) and Wisconsin (1907). By 1927, 48 states had followed suit (Bradley, 1996b, pp. 5–6). Statewide regulation replaced "home rule" franchises that often benefited the firm without requiring "public interest" regulation in return. Incidences of corruption between city fathers and the captains of industry were troubling, and the new arrangement of statewide regulation by full-time officials was considered less political and more scientific (Pond, 1925, pp. 6–7; Bradley, 1996c, pp. 75–76).

Massachusetts's pioneering law was the start of a vigorous interventionist process between the regulators and regulated. Approximately 90 laws were enacted between 1885 and 1900 to make the state's original law more effective (Bradley, 1996b, p. 5). The chief reason for Massachusetts's "wide-reaching inquisitorial powers" (Gray, 1901, p. 271) was to uncover and judge opportunistic strategies to maximize profits under regulatory constraints. Since firms were typically in a position to charge higher rates to their captive customers and increase total revenue, it became lucrative to avoid write-downs or write-offs of obsolete assets, while aggressively purchasing assets from other firms to enhance the rate base upon which a rate of return was applied. At issue were not only buildings and equipment but also patents, internally developed or purchased. "Overcapitalization" or "stock watering" was important for firms under public-utility rate-making that faced a shrinking rate base from depreciation charges (Bradley, 1996b, p. 5).

The cat-and-mouse game between firms and state regulators – first in Massachusetts and then across the country – became secondary to a new "regulatory gap" that emerged in the 1920s when long-distance pipelining allowed interstate *natural gas* to displace more expensive and more polluting manufactured gas. The Commerce Clause of the U.S. Constitution left state regulators powerless to control the purchase of out-of-state gas by local distributors. Nor could state officials block a distribution company operating an interstate transmission from using an intra-firm *transfer price* to charge and receive at wholesale what public-utility ratemaking denied the firm at retail. So long as final users would still buy enough gas at a higher price to increase total revenue (and under exclusive franchises demand was less sensitive to price than it otherwise would be), the integrated company was well positioned to circumvent regulatory constraints.

This "breakdown of regulation" led Congress to pass the *Natural Gas Act of 1938*, which subjected interstate gas transmission companies to public–utility regulation of entry, rates, and terms of service by the *Federal Power Commission* (FPC) (Bradley, 1996b, p. 9). The interstates blocked the legislation until they received the full regulatory covenant – a provision requiring new entrants in areas already served by an interstate line to obtain a certificate of public convenience and necessity (Bradley, 1996b, pp. 9–11). Time-consuming hearing processes, which would involve hundreds of FPC staffers and outside attorneys, gave incumbents a leg up. It also would mean less competition at the wholesale level and service delays for millions of gas consumers in the years and decades ahead.

Government gas policy, in review, went from piecemeal local regulation to state public-utility regulation of integrated distribution companies and then to federal public-utility regulation of interstate transmission. The "city gate" market was now federally regulated at wholesale to complement state regulation at retail. *This left one part of the gas-industry chain unregulated – wellhead production.* "Upstream" natural gas producers were positioned to receive whatever economic rent federal regulators denied to "midstream" pipelines and state regulators denied to "downstream" distribution companies that (captive) consumers were willing to pay. This new "regulatory gap" was also present for municipal gas companies that received gas that was not regulated at the wellhead.

The FPC administratively responded in 1940 under the "just and reasonable" pricing provision of the Natural Gas Act with a new policy imposing cost-based price ceilings on affiliated sales between a pipeline's production subsidiary and the pipeline division. Such "field orders" were punitive to the involved integrated companies, and they responded by selling their production properties to non-integrated producers to receive market value (Bradley, 1996b, p. 12).

The regulatory gap now remained for producer and interstate pipeline engaged in arm's length transactions. (Intrastate sales were not regulated.) In 1954, the Supreme Court ruled that all gas sales for resale in interstate markets came under the jurisdiction of the Natural Gas Act to, in its words, "plug the 'gap' in regulation … [for] protection of consumers against exploitation" (quoted in Bradley, 1996a, p. 378). This completely regulated the upstream interstate market to complement midstream and downstream regulation. The intrastate market, where gas was sold by producers to pipelines or distribution companies wholly within the same state, was not under federal price regulation, just the supervision of state utility commissions (or in the case of Texas and a few other states, railroad commissions).

Fig. 2 shows the cumulative process that began with the *initiating intervention* of government street ownership and corporate charter policy.[5] This beachhead led to special-provision gas-company charters and municipal lighting contracts – the opening stanza of government involvement in the gas industry. "Home rule" charters specified rates for street lighting and sometimes contained special provisions restricting new entry. Phase 1's consequent intervention led to statewide public-utility regulation (Phase 2),

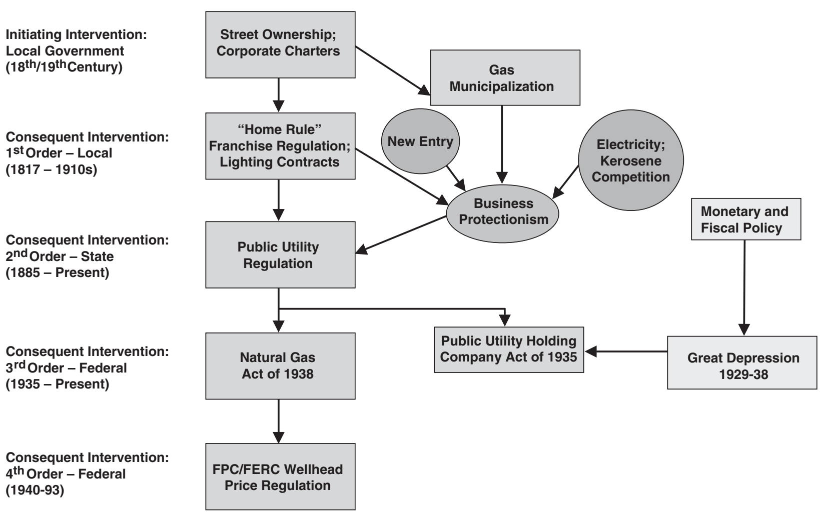

Fig. 2. U.S. Public Utility Regulation – Gas (Part I).

which in turn led to federal regulation of interstate pipelines (Phase 3) and federal regulation of wellhead transactions (Phase 4).

Gas-industry interventionism involved other dynamics that are part of the linkage of Fig. 2. A national network of municipal gas companies served as initiating intervention for private-side regulation since industry leaders rallied toward public-utility regulation in part to quell the threat of municipalization. The Great Depression, itself a consequent of government intervention into money and banking, contributed to industry instability that engendered demand for regulatory protection, not to mention a federal law prohibiting common ownership of multiple distribution systems. *The Public Utility Holding Company Act of 1935* (PUHCA) led to divestitures where commonly held gas and electric divisions, as well as interstate transmission and distribution affiliates, were separated and sold (Bradley, 1996b, p. 8).

FPC regulation of gas producers in the 1940s began a tar baby exercise. The wellhead market hardly had the "natural monopoly" characteristics of interstate gas pipelines and distribution companies, however defined. Cost-based ratemaking was problematic for many reasons, including assigning a well's costs between associated flows of unregulated oil and regulated natural gas. The FPC under its newfound authority over all interstate transactions (1954 forward) would implement four successive wellhead-pricing regimes in the next three decades with the problems of each leading to the next. Each stanza of "just and reasonable" pricing under the Natural Gas Act represented a *cumulative process within a cumulative process*. Printed matter of FPC activities, meanwhile, would grow as hearings became more politicized and new areas of regulation were assumed. The first volume of FPC matters from 1931 through mid-1939 totaled less than 1,000 pages. Volume 2 was well over 1,000 pages and covered mid-1939 through 1941. In the mid-1940s, weighty volumes were published yearly, and by the mid-1950s, they became semi-annual. Natural gas issues were responsible for most of this growth, but interstate electricity and waterway issues also occupied the commission's attention.

The first three FPC wellhead natural gas pricing methodologies were (Bradley, 1996b, 12–14):

- *Individual-producer* price regulation (1954–1960), which treated some 5,000 gas production companies selling gas destined for interstate commerce, however small, as public utilities subject to federal control. This resulted in what President's Kennedy's Landis Commission called "the outstanding example in the federal government of the breakdown of the administrative process" (quoted in Bradley, 1996b, pp. 12–13) as firms "pancaked" rate request after rate request while regulators grappled with determining cost-based maximum price assignments.

- *Area* price regulation (1960–1973), where the U.S. natural gas map was divided into 23 regions for "in-line" pricing for "new gas" contracts and slightly lower prices for "old gas" contracts. "Consumerist pricing" by President Kennedy's new slate of FPC commissioners rolled back prices in many instances, contributing to critical gas shortages in the winter of 1970/1971 in interstate markets. (Gas shortages were not experienced in unregulated intrastate markets.)
- *National* price regulation (1974–1978), whereby a single cost-based price ceiling was set to reduce the complexity introduced by the area approach. The price liberalization that was necessary to attract gas to interstate markets required regulators to jettison cost-based ratemaking for a new methodology based on "the price of competitive fuels, the impact upon supply and demand, inflationary pressures, the nation's natural gas shortage and conservation factors" (quoted in Bradley, 1996b, p. 14).

Prices were still below market-clearing levels despite the FPC's attempt to relax price controls and reduce administrative complexity. Interstate gas shortages were experienced for the second time in the winter of 1976/77. As before, gas-state consumers basked in gas surpluses as production stayed in unregulated home markets. In addition, gas-consuming industries began relocating to gas-states to take advantage of secure, competitively priced supply. This plenty-amid-crisis resulted in the *Natural Gas Policy Act of 1978* (NGPA), the fifth stanza of FPC [now *Federal Energy Regulatory Commission* (FERC)] regulation, which set maximum intrastate gas prices for the first time in exchange for higher permitted prices elsewhere.

Fig. 3 illustrates the cumulative dynamics of gas interventionism at the wellhead. The initiating/enabling intervention was the Natural Gas Act of 1938, which was interpreted by the FPC and then the U.S. Supreme Court as extending "just and reasonable" pricing to natural gas at the wellhead. Five phases of consequent regulation – the second expansionary, third and fourth amendatory, and fifth both expansionary and contractionary – are linked below.

Some 20 categories of natural gas were established for pricing purposes under the NGPA, depending on the age and location of the gas find. Some categories were targeted for immediate or prospective decontrol, while "old gas" categories remained under NGA price ceilings. Intrastate gas, as mentioned, was regulated for the first time, the quid-pro-quo for price increases and deregulation elsewhere. The perversity of the "tiers" or "vintages" was

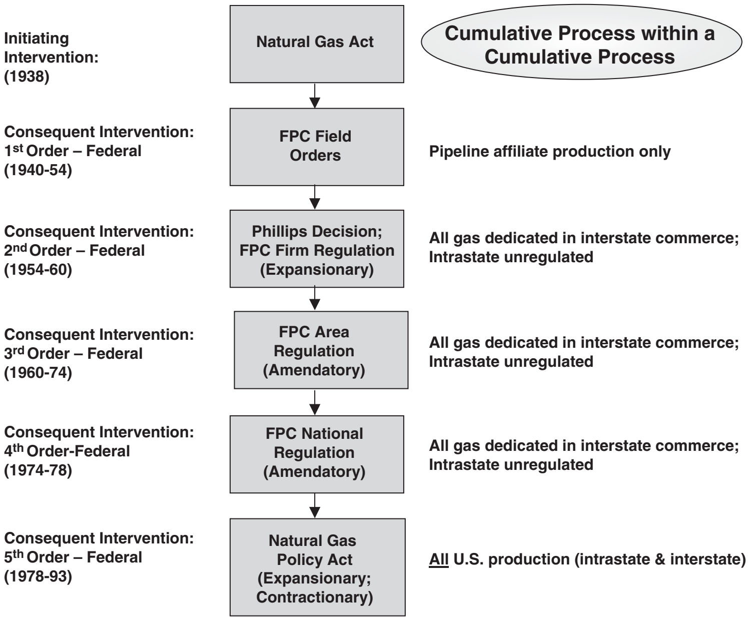

Fig. 3. U.S. Wellhead Natural Gas Regulation (Part II).

demonstrated when one driller struck natural gas but re-drilled the well from a nearby hill to break the 15,000 feet barrier to achieve unregulated pricing (Bradley, 1996b, p. 15). This was *superfluous entrepreneurship*, defined by Israel Kirzner (1985, p. 144) as regulatory-induced "pure profit opportunities that would otherwise have been absent."

The NGPA was part of the five-part *National Energy Act of 1978* (NEA), which was passed in response to the natural gas crisis of the winter of 1976/77. Already, the Emergency Gas Act of 1977 gave special powers to the FPC, soon to be the FERC, to expedite gas transfers between companies and imports from Canada. The five major pieces of legislation were (Cochrane, 1981, pp. 584–585):

- NGPA, which in addition to regulating producer prices relaxed interstate transmission regulation to facilitate the movement of gas from surplus to shortage areas.
- *Powerplant and Industrial Fuel Use Act*, which prohibited natural gas burning in such facilities to reserve supply for residential and commercial usage.

- *Public Utility Regulatory Policies Act*, which, among other provisions, subsidized the construction of new gas-fired combined-cycle power plants by non-utility owners.
- *National Energy Conservation Policy Act*, which mandated energy-efficiency standards and subsidized conservation, programs to reduce energy demand.
- *Energy Tax Act*, which implemented a raft of tax breaks for energy efficiency.

These interventions intended to *construct* equilibrium within a price-control framework by further intervening to increase supply or reduce demand – a policy described by one economist as *gapism* (Mitchell, 1974, pp. 17–26). Gapism is consequent intervention, a government effort to address the problems created by its shortage policy (effective price controls).[6]

Fig. 4 shows the linkage between intervention causing natural gas shortages, including the secondary cause of petroleum price regulation that shifted demand to gas from fuel oil shortages, as well as consequent intervention intended to address the shortages. These laws represented expansive intervention, although some liberalization was present in the complicated, politically salable stew.

Despite its complexity, the NGPA "worked" in the sense of ending natural gas shortages. Yet the regulatory framework replaced one crisis with another.

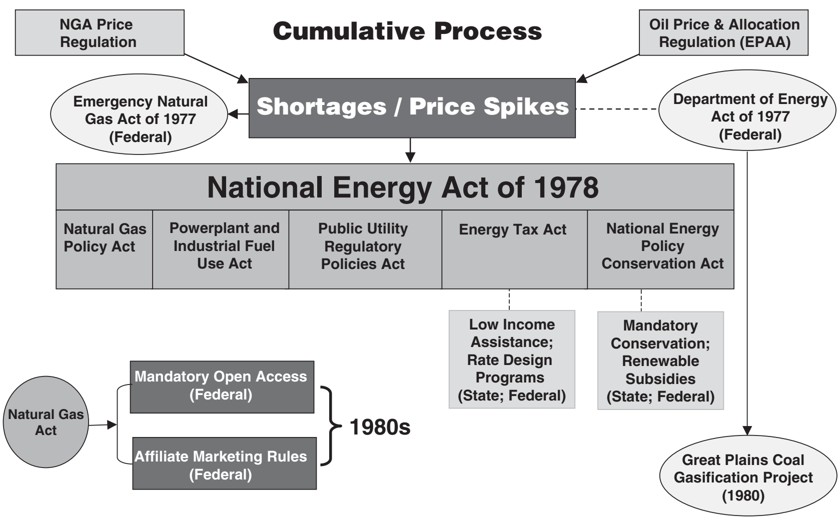

Fig. 4. U.S. Natural Gas: Crisis Interventionism (Part III).

Interstate gas pipelines found themselves sandwiched between wellhead contracts that escalated under NGPA pricing provisions and industrial and power plant users who could not afford to purchase the gas. An industrial recession and fuel-switching to cheaper fuel oil were part of this problem.

The "gas bubble" led to administrative regulation by the FERC to substitute cheaper spot-market (short term) gas for more expensive gas under long-term contracts – and allow pipelines to offer short-term transportation. This cumulative process within a cumulative process deconstructed traditional public-utility regulation; now interstate gas pipelines no longer bought and sold gas but "unbundled" by transporting supply for third parties for a carriage fee. The *mandatory contract carriage era* was largely complete by the 50th anniversary of the Natural Gas Act of 1938 (Bradley, 1996b, pp. 16–19; Tussing & Tippee, 1995, pp. 204–216; 223–249).

The reconstruction of the wholesale market by the FERC in the 1980s and early 1990s was cumulative to the market changes created by the NGPA to 1978 as well as exogenous factors such as macroeconomic fluctuations and falling oil prices. Federal wholesale mandatory access, in turn, has sparked interest in state-level retail access where independent marketing companies sell directly to homeowners and other end users and pay a fee to the local distribution company for using its pipes. The cumulative process of subsequent intervention continues in its second century.

Two interventionist legacies remained after markets turned from shortages in the 1970s to surpluses in the 1980s: *conservationism and alternative energy subsidies*. Reduced gas usage – whether direct or indirect through electricity conservationism – became an end in itself, fostering a variety of government interventions from appliance efficiency mandates to conservation programs funded by utility ratepayers (Wirl, 1997). A variety of subsidies for wind power and other favored renewables (solar, geothermal, biomass but not hydroelectricity) were enacted at the state and federal level (Bradley, 1997). Gas shortages also sparked interest in synthetics, which resulted in the federal loan guarantees authorized in 1977 legislation for the Great Plains Coal Gasification Project in 1980.[7]

3. STUDY #2: PUBLIC-UTILITY REGULATION OF ELECTRICITY

In a landmark presidential address in 1898 before the National Electric Light Association (now Edison Electric Institute), Samuel Insull, head of Chicago Edison Company, urged his fellow executives to endorse a new political agenda between the extremes of "municipal socialism" and "acute competition." The competitive franchise, complained Insull, "frightens the investor, and compels corporations to pay a very high price for capital." The "inevitable" consolidation, he argued, leaves the combined corporation with the economic wastes of duplicate facilities and high interest costs. The solution was franchise protection for rate regulation. In Insull's words (quoted in Bradley, 2003, p. 46):

> The best service at the lowest possible price can only be obtained ... by exclusive control of a given territory being placed in the hands of one undertaking ... In order to protect the public, exclusive franchises should be coupled with the condition of public control requiring all charges for services fixed by public bodies to be based on cost, plus a reasonable profit ... The more certain [franchise] protection is made, the lower the rate of interest and the lower the total cost of operation will be, and, consequently, the lower the price of the service to public and private users.

The crusade for regulation, including a variety of public relations efforts bordering on scandal (Olasky, 1987, pp. 33–43), bore fruit. By 1914, one economist concluded, "all now seem to assent to the proposition that municipal utilities must be regulated" with only "the point of difference [being] as to the method and extent of regulation" (King, 1914, p. 23). Twenty-eight states would establish statewide public-utility commissions between 1910 and 1915 alone (Bradley, 2003, p. 50). What Emerson McMillin and other gas industry leaders gained for their industry, Samuel Insull and his followers secured for the electricity industry. Political capitalism, not laissez-faire, was alive and well in gas and electricity – as it was in other major sectors of the U.S. economy such as banking and railroads.

Initial state public-utility regulation of electricity began a long-lived cumulative process. As on the gas side, state commissions found themselves reaching deeper and deeper into managerial decision-making to make the regulation of power generation and distribution more effective. Summarized C. O. Ruggles, (1937, p. 56):

> There has been a steady growth in commission jurisdiction over more types of utilities, and greater authority over the managerial affairs of the utilities. This latter tendency was apparent as early as 1890 [in Massachusetts with manufactured gas], but it is doubtful if anyone at that time could have anticipated the extent to which internal operations of utilities would be made subject to actual regulation by utility commissions ... Increased attention was focused especially on such matters as the power to change contract rates, to issue terminable or indeterminate permits, to control depreciation rates, to approve consolidation and mergers, and to authorize the construction of electric transmission lines.

As on the gas side, early electricity municipalization was cumulative to the initiating/enabling intervention of municipal street ownership. Later municipalizations were cumulative to "home rule" regulation where in some cases the government firm was organized in response to politicized franchise regulation. Richard Ely and other economists made this argument for municipalization in the 1880s; politicians made the argument in their respective locales. Detroit, for example, established an electric municipality in 1895 after political corruption was uncovered with their franchises (Rudolph & Ridley, 1986, pp. 22–23).

Statewide regulation with power, as with gas, was not the panacea that advocates had hoped. Opportunistic strategies by firms to maximize profits in the face of regulatory constraints left captive ratepayers with a bad deal. One economist of the day concluded (quoted in Bauer & Costello, 1949, p. 372):

> After a twenty-year struggle with rate regulation the public authorities today are scarcely in a better position than when they started. During these two decades they have conducted endless investigations, caused the expenditure of hundreds of millions of dollars, piled up mountains of records and opinions; and mostly have not reduced rates when fairly justified, nor advanced them when reasonably needed. They are all but helpless before the huge task of prescribing rates for the many utilities operating under greatly varying conditions, rapidly shifting prices and tremendous transitions in industrial organization – unless principles and policies of regulation are definitely established and exact methods prescribed.

Franklin D. Roosevelt, then governor of New York, opined (quoted in Prendergast, 1933, p. 267):

> The condition of over-capitalization by the issuance of watered stock has come about under the regulation of public utilities by public service commissions, so that the policy has failed to maintain that degree of protection for the public, which was contemplated at the outset. It appears to me that the policy of public service commission regulation has broken down and proved itself ineffectual for the purposes originally intended.

Discontent in the roaring 1920s could only grow with the Great Depression. The fall in 1932 of the House of Insull – the Middle West Utilities holding company controlling one-eighth of the national distribution network – piqued congressional interest for major reform. Two major federal laws affecting electricity resulted in 1935.

The *Federal Power Act* regulated entry and rates for electricity sold from one utility to another under a broad interpretation of interstate commerce. The familiar term "plugging regulatory gaps" applied. Explained one study (Burns, 1948, pp. 78–79):

> The FPC was given jurisdiction over electricity in interstate commerce in order to close a gap in regulation. A considerable quantity of electricity is transmitted in interstate commerce and sold at wholesale to companies engaged in distribution to ultimate consumers. Since the wholesale rate is an interstate rate, a state commission does not control it, yet it has an important effect on the costs of a company whose rates to ultimate consumers are subject to state commission control. Obviously, regulation of the rates to ultimate consumers could not be effective or intelligent unless the state commission investigates the reasonableness of the wholesale rate, but this was beyond its control.

The second law regulated utility holding companies, which were at the center of many regulatory controversies. PUHCA of 1935 addressed a "lack of effective public regulation" that created "abuses … injurious to investors, consumers, and the general public" (Pub. L. No. 74–333, 49 Stat. 803 at 804). By breaking up multi-state, multi-system holding companies, the law sought to eliminate a variety of opportunistic company practices where profit making could be transferred from regulated to unregulated divisions. Henceforth, only one integrated system could be owned by a company to simplify complex interstate "financial legerdemain" (Dewing, 1953, p. 1003) that is "not susceptible of effective control by any State" (49 Stat. 803).

The federal extension was consequent to the failures of previous regulation. Accounting historian George May noted how gaming the financial statements was sport in the regulated public utilities, not unregulated firms (May, 1943, p. 297):

> The grant to a regulatory commission of power over accounting in unregulated industries was not and could not have been supported by a claim that abuses had developed in that field which did not exist where accounting was regulated. On the contrary, the practices, which had become discredited were more general in the regulated industries (and among the utility holding companies) and had spread from those fields to unregulated industry to only a minor extent where they had spread at all. This is true of the non-acceptance of the cost amortization concept of depreciation; of reappraisal and improper charges against capital surpluses resulting there from; of pyramiding of holding companies; of periodical stock dividends improperly accounted for; and of the practice of charging to surplus items, which more properly belong in the income account. These together constitute the major defects of accounting that had developed in the prosperous period that ended in 1929 and in the depression that followed.

The long history of electricity regulation is illustrated in Fig. 5. Government power policy paralleled the experience with gas, with the major difference being passage of the Federal Power Act three years before the Natural Gas Act – although both were originally part of the same bill. Only with the interstate gas shortages in the 1970s would the federal path for gas and electricity diverge.

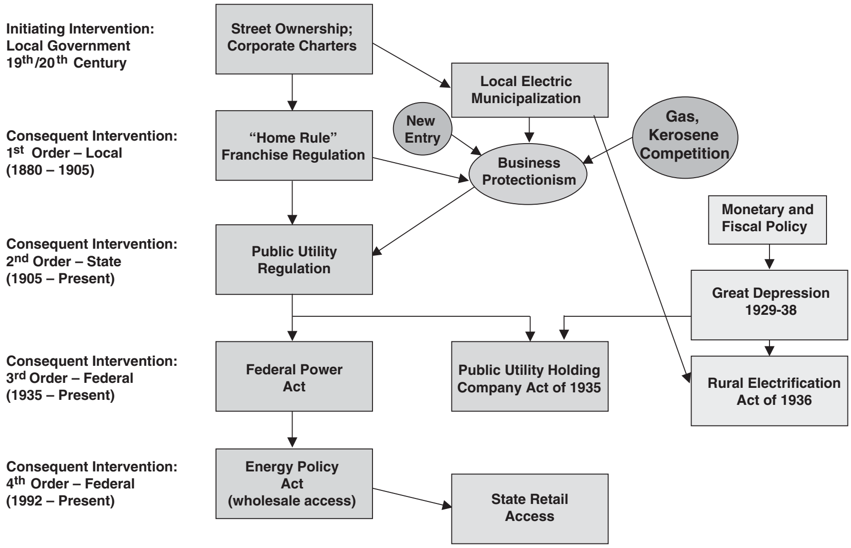

Fig. 5. U.S. Public Utility Regulation—Electricity.

The cumulative process of government intervention into electricity markets slowed in the 1940–1970 period, notwithstanding the rise of the nuclear power industry, one that would not have come into being without accident liability limits enacted in the *Price-Anderson Act of 1957* (U.S. Department of Energy, 1988, p. 105). Electricity rates fell in real terms as technology improved and the prices of energy inputs held stable. Life was serene inside the franchised monopolies where every pound of engineering required only an ounce of entrepreneurship. This radically changed in the 1970s when turmoil in oil and gas markets impacted the production and distribution of electric power. PURPA was enacted to incite the entry of independent (non-utility) power producers to compete, for the first time, with integrated power utilities as well as with municipalities. This meant requiring utilities to purchase power from the upstarts under specified conditions (Sweeney, 2002, pp. 14–16).

It would not be until the 1990s that fundamental changes would begin to occur for electricity as it had occurred for gas over a decade before. The *Energy Policy Act of 1992* set into motion a new regulatory regime, mandatory open access at the wholesale level, where utility owners of the transmission grid had to grant access at non-discriminatory rates to outsider parties to move power. For the first time, independent producers or traders could wholesale power to utilities or municipalities.

Gaining access to utility wires to serve end users was a state matter. States began to implement mandatory open access at retail, but the momentum stopped when California's half-slave, half-free "deregulation" effort produced the electricity shortages of 2000–2001. The state's crisis was the result of its own multi-decade cumulative interventionist process with electricity. "Each stage, and in fact the whole process" of California electricity regulation, one economist concluded, "should be seen not as a random set of disconnected events but rather as a continuing sequence in which choices were made" (Sweeney, 2002, pp. 2–3).

4. STUDY #3: U.S. WATER POWER INTERVENTION

A cumulative interventionist processes can be outlined with water power, known in the trade as hydroelectricity. The federal government as waterway owner assumed responsibilities for navigation, flood control, irrigation, and land reclamation. Private hydroelectric projects that first emerged in the 1890s were also a federal matter. Beginning in 1903, federal policy turned against private development of the "public" resource (Bradley, 1996c, p. 91), an impasse that was removed with the *Water Power Act of 1920*. This act created the FPC to issue 50-year licenses and set "reasonable, nondiscriminatory, and just" (cost-based) rates for water power in interstate or foreign commerce pursuant to the Interstate Commerce Act of 1887 (Pub. L. No. 66–280, 41 Stat. 1063 at 1073–1074; Bradley, 1996c, p. 92). The cumulative process crossed between regulated industries.

Municipal provision of hydropower became a political tool to lower private rates, subsidize rural users, and provide jobs during the Great Depression (Bradley, 1996c, pp. 93–94). The problems of statewide public utility regulation generated demand for such government competition. Explained one study (Burns, 1948, p. 493):

> While the federal government until 1933 regarded electric power solely as a source of revenues to subsidize other functions, especially irrigation, power has been sold since 1933 for other reasons. It was believed that rates charged by electric utilities were too high, and that state regulation could not bring them down. This view was based upon the cumbersome and ineffectual method of rate regulation on the fair-return-on-fair-value principle, and the failure to control operation and capital costs. It was held that publicly operated plants could by charging lower rates, provide a check upon private rates more effective than state regulation. Such a policy was actively supported by President Roosevelt.

The nation's largest hydroelectric enterprise, the federal Tennessee Valley Authority (1933), was built after private applications to commercialize the

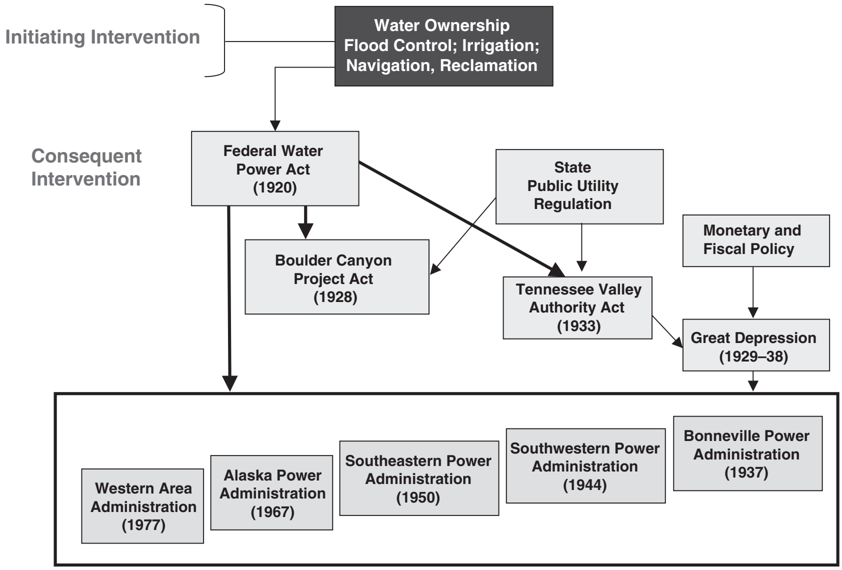

Fig. 6. U.S. Federal Water Power Intervention.

Tennessee River were stymied by authorities (Bradley, 1996c, pp. 95–96). This was a direct case of government intervention inviting further involvement. In 1937 the Bonneville Power Administration Act authorized the completion of hydro facilities in the Pacific Northwest as a federal/taxpayer project, the first of five federal power marketing agencies to be built in the next decades as seen in Fig. 6.

5. STUDY #4: U.S. STATE PETROLEUM CONSERVATION REGULATION

Oil and gas are migratory minerals that can be drained by any driller who has legally penetrated the reservoir from the surface. Competing rights to the reservoir raised the question: who owns what oil and when? U.S. jurists tackled the problem with what became known as the *rule of capture*, which defined initial ownership as the point at which the driller physically produced the oil rather than trying to assign rights to oil or gas in place in the reservoir (Bradley, 1996a, pp. 59–63). The ensuing race for possession made the U.S. oil industry hyper competitive as new wells were quickly sunk into discovered reservoirs and each driller produced as much oil as could be sold or stored above ground – or it was simply wasted in the trying (Bradley, 1996a, pp. 64–69).

Drainage competition under the rule of capture became a national issue when mega-fields began to be discovered in Oklahoma, Texas, and California in the 1920s. Concerns about the U.S. running out of oil quickly gave way to industry angst about falling prices. Unrestrained drilling and full-flow production were decried as "physical waste" and "economic waste." "Overdrilling" was contrasted with wider-spaced wells that could lower production costs; "overproduction" was contrasted with restrained flow that better utilized the natural pressure of the reservoir to increase ultimate oil recoverability (Bradley, 1996a, pp. 88–89).

Integrated oil companies generally favored restrained production from fewer wells to reduce costs and support prices in their production-refining-marketing operation. They also welcomed imports that were either from their own international operations or the lowest-cost feedstock for their refineries. Independent producers, on the other hand, many of the mom-and-pop variety, favored maximum production to service their debt and put cash in their pocket. Refiner and marketer profitability was not their concern, and foreign oil was the enemy. A political solution would have to reconcile the interests of big oil and little oil; integrated oil and non-integrated oil, and domestic oil and international oil.

Wellhead "conservation regulation" began in the leading oil states of Texas and Oklahoma in the 1920s and reached virtually all producing states in the next decades. The most common rules set:

- The "maximum efficient rate" (MER) of production for each well
- A "market demand factor" as a percentage of MER as a maximum rate of production per well
- Well spacing minimums (typically 40 acres for oil and 640 for natural gas)
- Maximum gas/oil ratios for production of oil with associated natural gas
- Rules for "pooling" or "unitization" whereby the majority of operators could force a minority to join them in a joint production plan per reservoir

Many oil and gas scholars have simplistically concluded that "high transaction costs" between reservoir co-owners under the judiciary's rule of capture created a "market failure" necessitating government activism to prevent wastage of oil and natural gas (Zimmermann, 1957, pp. 109–113, 126; Libecap & Smith, 2001). An alternative interpretation (Bradley, 1996a, Chapters 2–4) has identified a series of government interventions that discouraged private solutions to common pool challenges – preventing, as it were, the strongest market participants from achieving a more rational level of drilling and production. The economic incentive was to lower cost by avoiding unnecessary wells and to maximize the capital value (salable value) of a property by efficiently utilizing reservoir pressure for natural recovery. The role of entrepreneurs is to act creatively to increase profits, which in this case could be done by either implementing a common plan of production or consolidating ownership to implement the same production plan.

A variety of state and/or federal interventions *discouraged cooperative solutions* or *encouraged autonomous behavior* (offset drilling and drainage competition) in the production of oil and gas in the crucial 1926–1935 ''overproduction'' period. These public policies were:

- *State and federal antitrust law*, which prohibited associations between firms to restrain output and, theoretically at least, increase price. ''The Texas antitrust laws originating in 1889 were antithetical to the very concept of [oil and gas] unitization,'' just to use one example (Weaver, 1986, p. 383). While some legal experts opined that antitrust did not apply to oil and gas activity on such a small scale, the industry was unable to receive an antitrust exemption from state or federal officials. This legal gray area was not comforting to potential targets. Stated the head of Jersey Standard (now Exxon Mobil) at the time: ''It is all well to say that [antitrust revision] amounts to asking the authorities to lower an unloaded gun. [But] the world is full of people whom the pulling of a trigger on an unloaded gun pointed straight at them could discomfort'' (quoted in Bradley, 1996a, p. 123).
- *Corporate taxation* whereby joint operating agreements became associations subject to double taxation – first on business profits and then personal income received from the business. Well operators as unincorporated entities were subject only to the personal income tax, but the Internal Revenue Service included ''associations, joint stock companies, and insurance companies'' as corporations for tax purposes from 1918 to 1935 (quoted in Bradley, 1996a, p. 125).
- *Federal land policy* that either discouraged or prohibited private unitization agreements. Unit agreements were prohibited altogether on federal land prior to 1930. After this time, unitization was allowed subject to the authority of the Department of Interior to set the unit's rate and quantity of production – an unsettling factor for operators. Bureaucratic delays of months at best and years at worst were encountered. Only 6 out of 500 submitted unit agreements were approved by 1935, leaving drainage competition between reservoir co-owners as the only alternative (Bradley, 1996a, pp. 126–127).

- *Conservation regulation*, which created mal-incentives that worked against rational oil production as defined by the self-interest of the operators themselves. "Allowable" assignments and well spacing exemptions rewarded smaller and poorly situated wells at the expense of more productive wells, removing incentive for cooperative development (Bradley, 1996a, pp. 127–128). In the words of one legal scholar, the "vested … regulatory inheritance" of the inefficient created "profitable obstructionism" against the efficient (Weaver, 1986, pp. 108–109).
- *Oil pipeline carriage requirements* that encouraged (subsidized) inefficient wellhead practices. State and then federal laws, which required a pipeline to accept deliveries up to capacity and then equally prorate between shippers if oversubscribed, encouraged uneconomic drilling and slowed the consolidation process. Such "common carrier" or "common purchaser" laws prevented contractual arrangements, albeit "discriminatory" to some potential or existing shippers, to better match upstream supply to downstream demand (Bradley, 1996a, pp. 118–119, 612–618, 776–785).

In 1931, fairly early in what became a very long cumulative interventionist process, a crisis in state wellhead regulation emerged. Flush production in the great oil fields of East Texas and Oklahoma City drove crude prices to record lows. The 211-square-mile East Texas oil field, in particular, was a production behemoth, and prices in the field dropped to as low as a dime a barrel (about $1.25 today). Illegal or "hot" oil production overwhelmed the enforcement capabilities of state regulators, particularly when the local courts sided with independents and enjoined conservation orders (Bradley, 1996a, pp. 92–99, 138, 637–654).

A crossroads was reached between a tough-love market solution and solidified regulation. As unrest was boiling over, the *Oil and Gas Journal* opined, "It would be better to open up all the fields, go through the comparatively brief period of 15-cent oil, and then start the recovery with politicians eliminated from the picture" (quoted in Bradley, 1996a, p. 117). But rather than allow weak, inefficient companies to leave the scene – a reorganization that was sorely needed to get the industry on a fewer well/delayed production basis – martial law was declared in the well zones of East Texas and Oklahoma City by the respective state governors. The fields were completely shut down for a period and then reopened under strict allowables. State conservation regulation survived a near-death experience to continue the cumulative interventionist process. This was a failure of public policy and not the market's ability to rationalize petroleum production.

Other shortcomings exist with the market failure/government solution interpretation of U.S. oil and gas extraction under the rule of capture. First, rapid production was justified to an extent from the universal law of time preference where present production (money) is preferred over later production (money), other things the same (Bradley, 1996a, p. 108). Second, producers in the early decades of the oil industry worked with the technological knowledge of the time. Some theories of reservoir mechanics concluded that more wells and natural production rates recovered more oil, not less. Practices that would later be recognized as inefficient were not self-evident at the time given the then-existing state of knowledge (Bradley, 1996a, pp. 109–113). Third, market critics fail to adequately consider an alternative private-property regime whereby the first discoverer of a reservoir could claim to own ("homestead") the entire contiguous deposit. This would eliminate, or at least reduce, the high-transaction-cost problem of reservoir ownership and production (Bradley, 1996a, pp. 64–74).

A schematic of the above revisionist interpretation that links the "necessity" of oil conservation regulation to pre-existing government barriers to coordinated production is presented in Fig. 7.

What was the cumulative process between initiating intervention and consequent intervention to sequentially link the major oil conservation laws?

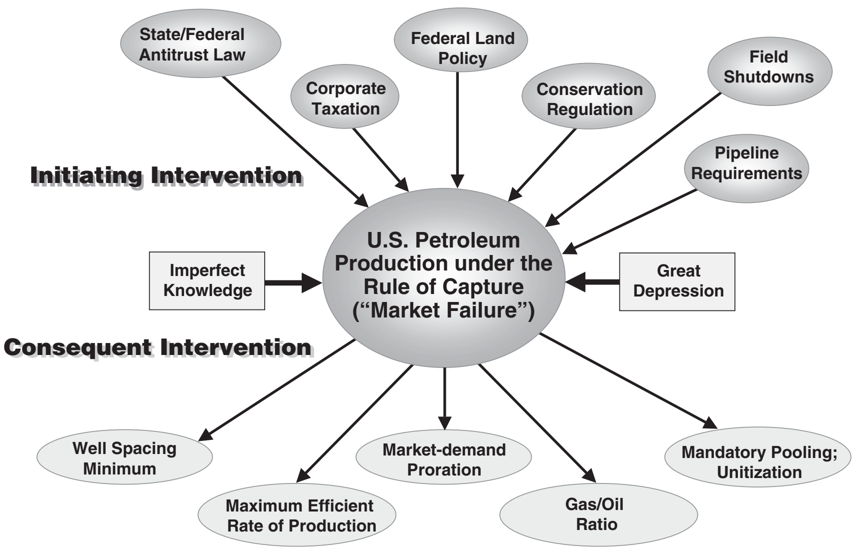

Fig. 7. Rule of Capture Schematic.

Oil companies in the Southwest negotiated voluntary agreements in some of the very largest fields in the mid-1920s to stem the flow of crude and stabilize prices. But free market cartels sow the seeds of their own demise since production cuts by some create profitable opportunities for others to increase production either inside (by cheating) or outside the cartel. The voluntary effort failed, and disappointed producers turned toward a political solution (Bradley, 1996a, pp. 88, 91).

State conservation regulation began in 1927 when Oklahoma and Texas instituted proration for oil wells in particular fields. Partial regulation increased incentive for more production elsewhere, a regulatory gap, and each state responded by expanding proration statewide in 1928. This shifted the regulatory gap to the neighboring oil states of Louisiana, New Mexico, Arkansas, and Kansas. Each adopted proration in 1935/36 as strongly desired by their neighbors. The Interstate Oil Compact Commission was formed in the same period with an antitrust exemption from Congress to provide statistical support and coordinate production cutbacks for its state members – creating a quasi-cartel, as it were. Thus partial state regulation grew in classic fashion to statewide control and then to interstate coordination (Bradley, 1996a, pp. 87–106).

Comprehensive proration in all the major oil states except California, which was geographically isolated from the warring southwest oil states, necessitated a federal component. State enforcement proved difficult in the face of clever "hot oil" operators and sympathetic local judges, particularly in Texas. A federal solution was needed, particularly with "hot" (illegal) oil escaping into interstate commerce. A one-mill-per-barrel federal crude oil tax in 1934 was used to find, trace, police and prosecute the hot oil artists. The *Connally Hot-Oil Act of 1935* prohibited the transportation of illegally produced oil in interstate commerce. With federal agents on the scene, the regulatory gaps were closed and enforcement accomplished after nearly a decade of turmoil (Bradley, 1996a, pp. 644–651).

Another layer of federal involvement was necessary to prop up the oil-state cartel. Imports were not regulated – a regulatory gap. Sizeable oil tariffs in 1932 and a short-lived oil quota during the New Deal plugged this hole, but a boomerang effect occurred since the U.S. was a *net exporter* of crude oil. Foreign oil, turned away from the U.S. border, displaced U.S. oil exports to foreign markets. Protectionism did not have the same effect as domestic output cutbacks did, although it was the political tonic to get independents to go along with the integrated majors' preference for domestic proration. The quid-pro-quo rescued corrupt, inefficient state conservation regulation (Bradley, 1989, pp. 64–67).

A far bigger test came for prorationing after growing imports made the U. S. a net importer of crude oil, which first occurred in 1947. By the mid-1950s domestic producers were at war with importing companies as mandatory proration had cut back production in the Southwest oil states to under one-half of MER levels (Bradley, 1996a, pp. 171–175). After voluntary import reductions failed, the *Mandatory Oil Import Program of 1959* (MOIP) set a quantity ceiling on tariff-free imports. This move rescued state conservation regulation – but at the expense of foreign producers whose oil could only flood international markets to drive prices down. Officials of Venezuela, the leading exporter to the U.S., responded by putting together what became the Organization of Petroleum Exporting Countries (OPEC) in 1960 (Bradley, 1989, pp. 67–69). The machinations of OPEC ever since are part of the cumulative dynamics of domestic U.S. oil policy.

Fig. 8 links the formation of OPEC to the beginnings of market-demand proration in the 1920s. The links are shown between government disincentives to coordinated production, oil-state conservation regulation, federal regulation to supplement state control, and, finally, oil import limitation.

Petroleum shortages in the 1970s made domestic oil proration and oil import controls things of the past, but the pro-oil policies of these decades would be remembered when the balance of political power shifted to the oil

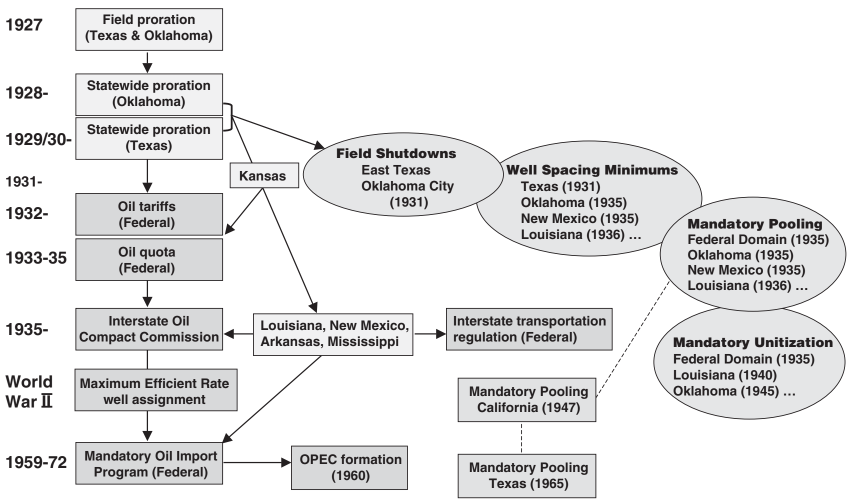

Fig. 8. Cumulative Path of U.S. Oil Conservation Regulation.

consuming states. In a political sense, the anti-oil legislation of the 1970s was cumulative to the pro-oil intervention preceding it (Bradley, 1996a, pp. 1840–1841).

6. STUDY #5: FEDERAL PETROLEUM PRICE & ALLOCATION REGULATION IN THE 1970S

Government intervention into petroleum markets in the 1970s is a monument to cumulative dynamics and regulatory failure. From an initial (and initiating) intervention of inflationary monetary policy came the *Economic Stabilization Act of 1970*, which gave the President the authority to enact wage and price controls. President Richard Nixon invoked his power on August 15, 1971, by setting a 90-day freeze on all wages and prices in the U.S. economy.

The first peacetime price control program in U.S. history would go through five phases over the next 33 months and distort oil more than any other major industrial sector. Petroleum shortages developed in late 1972, and Congressional hearings on fuel shortages and energy conservation followed. The Arab OPEC production cutback in late 1973 worsened the situation, but it was federal price regulation, not the Arab Embargo, which fathered the energy crisis – an on-and-off crisis that persisted until decontrol and market adjustments set in during 1981.

While Nixon's discretionary price controls were lifted for the rest of the economy, oil prices and allocation were comprehensively regulated in the *Emergency Petroleum Allocation Act of 1973* (EPAA). The EPAA linked price controls to allocation controls. "The creation of Part 212," stated the Federal Energy Office, "recognizes the compelling necessity of viewing both allocation and price problems within the context of a single regulatory framework" (Quoted in Bradley, 1996a, p. 1787). Two central elements of the mandatory allocation program, the supplier/purchaser rule and buy/sell program,[8] had complicated, controversial lives amid inherited and self–inflicted distortions. The same was true with price controls that disaggregated crude oil into two crude oil tiers in 1974, three tiers in 1976, five tiers in 1977, and eight and then eleven tiers in 1979.

The intervention-begets-intervention story was true with a vengeance in the seven-year EPAA reign. The new law required that available crude oil be "equitably distributed" to U.S. refiners in volume and price (Bradley, 1996a, p. 1205). Yet multi-tiered oil price ceilings for domestic oil, coupled with non-regulated imports, created the opposite situation. Inland refineries tied to domestic oil capped at $5.25 per barrel in 1974 were greatly advantaged over coastal refineries paying the world price near $10 per barrel (Bradley, 1996a, p. 1206). This competitive distortion resulted in a major new regulatory program for refineries that began in early 1975. The *Old Oil Entitlements Program* required refiners with an average crude acquisition cost of less than the national average to write a monthly check to an oppositely situated refiner.

The entitlements "equalization" program was skewed from the beginning. A special provision, the *small refiner bias*, awarded "bonus entitlements" to refine low-cost oil that could be used or sold. This subsidization of small refiners, even "tea kettles," sized far below the optimum scale of plant, continued the same favoritism that existed under the MOIP and Nixon's oil allocation program.

A second program that distorted the crude equalization program was the special exemptions and exception relief given to refiners that demonstrated that their competitive viability was threatened under the program. Dozens of refineries, generally the most inefficient or just the most politically astute, were exempted from the entitlements program entirely or in part. But this was a zero sum game; for every winner there was a loser, and the losers were typically the largest and most efficient refiners (Bradley, 1996a, pp. 1209–1215).

The refiner entitlements program was the most visible and criticized program under the EPAA. Its distortions were well documented and skewered by applied economists (Arrow & Kalt, 1979; Kalt, 1981). A less visible regulatory episode grew up alongside oil price and allocation controls – the *oil reselling boom*. Some context is necessity for understanding what arguably was the most bizarre experience in U.S. regulatory history (Bradley, 1996a, pp. 707–710).

The nation suffered through several major petroleum shortages during the 1970s, but for much of the time supply and demand meshed despite price controls designed to "protect" domestic consumers from world oil prices. Why did U.S. consumers pay record-high oil prices – even the artificially inflated price of world oil – *despite* maximum price regulations at the wellhead and at all points downstream?

Part of the answer was well recognized by regulators and most energy experts. Domestic refiners were free to pay the world price to obtain much-needed crude supply – or the United States would, in effect, be embargoing itself. This put refiners in a position to *bid up* the price of unregulated oil that was mixed in with regulated (underpriced) oil so long as the average cost was what the market would bear in downstream markets. Such regulatory-induced averaging, which increased the cost of imported oil by an estimated 10% and 20%, negated some of the "benefits" of regulated oil for consumers (Kalt, 1981, pp. 286–287).

The oil-reselling boom involved taking price-regulated (underpriced) oil and reselling it until its price approached unregulated levels. A *regulatory gap* that energy planners could not plug allowed this to happen. Ceiling prices for crude oil or (post-refinery) oil products were set on a cost-plus basis where the legal price was a combination of verifiable costs and a "normal" profit. While physical transportation, refining, and retailing involved a limited number of markups, *resellers* could buy and sell the oil without limit. Oil traders sprang up with little other purpose than to buy and resell price-regulated oil until it reached its market-clearing level. Each reseller was subject to a maximum price based on its cost and allowed margin, but there was no law limiting the number of times a reseller could sell the oil back and forth ("daisy chaining") to make margins over many transactions instead of one.

Hundreds of resellers consummated hundreds of thousands of transactions with crude oil between the producer and refinery *and* with petroleum products between the refinery and retail outlets. The good news is that the resulting price increases kept motorists out of gasoline lines for the most part; the bad news is that domestic oil producers were prevented from producing an estimated one million more barrels per day (Kalt, 1981, p. 287). The revenue that would have gone to oil producers (and royalty owners) instead went to foreign oil producers and fly by-night resellers—some or many who became "regulatory millionaires." This was another example of what Israel Kirzner has labeled *superfluous entrepreneurship*.

Fig. 9 links together major interventions that marked the most federally regulated petroleum decade in U.S. peacetime history,[9] beginning with Nixon's wage and price control program and continuing until the repeal of the EPAA on January 28, 1981.

The original EPAA regulations covering 27 pages in the *Federal Register* in early 1974 were supplemented by over 5,000 pages of amendments in its first two years (Johnson, 1976, p. 297). In the seven years of the EPAA, noticed Joseph Kalt (1983, p. 98), there would be "no fewer than six different regulatory agencies and seven distinct price control regimes, each successively more complicated and pervasive." Even Edward Kennedy (D-MA), a longtime supporter of petroleum regulation, complained about the "outrageous weed garden of regulation" (Burt & Watts–FitzGerald,

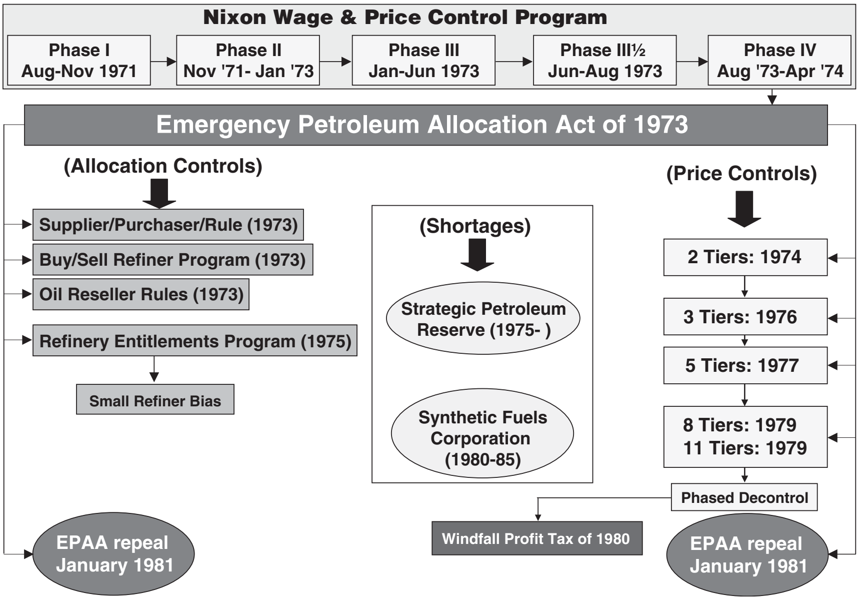

Fig. 9. U.S. Petroleum Regulation: 1971–1981.

1980, pp. 146–169). Other officials likened spiralling intervention to "Chinese water torture" (Yergin, 1991, p. 659).

The unprecedented peacetime exercise in cumulative intervention went far beyond the EPAA. Between 1977 and 1980, over 300 energy bills were considered in Congress. States considered many more. Dozens of state and federal laws mandated energy efficiency and conservation. Major federal laws created the *windfall profit tax*, the *strategic petroleum reserve*, and the *synthetic fuels corporation*. These interventions, in turn, created problems that necessitated modifying intervention and, in some cases, repeal. One journalist's comment was illustrative: "The troubled U.S. effort to build a strategic stockpile reflects a general frustration generated by the energy crisis: every solution to the problem seems to create tremendous problems of its own" (quoted in Bradley, 1996a, p. 1788).

The detail of oil and natural gas intervention in the 1970s can be simplified into its bare essentials as shown in Fig. 10. Gapism, as mentioned above, is the government's fix-it policy in the face of its shortage policy of effective maximum price controls. Gapism goes beyond allocation regulation that simply *manages* a shortage. Gapism is *regulation, taxation, and*

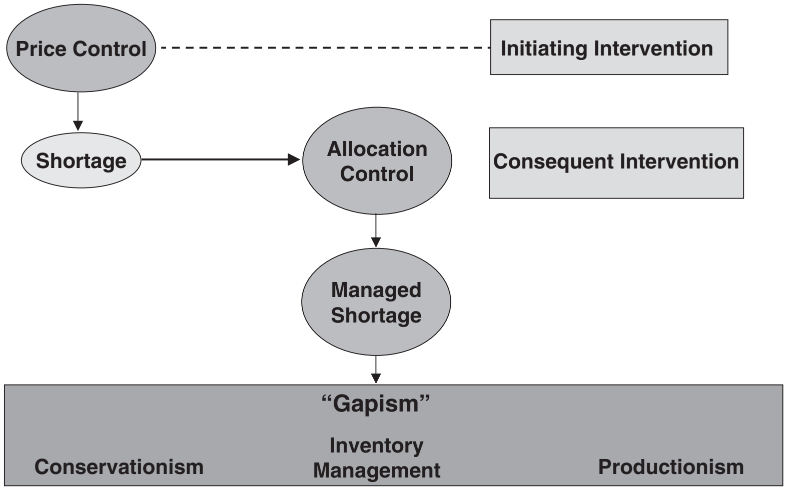

Fig. 10. Dynamics of Gapism.

subsidization that either increases supply, decreases demand, or constructs inventory.[10] Seen in this way, the illustration could apply to other goods and services that might fall under effective price ceilings.

7. CONCLUSIONS

The similarities between interventionism in the three distinct energy industries – gas, electricity, and petroleum – can be appreciated. Public utility regulation of gas, and electricity, and state conservation regulation of oil production, were all instigated by industry lobbying with the aim to tame free-market competition.[11] As economist Joseph Schumpeter recognized so well, competition, whether between few or many firms, was "an ever-present threat" that "disciplines before it attacks" (Schumpeter, 1942, 1962, p. 85) A buyers' market replaced a sellers' market as each industry matured, and political entrepreneurship supplanted, to one degree or another, market entrepreneurship. Once government intervention began, subsequent intervention proved necessary in an effort to make prior intervention work – a cumulative process that can be understood using an Austrian or process typology of interventionism.

Austrian political economy (Ikeda, 1997, p. 1) is an underutilized tool of history and aid to public policy formation. Great swaths of interventionism in the U.S. and other economies around the world remain to be interpreted and classified using the typology presented herein – or an improved one. U.K. economist Colin Robinson, for example, has noted a "law of increasing intervention" in British fuel policy attributable to "the unintended and unforeseen market effects which often follow from central intervention" (Robinson, 1971, pp. 9–10). What interventions were initiating and consequent? How many phases can be differentiated over time, and which were expansionary, contractionary, or neutrally amendatory? Where does the process stand today, and what lessons can be learned from this experience relative to other interventionist processes in different regions and time periods? Such questions are the beginning of a more formalized approach to comprehending interventionism that is a new frontier for Austrian economics.

The cumulative process of *prospective* intervention – such as current proposals to regulate greenhouse gas emissions to address the alleged human influence on global climate (Holdren, 1990) – can be considered. What is likely to be the initiating intervention? How will firms respond? How will regulators respond to business opportunism, even "superfluous entrepreneurship"? Will political forces restrict regulatory responses? Such a mapping, complete with competing scenarios, will inform the interventionist process in formation, quite possibly interject a cautionary note about launching an initiating intervention.

New and better history will result from the iterative process between theory and history facilitated by using an Austrian typology of interventionism. Such assemblage, within and across industries and political jurisdictions, could well improve our theoretical understanding – if only in the sense of better understanding the limits to pure theory in a kaleidoscopic world.

NOTES

1. These case studies of interventionism are general rather than exhaustive summaries. More detail for each is provided in my cited writings. Regarding local or state-level activism, each jurisdiction would have its own interventionist dynamic. This essay abstracts from this level of detail by identifying commonalities to singularize "local" and "state" before its link to federal regulation.
2. The adjective "neutral" should be interpreted to mean relatively to the other two categories, expansionary and contractionary, and not absolutely in the sense of not impacting economic in equal proportion. All government intervention has non-neutral effects on individuals and firms compared to its absence.
3. Federal regulation of wellhead natural gas prices since 1978, discussed below, is an example of a contractionary process.
4. The politics of oil and gas intervention is discussed in Bradley (1996a, Chapter 30).

5. This intervention can be described as much as enabling as initiating since the intervention itself was not directly in the gas industry but set up – or all but destined – gas industry intervention.

6. A schematic of gapism is shown in Fig. 10.

7. Great Plains would default on its $2 billion federal loan in 1986 amid falling natural gas prices; the federal Synthetic Fuels Corporation was terminated in 1985 after a five-year life.

8. The supplier–purchaser rule attempted to lock-in historical relationships between oil sellers and buyers between the wellhead and refinery and between refining and retail; the buy/sell program attempted to equitably allocate crude oil to refiners (Bradley, 1996a, pp. 674–676).

9. Federal petroleum regulation during World War I, World War II, and Korea can be interpreted through a dynamic typology of interventionism (Bradley, 1996a, pp. 1774–1775, 1779–1782).

10. The Strategic Petroleum Reserve is an example of inventory management with oil. Inventory management on a day-to-day basis would probably be subsumed under allocation regulation.

11. Industry or *internal intervention* can be contrasted with *external intervention* sought by parties outside of the industry. The great majority of energy intervention has been internal (Bradley, 1996a, pp. 1820–1851).

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THE DYNAMICS OF INTERVENTIONISM: A CASE STUDY OF BRITISH LAND USE REGULATION

Mark Pennington

1. INTRODUCTION

Over the last century, governments throughout the established democracies have increasingly sought to regulate land markets via all manner of interventions. Such policies have typically been defended on the 'market failure' grounds of orthodox welfare economics. Absent government action, it is argued, price signals will not be reflective of the relevant opportunity costs, owing to the prevalence of externality and public goods problems in the market for land.

The Austrian school of economics has, of course, long been sceptical of such claims. The epistemological case against government planning as originally set out by Mises and Hayek suggests that without a functioning market in public goods planners will lack the necessary information with which to 'get the prices right'. The result of intervention, therefore, is likely to be the creation of shortages and surpluses in the affected markets, which will then lead to demands for further government action in a cycle of progressively worsening intervention. In addition to such failures stemming

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from the absence of omniscience, scholars in the public choice tradition have pointed to the absence of benevolence as a further source of 'government failure'. Seen from this perspective, government action invariably creates special interest beneficiaries who will be resistant to the repeal of interventionist measures, however, inimical these may be to the general weal.

Given the widespread growth of government land use regulation the practical experience of land use planning should provide a useful testing ground to examine the political economy of interventionism. Land use controls should provide a particularly revealing instance of interventionist dynamics because, perhaps more than any other aspect of the regulatory state, attempts to balance competing demands for the use of land have immediate knock on effects in multiple different policy areas. This paper examines the experience of British land use regulation as a case study of interventionism. In doing so it offers a theoretical synthesis of 'Austrian' and public choice approaches and an empirical case with which to explore their relevance. While offering confirmation of the basic framework, the paper highlights the need for further theoretical development in order to account for the growth of land use regulation combined with the apparent retreat of the state in other policy fields.

1.1. The Dynamics of Interventionism

The classical liberal critique of interventionism posits two central tendencies that are considered inherent to all governmental attempts to control market processes – that intervention will fail to achieve its original objectives and that such failures will get progressively worse over time. There are in turn, two dimensions that underlie the tendency towards 'government failure' in this regard. The first, following the Austrian school, examines the epistemological deficiencies of intervention and the dynamics this sets in train, while the second drawing on elements of public choice theory, highlights the defective incentive structures that the process of intervention creates and tends to solidify.

1.2. Epistemological Dynamics

The epistemological argument against interventionism is a subspecies of the more general critique of government planning developed by the Austrian school and Mises and Hayek in particular (Mises, 1940; Hayek, 1944). Seen from this perspective, the failure of comprehensive government planning stems from its chronic inability to co-ordinate the multiple plans and actions of different individuals and organisations under conditions of complexity and uncertainty. According to the Austrian school, all human action involves unintended consequences – owing to the cognitive limits of the human mind individuals and groups cannot be aware of all the different ramifications of their actions both to themselves and the wider society at large. *The* central problem of social co-ordination, therefore, is to enable different individuals and groups to adjust their behaviour to circumstances and interests of which they are not and cannot be fully aware (Hayek, 1948a, b).

It is precisely in this vein that the 'spontaneous order' generated by market processes though 'imperfect', shows its superiority over government planning. In an unfettered market economy no exchange will take place unless both parties expect to benefit. In turn, the structure of relative prices that emerges from multiple acts of exchange enables people to calculate which goods are more or less scarce and to adjust their behaviour accordingly. Movements in the relative prices of land, labour and capital encourage consumers to shift from more to less expensive alternatives. Similarly, the signals of profit and loss indicate to producers the relative success of competing production plans in satisfying the requirements of consumers.

As Hayek (1948) argues, the price system enables people to adjust their behaviour to the plans of widely dispersed actors by communicating in condensed form the 'circumstances of time and place' including changes in tastes, entrepreneurial innovations and other context-specific factors that can never be comprehended in their entirety. For a government planning mechanism to achieve an equivalent level of co-ordination would require that those in the relevant authority be consciously aware of all the relevant facts necessary to co-ordinate all the components that form a complex economy. It is, however, the cognitive inability of planners to access the myriad changing circumstances affecting the behaviour of individuals and firms that prevents central planning of this type.

It is important to emphasise at this juncture that such problems apply equally to 'bottom-up' approaches to 'planning', which advocate pluralist politics as a way of securing adjustment between competing demands as an alternative to 'top-down' bureaucratic control. The information emergent from the interplay of interest groups, politicians and different government agencies is by no means equivalent to that generated from exchange relations in private markets (Wohlgemuth, 1995, 1999). In the latter, the structure of relative prices is constantly updated via the continuous buying and selling decisions of millions of individuals. Pluralist politics, by contrast, is far less continuous in its decision mode with no standard feedback mechanism between 'demanders' (voters and interest groups) and 'suppliers' (politicians and bureaucrats) in the period between elections. Moreover, the vote of someone who values a particular good very highly counts for no more than that of someone else who places the same good much further down her scale of individual values (Steele, 1992). Political actors, therefore, have no common denominator of changing relative scarcities equivalent to money prices and will produce decisions that are not reflective of underlying patterns of supply and demand (Mises, 1920; Hayek, 1948c). The misallocation of resources and the absence of an effective feedback mechanism to correct for such errors will be evidenced in the persistence of shortages and surpluses across the political economy.

From an Austrian perspective, policies that attempt to control or steer individual markets in accordance with government determined objectives will be subject to the same epistemological deficiencies as attempts to plan the pattern of production and consumption across the economy as a whole (Mises, 1940; Burton, 1984; Ikeda, 1997). The logic of interventionist politics involved in measures such as price control or product regulation is the imposition by political authorities of terms that would otherwise *not* be agreed upon by parties to a voluntary exchange. As a consequence, the range of options people are willing to offer one another is reduced and the market no longer communicates the full spectrum of available opportunities for exchange (Holcombe, 2002). The use of force is crucial to an 'Austrian' understanding of interventionism in this regard. Owing to the epistemological problems outlined above the government and those seeking to influence it via the political process *cannot* be aware of the 'circumstances of time and place' that are known *only* to those willing to enter a *voluntary* exchange. The result of coercive intervention in the market economy, therefore, will be unmet demands or unsold supplies in the areas afflicted by government action.

A secondary aspect of the Austrian analysis is that interventionist measures will become more widespread over time as governments respond to initial policy failures by seeking a further extension of their powers (Mises, 1940; Burton, 1984; Ikeda, 1997). Because the market economy is a complex network of inter-connected exchanges, the negative effects of intervention in one area will ripple out into related markets and eventually may permeate the entire economic system. Thus, interventions in one area beget interventions elsewhere, in what becomes an increasingly complex web of controls and subsidies across a range of interconnected markets. As interventions spread throughout the economy, co-ordination failures epitomised by shortages and surpluses multiply because the different branches of government are unable to trace the original source of the problems with which they are dealing. Without the continuous feedback provided by a flexible set of relative prices and profits/losses, there is no effective mechanism to transmit information about circumstances and interests *which cannot be directly observed* and to facilitate mutual adjustment between the often contradictory policies carried out by different government departments.

1.3. Incentive-Based Dynamics

The 'Austrian' critique of interventionism makes no assumptions about the motivations of those involved in the decision process, but points instead to the insurmountable problems involved in co-ordinating the plans of dispersed actors in the absence of market-generated prices. Public choice theorists, by contrast, and especially those of the Virginia school argue that interventionism creates special interest beneficiaries who resist attempts to repeal ill-judged policies, however much these damage the public weal (Buchanan & Tullock, 1962; Olson, 1982; Tullock, 1989, 1993; Mitchell & Simmons, 1994). From the perspective of public choice theory political actors are not 'economic eunuchs' concerned to maximise 'social welfare', but instead are purposeful actors pursuing individual self-interest. The character of the interventionist process, therefore, must be analysed in terms of the incentive structures that this process generates.

While the Austrian critique of interventionism is conceptually distinct from the analysis of political self-interest put forward by the Virginia school of public choice, in practice these arguments are closely linked. It is as a consequence of the insuperable problems involved in knowing the content of the 'public interest', that individuals operating within the political process act according to those interests that they do actually know, i.e. their own and those of their immediate circle (Boettke, 1995; Boettke & Lopez, 2002). The latter point, it should be emphasised applies equally to those driven by what might be considered non-material and even altruistic motives as it does to those pursuing pecuniary gain and more narrowly 'self-interested' concerns. Hayek (1944, p. 61) makes this point especially clear in his discussion of the 'single-minded idealist' which is worth quoting at length.

> In our predilections and interests we are all in some measure specialists. And we think that our personal order of values is not merely personal but that in a free discussion among rational people we would convince others that ours is the right one. The lover of the countryside who wants above all that its traditional appearance should be preserved…less than the health enthusiast who wants all the picturesque but insanitary cottages cleared away, or the motorist who wishes the country cut up by big motor

> roads, the efficiency fanatic who desires the maximum of specialisation and mechanisation no less than the idealist who for the development of personality wants to preserve as many independent craftsmen as possible, all know that their aim can be fully achieved by planning – and they all want planning for that reason. *But, of course, the adoption of social planning for which they clamour can only bring out the concealed conflict between their aims"* (emphasis mine).

In the market economy, individuals are informed *indirectly* by the price system of and may adjust their behaviour to, the conflicting demands of others (however, motivated) who they may never meet and of whose interests and values they *cannot be directly aware*. In a political environment devoid of price signals, by contrast, the *only* information that people can draw upon when choosing how to act is that of their immediate personal interests and the incentives to pursue these provided by the democratic polity. These incentives are of a fundamentally different character to those in a market economy with secure rights of property. Market processes are based on voluntary exchange and provide incentives for individuals and firms to come to mutually agreeable terms because no exchange will take place unless both parties expect to benefit. In the institutional arena of majoritarian politics, however, access to the coercive power of the state allows some actors to impose their preferences and to extract resources from others who would *not* have voluntarily agreed to such terms. As a consequence, securing access to the state becomes *the* central object of political competition (Holcombe, 2002; Olson, 2000).

It is in the specific context of democratic political competition that the incentives for special interest control, highlighted by public choice theorists, come firmly into play. Whereas, co-operation in the market economy is based on individual acts of voluntary exchange, co-operation in the political process requires collective action. The incentives for collective action, however, differ depending on the specific character of the interests concerned. Ceteris paribus, groups with a smaller potential membership (such as producer lobbies, or those intensely committed to a 'cause') find it easier to overcome the transaction costs of organisation and mobilise incentives against those who may be tempted to 'free ride' on the actions of the group. Larger, more diffuse interests (such as consumers and taxpayers) on the other hand, may find the benefits of successful action so discounted by the irrelevance of an individual to supply that it is seldom worthwhile to join such a group (Olson, 1965). Politicians and bureaucrats concerned to maintain their own power will, therefore, be more likely to respond to the demands from concentrated interests at the expense of larger, diffuse interests that remain chronically unorganised.

Unfettered market processes are, of course, far from 'perfect' and are subject to inefficiencies associated with the existence of externalities. Markets, however, do at least provide incentives to internalise costs *over time* and to remove inefficiencies by offering rewards to those successful at bringing the relevant values within the realm of voluntary contract. *Any* case of external benefits/costs provides a profit opportunity for an entrepreneur who can define property rights and contracts so that those currently 'free-riding' on collective goods or imposing negative external effects on their neighbours (e.g. pollution) are required to pay for the benefits concerned.

The logic of democratic politics, by contrast, is to *externalise* costs. Because the political process is based on majoritarianism and coercion rather than voluntary exchange, there are *always* opportunities for majority coalitions to use the apparatus of the state to extract transfers from and to impose costs on other sections of the electorate (Holcombe, 2002; Olson, 2000). The inevitable result is the creation of a 'Hobbesian dilemma', where no interest group has an incentive to desist from using the state apparatus as a source of coercive gain, because to do so would leave the field open for rent seeking by the less scrupulous (Barry, 1984; Burton, 1984). It is the persistence of such rent seeking behaviour combined with the epistemological deficiencies of interventionism outlined earlier that have become the hallmarks of the British system of land use regulation and it is to this system that attention now turns.

2. BRITISH LAND USE REGULATION AND THE DYNAMICS OF INTERVENTIONISM[1]

2.1. Land Use Regulation in Britain

The British system of land use regulation is one of the most comprehensive of such systems anywhere in the industrialised world. Following the 1947 Town and Country Planning Act, virtually all non-agricultural land uses have been subject to a requirement to obtain planning permission as a direct consequence of the nationalisation of development rights. Anyone wishing to develop their property must apply for planning permission to a local authority, which must decide the application on the basis of a land use strategy, which must itself be approved by the central government agency responsible for the planning system as a whole (currently, the Office of the

Deputy Prime minister). The magnitude of the changes wrought by the introduction of this system is captured by two leading planning lawyers,

> It is impossible to exaggerate the importance of July 1st 1948 from the viewpoint of the local planning authority, the landowner, or the building developer, for the 1947 Act conferred some of the most drastic and far reaching provisions ever enacted affecting the ownership of land and the liberty of the owners to develop and use his own land. Indeed, after 1947 ownership of land carries with it nothing more than the right to go on using it for existing purposes." (Grant & Heap, 1991, p. 18).

The initial intent of the post-war planning framework was to establish an apparatus of central economic control, with economic development and environmental protection issues dealt with via an 'integrated system' of 'strategic planning' wherein local government agencies would implement plans prepared at the national and regional levels (Cherry, 1996; Deakin, 1985). The framers of the 1947 legislation had assumed that the state itself would become the dominant actor in the development process with local authorities purchasing land for development as required. Under this system, however, property owners were to receive none of the gain resulting from the appreciation of their assets when government authorities purchased property or planning permission for private development was granted. Rather, a 100% 'development charge' was to be levied on all such 'windfall gains'.

The above provisions effectively removed any incentive for landowners to part with their property and combined with the financial constraints on local authority land acquisition brought about by burgeoning public sector spending deficits in the aftermath of the war, were thought to be stifling the required level of urban re-development (Cherry, 1996; Deakin, 1985). As a consequence, the incoming Conservative administration of 1953 re-established market value as the basis for land transactions, the development charge was abolished and the private sector resumed a lead role in the process of building and construction. While subsequent Labour administrations re-introduced a substantial development land tax (as with the Land Commission Act of 1967 – revoked by the Conservatives in 1971), this was never at the punitive levels introduced under the initial 1947 town planning legislation. For the bulk of the post-war period, therefore, the British system of land use planning has operated as a 'mixed economy' system, which has sought to guide and regulate private sector development rather than supplant the operation of the land market per se. Within this context, the principal mechanism used to shape the pattern of land use has been the designation of special environmental sites such as Green Belts and Areas of Outstanding Natural Beauty. Designations of this sort aim to minimise 'urban sprawl' and to ensure an appropriate balance between the competing demands of environmental protection, industry, agriculture and residential development.

2.2. Epistemological Dynamics

A primary implication of the Austrian critique of interventionism is that such policies will fail to achieve their desired objectives owing to fundamental epistemological problems facing the 'interveners'. In the case of the interventions wrought by the British system of land use control such deficiencies and the policy responses to them have been notably apparent in terms of environmental protection. The effects of green belt policy in particular, highlight the inability of planners to judge the environmental opportunity costs of alternative land use decisions in the absence of market-generated prices.

Green belts operate as an effective ban on development within the designated areas and have been adopted widely in the post-war era in an attempt to restrict the outward growth of urban areas and to protect aesthetically attractive sites within easy reach of the major cities. As a blanket ban on development, however, these policies pay insufficient attention to the huge variations in environmental quality that occur *within* the designated zones and have often shifted development pressure to more environmentally sensitive sites *beyond* them (Herington, 1990; Simmie, 1993). The London green belt, for example, while including chalk down-land and wooded hills also contains large tracts of low-grade agricultural land alongside disused gravel pits and quarries. While the latter are 'protected' from development by their green belt status, pressure for new building mounts in potentially more attractive and more valued sites in the rural areas outside the green belt. Similar problems have been manifested at the national level with some of the less prosperous parts of the country, where more development might actually be welcomed (in the North and North West, for example), actually having the highest percentages of green belt land (Simmie, 1993).

Co-ordination problems of the above ilk stem in large part from the inability of regulators to allocate land to the most appropriate uses in the absence of market prices. Insofar as land use regulations are introduced via administrative fiat and are not purchased from landowners for a price (as would be the case were controls organised contractually via restrictive covenants, for example) then price signals indicating variations in environmental quality relative to development pressure are lacking. As a consequence, the environmental objectives of policies such as the green belt may not be satisfied. Areas of low environmental quality and relatively low development pressure appear to have been subject to 'excessive regulation', while those exhibiting high environmental quality and intense development pressure may not have been regulated sufficiently.

Environmental objectives have been further compromised by the interaction of land use planning policies with other interventionist measures and in particular the subsidisation of the agriculture sector, initially under the provisions of the 1947 Agriculture Act, and since 1973 by the European Common Agricultural Policy. The latter has had a disastrous environmental impact with subsidies encouraging the spread of intensive farming techniques onto otherwise marginal lands with a concomitant loss of habitats and species (Bowers & Cheshire, 1983; Winter, 1996). Green belts and other land use designations, therefore, in so far as they have acted to 'conserve' the countryside, have done so for the depredations wrought by subsidised agri-business (Evans, 1991).

As the theory of interventionism suggests the response of policy-makers to such failures has been to seek a further extension of regulatory controls in order to 'correct' for the errors brought about by the initial policy intervention. In the case of green belt policy, the response of planners to the 'leapfrog' effect, which has shifted development to more environmentally sensitive areas, has been to extend environmental designations to these areas as well. Thus, during the 1980s (the supposed heyday of Thatcherite de-regulation) the area of land designated green belt increased by 147% from 1.7 to 4.2 million acres to account for 14% of the land area England and Wales (Cullingworth & Nadin, 1994). The wider effect of this tendency has been a steady increase in the proportion of the UK land area, which is covered by environmental instruments, such that at present over 50% of land is subject to one or more statutory controls. As the number of official site designations multiplies, however, these become increasingly useless as environmental protection tools, with no effective mechanism to differentiate vast discrepancies in environmental quality that occur within the designated zones.

A similar policy response has been evident in terms of the negative effects on economic development prospects in those parts of the country, especially in the North that may have been subject to an excess of environmental controls. In this instance, rather than liberalising the green belts around economically depressed cities such as Liverpool and Newcastle, the favoured option has been to 'pump-prime' these areas with all manner of subsidies and grants in an attempt to stimulate development. Initially such policies targeted subsidies to those industries and firms willing to locate away from the congested South East. The failure of such policies in the 1960s and

1970s, however, has now led to an alternative approach focused on changing the image of the older industrial cities via substantial programmes of urban renewal. In the agricultural realm meanwhile, rather than reducing the subsidies that have been responsible for excessive intensification, policy-makers have responded by introducing a competing set of subsidies, *on top* of the pre-existing agricultural support, which aim to encourage farmers to adopt conservationist measures.

Not surprisingly, the inability of regulators to allocate land effectively with regard to environmental protection objectives has also had ripple effects in related aspects of the land market and in particular the market for residential land. Without prices highlighting variations in the demand for environmental quality in relation to the demand for new homes, planners have been unable to balance these competing demands on land use. As already noted, green belts and equivalent controls prevent land that might be environmentally suitable for development from being brought into use and divert pressure towards more environmentally sensitive areas. As policy-makers have responded to such problems by extending land use designations still further, however, progressively smaller amounts of land have been allocated for residential development. The rate at which land transfers from agricultural to urban uses has declined from 15,000 Ha in the 1950s, down to 10,000 Ha in the 1970s, 5,000 Ha in the 1980s and approximately 3,000 Ha in the 1990s.

Thus, agricultural land, often exhibiting relatively low environmental quality has been prevented from transferring to urban uses and the government continues to pay farmers to produce food which no one wants to buy, while simultaneously, chronic shortages of housing land persist throughout much of the country.

The imbalances brought about by such policies are readily apparent in a comparison of the price differentials that have emerged between land allocated with permission for housing development and that for land which has been zoned for agricultural use. Table 1 displays the scale of these discrepancies in four different areas of England. The effect appears to be most pronounced in South East England (Reigate and Wokingham) where agricultural land prices are a tiny fraction of housing land prices. Even in the less prosperous North of England, however, (Beverley and Barnsley), planning controls have constrained the supply of housing to such an extent that the price of housing land far exceeds its agricultural value.

That government land use planning is largely to blame for chronic housing shortages is indicated in stark form by historical data gathered by Cheshire and Sheppard (2002). In the 50 years following the 1947 Town and

Table 1. Housing Land and Agricultural Land Prices in Four British Case Studies, 1975–1990.

	Housing £ per hectare	Agriculture £ per hectare	Agricultural as a % of Housing
Reigate			
1975	75,000	1,620	2.2
1990	972,000	4,940	0.5
Wokingham			
1975	67,000	1,980	3.0
1990	1,070,000	6,790	0.6
Beverley			
1975	19,000	1,750	9.2
1990	480,000	4,940	1.0
Barnsley			
1975	27,000	1,450	5.4
1990	210,000	6,180	2.9

Source: Gerald Eve Consultants and Cambridge University Department of Land Economy (1992, p. 26).

Country Planning Act, the real price of land for housing has risen by between 600% and 700% and during the boom of the late 1980s and the current housing boom, prices have been as much as 1300% above their 1947 levels. These increases have not been matched by any other sector of the British economy (with the possible exception of the wages paid to football stars) and have typically ran at between two and three times the general rate of inflation (Evans, 1991).

The magnitude of the price increases cannot simply be attributed to the effects of a growing population and rising demand stemming from rapidly improving living standards. Similar rises in living standards occurred during the previous era of a relatively unfettered market system that prevailed until the 1930s. As Cheshire and Sheppard point out, from 1892 to 1931, despite an increase in the number of households of 61% and substantial growth in real incomes, the real price of land actually fell.

Throughout this period, the market was able to respond to increased demand in precisely the way that one would expect, with transport improvements such as railways and latterly car use, increasing the effective supply of urban land to match the growth in demand.

It is evident, therefore, that the principal cause of rapidly accelerating house prices and the increasing inability of even middle-income groups to afford access to housing space has been the continued extension of regulatory controls on land use. Again, however, rather than address the 'planning failure' at root, the policy response has been to seek further regulatory intervention to address what are often depicted as 'market failures'. In the current context, the 'New Labour' administration has sought to tackle the 'failure' of the market to supply affordable housing, by direct interventions in the housing market itself. Rather than liberalise the market and allow an increase in the supply of land for housing a policy of providing subsidised 'affordable' homes targeted at middle-income (and often public sector) professionals such as nurses and teachers (described as 'key workers') has been introduced. This particular policy is likely to be counter-productive and to bring forth calls for yet more intervention. At a time when housing is increasingly scarce owing to excessive planning controls, lower prices for 'key workers' will encourage the additional consumption of housing space. On the supply side meanwhile, government mandates to provide such 'affordable housing' will discourage developers from increasing supply at an appropriate rate. The result, therefore, is likely to be a still wider discrepancy between the supply of and the demand for housing space.

2.3. Incentive-Based Dynamics

The continued epistemological problems of land use intervention discussed above are in part a reflection of the unwillingness of politicians to consider deregulatory alternatives owing to the power exerted by a variety of special interest beneficiaries. Interest group politics has long been a key element in shaping the policy contours of the planning system, with agricultural, amenity and building interests all competing for control of the regulatory apparatus. The power of the agricultural interest was immediately apparent in the early days of the new planning system when in stark contrast to urban uses such as housing and retail, agricultural developments were excluded from the need to obtain planning permission (Howarth, 1990; Pennington, 1996). Nonetheless, it would be unwise to entirely attribute the 1947 legislation *itself* to rent-seeking behaviour, given the overwhelming importance at the time of ideological support within ruling elites for widespread state intervention. What may be said with confidence, however, is that the policy framework instituted by this climate of ideas created a set of special interest beneficiaries, which have proven extremely difficult to dislodge owing to the incentive structure instituted by the planning regime.

As noted above, agricultural interests have been important beneficiaries of land use regulation. Tenant farmers, in particular, as represented by groups such as the National Farmers Union gained in a substantial way from the initial planning legislation, which redistributed development rights away from landowners and combined with the policy of agricultural support guaranteed the incomes of farmers. Prior to the 1947 legislation, tenant farmers were in a precarious position with the encroachment of urban land uses such as housing into rural areas often resulting in landowners issuing a notice to quit (Newby, 1985). Land-owning farmers meanwhile have been largely compensated for their loss of urban development rights in the post-1947 era by farm subsidies which have to a significant degree made up for their lesser ability to diversify out of agricultural production. As a consequence, the farm lobby has come to represent a powerful political force to maintain subsidised agricultural uses and has often blocked moves to liberalise the market in land (Evans, 1991).

The second and perhaps the most important set of special interests involved in the process of land use regulation, are constituted by the local amenity or 'nimby' lobby (see, for example, Shucksmith, 1990; Simmie, 1993). These groups, eager to protect local environmental amenities such as scenic views, and the property values that go with such assets are keen to prevent any development from taking place 'in their backyard' and have been empowered by the process of land use planning in the pursuit of such aims. In more recent years, parochial groups of this genre have also been joined in coalition by an increasing number of 'idealist' environmental activists seeking a more general halt to the process of urban development in rural areas.[2]

The restrictions on land use that are demanded by environmental groups are provided as an essentially 'free good' to those able to organise sufficient political clout. While some commentators regard controls such as green belts as equivalent to the restrictive covenants that might emerge under private contractual planning as Fischel (1985) observes, the crucial difference is that under the latter a financial price must be paid for the exercise of controls over other peoples' property. This position is equally the case when a developer imposes covenants on buyers of new residential lots. In this case, the price paid by the developer is the opportunity cost of allowing land to be used for some activity not permitted in the covenant. Since it is developers/landowners who are attempting to maximise the value of their assets under such a system they are led to at least consider the alternative uses to which their land might be put. Consumers of amenity values meanwhile are required to pay developers for land use controls such as covenants and are as a consequence faced with the immediate cost of the level of regulation they are demanding (Pennington, 2002).

Under the British planning system, by contrast, organised amenity interests are able to transfer de facto property rights for amenity values to themselves via the processes of interest group participation. The interests of those consumers who might benefit from additional levels of residential development are seldom if ever represented in such processes because they do not constitute a readily identifiable, site-specific group that can easily be mobilised (many will not even be resident in the areas concerned). As a consequence, regulations are 'supplied' to amenity interests at a 'price' which does not necessarily reflect the relevant opportunity costs and as a consequence the planning system is characterised by a pronounced anti-housing bias. Thus, evidence from the local planning process suggests that over 60% of the changes brought about by public participation result in reduction in the amount of new housing development proposed as against a mere 13% were development targets are increased (Adams, 1995). These processes are especially pronounced within designated areas such as green belts, where between 90% and 100% of planning applications are refused.

A third set of special interests to benefit from land use intervention has been the building and construction lobby. Developers favour a greater level of land release than either the agricultural or amenity lobbies, but it would be a mistake to view the building interest as supporting levels of development that might be feasible in a land market free from government controls (Evans, 1991; Rydin, 1986). On the contrary, the granting of planning permission confers a monopoly right on developers as other potential development sites are effectively excluded from the market. In such a situation, the larger corporate developers favour a controlled system providing permission to develop their own land while restricting access to potential competitors. Small firms in particular often find it difficult to access land with planning permission owing to their lesser ability to pay the often substantial rent seeking costs involved in hiring the necessary consultants and lawyers. Larger firms are able to afford a greater number of planning applications to spread the associated risks, a situation reinforced because the costs of application do not increase proportionately with the size of a development. The cost of planning permission for a development of 500 homes is lower per house than the cost of permission to build five homes. It is probably for this reason that the system tends to operate via the occasional 'drip feed' of a few large sites contained within the portfolios of corporate developers, rather than the release of a larger number of smaller plots owned by the smaller house-building concerns.

The planners who operate the system and who have a powerful budgetary stake in expanding the scope of the regulatory regime represent a final set of interests. Between 1962 and 1992 real expenditure on town and country planning in England and Wales increased by over 600%, a rate of increase three times the rate of real growth in the economy over the same time period. Neither does it seem that expenditure increases of this magnitude have been matched by improvements in the productivity of the relevant bureaucratic procedures. While total real spending on land use planning increased by over 600% between the 1960s and 1990s, the number of development applications processed by regulators increased by a mere 28% over the same period (Pennington, 2000, p. 103). Indeed, at one point in 1981 planning bureaucrats were actually processing fewer applications than in the early 1960s even though the intervening years had witnessed a real spending increase of 500% at that point in time (Pennington, 2000, p. 104). The difference between these figures must be accounted for, at least in part by the increasing bureaucratisation of the planning system and a process of rapid cost escalation fuelled by the planners themselves.

It should be evident that the interests gaining most from interventionism all favour a tightly controlled system which prevents the flexible transfer of land from one use to another; the agricultural lobby, because of the protection granted to subsidised farming; the amenity lobby because of the exclusionary protection afforded to local environmental assets; the construction lobby because of the barriers to entry raised within the building industry; and the planners themselves, because of the rents generated from the administration of ever more complex regulatory procedures. All of the above is readily explicable in terms of public choice theory, with a combination of producer lobbies, monopoly bureaucrats and site-specific amenity interests able to organise collectively to defend the rents they obtain from the planning regime. Equally predictable, is the inaction of the consumer interests who lose most from the process of interventionism. These are the individuals too numerous, too weak in terms of identity and with too small a stake to act collectively in order to challenge the status quo.

3. IMPLICATIONS FOR THE THEORY OF INTERVENTIONISM

The analysis thus far suggests that the British system of land use regulation exhibits the classic features of an interventionist regime. On the one hand, the process of intervention is afflicted with a variety of epistemological and co-ordination problems, while on the other the parameters of intervention are reflective of an incentive structure that allows special interest forces to extract rents from the policy regime. What though does the British experience with land use controls suggest in terms of where the process of interventionism is likely to lead in the longer term?

Broadly speaking, there are two schools of thought within the classical liberal tradition that have sought to explicate the longer-term trajectory of the interventionist process. The first of these owes much of its inspiration to Hayek's *Road to Serfdom* thesis and suggests that in the long run interventionism is a profoundly unstable institutional form. According to this view, the dynamic of the interventionist process suggests a move either towards a fully planned economy as the network of controls and regulations spreads inexorably throughout the whole of society, or faced with the prospect of totalitarian control, a reversion to a more or less market-driven system. The second view, by contrast, suggests that interventionism can reach a sort of equilibrium state somewhere between the opposing poles of the free and the centrally planned economy. Seen through this lens, while interventionism may well be inefficient it is, at least to some degree, a self-checking process because none of the special interests involved has the desire for controls to spread to the point where private ownership of the means of production is suspended in its entirety.

The British experience with land use planning fails to offer conclusive support for either of these theories, though on balance the evidence suggests somewhat more support for the second interpretation. While British land use controls do represent an ever more complex set of contradictory policies, after over 50 years of interventionist measures there is no indication that private ownership of land is about to be abolished and replaced with a regime of central control. Indeed, to some extent, the post-war experience of land use planning may be interpreted as a road *from* serfdom, and *towards* interventionism.

As noted earlier, the original intent of the 1947 legislation was to introduce a system of state-led urban development, with any gains from the private ownership of land subject to a 100% development tax. It was, however, the obvious failure of this system to deliver the necessary reconstruction, combined with substantial opposition from property owners that led to the progressive abandonment of socialist notions in this regard. The abolition of the development land tax by the Conservatives in 1951 and the restoration of the private land development market was, rather akin to Lenin's famed 'New Economic Policy'. Faced with the chaos wrought by central planning, the Bolshevik leader re-introduced private property in the agricultural sector in order to avert total economic collapse, though never returning to a fully market-driven system.

To some extent, the policy shifts away from complete nationalisation and towards interventionism in the case of land use mirrors a more general trend in the wider political economy of the British State over the post-war period. Much of this era can be interpreted as witnessing a gradual movement away from the comprehensive nationalisation programme of the war, furthered by the Atlee government in the immediate post-war years, towards a model of interventionism. While this process has not proceeded without interruption (the Labour administration of the late 1960s engaging in a further bout of nationalisation), the general direction has been *away* from *outright* state control, a movement, which gained momentum following the election of the Thatcher administration in 1979. The political economy of Britain, therefore, has seen a retreat of the state from the realm of direct ownership combined with the simultaneous extension of a complex network of interventionist regulations on the one hand, and the maintenance of a large transfer-based welfare state on the other. During the tenure of the Thatcher administration, for example, while the majority of nationalised corporations were privatised and subject to increased competition, this did not mark a complete withdrawal of the state from the economy. On the contrary, the 1980s witnessed the continued growth of the regulatory state, exemplified by expenditure increases on land use planning running at three times the rate of growth in the wider economy, combined with the continuation of an extensive redistributionist welfare regime.

These seemingly contradictory movements in state development are probably best explained by a public choice dynamic. A case can be made that co-ordination failures associated with outright nationalisation and exploitation of taxpayers and consumers by special interests in state monopolies have proven to be much more visible to the general electorate than is the case with alternative forms of state activity. In turn, it is the very visibility of nationalised industries that has provided opportunities for political entrepreneurs such as Mrs Thatcher to garner a sufficient degree of electoral support in favour of privatisation and de-regulation in these particular fields.[3]

By contrast, there continue to be powerful incentives for politicians to favour *alternative* forms of state involvement in social and economic affairs. The continued popularity of a transfer-based welfare state may best be explained by the capacity of the large ‘fiscal interest groups’ (such as pensioners) created by welfare policies, to swing the result of an election and thus to form the focus of political competition (Burton, 1984). Although frequently lacking formal organisation as interest groups, the income of such constituencies is often disproportionately affected by the actions of the state and they may be willing to switch political allegiance accordingly. These groups are, in their capacity as taxpayers, the principal 'donors' into welfare schemes and it is the tension between the conflicting roles of 'donor' and 'recipient' that may account for the oscillation between alternate bouts of enthusiasm for higher or lower taxing and spending that often characterises such regimes.

With regard to interventionism on the other hand, it is the very complexity and lack of transparency characteristic of cross-cutting regulatory controls that enables politicians to disguise their attempts to gather support from coalitions of organised interests while dispersing the costs across a largely unsuspecting electorate. Seen in this light, interventionism provides a particularly attractive coalition-building strategy for political entrepreneurs with no apparent limit to the opportunities available to disguise the transfer of income to rent seekers. The question remains however, is the process of interventionism itself likely to mutate into a more comprehensive form of state control, as an unintended consequence of responding to the demands from organised interests?

Barry (1984) has argued that there is *no* inherent tendency for interventionism to lead down a 'road to serfdom', because it does not pay for any of these groups to eliminate the private property 'goose' that lays the golden egg, ripe for subsequent exploitation. Burton (1984), however, has countered by pointing out that while it is irrational for rent seekers *collectively* to follow such a route, it *is* rational for each *individual* interest to continue rent seeking beyond the collectively optimal point. Access to the regulatory state constitutes a prisoner's dilemma, where the optimal strategy for each interest is to 'free-ride' *irrespective* of whether the other groups co-operate in limiting predatory behaviour. If a group co-operates while the others continue rent seeking then it will impose costs on itself, which will not be matched by any overall gain. If, on the other hand, a group continues rent seeking while other groups co-operate, then it can reap the benefits of the restraint observed by others. All groups, therefore, would benefit from limiting the extent of their demands, but no group has sufficient incentive to do so on its own. In the specific context of interventionist politics, the result of this particular 'tragedy of the commons' is likely to be the complete destruction of private property and the market economy.

Evidence from the British experience of land use controls fails to offer conclusive support for either of these theories. As the continued extension of controls documented in this paper has shown, there is little to suggest that the relevant interest groups are seeking voluntarily to limit the extent of their demands. Burton's thesis, therefore, seems accurate in that the process of rent seeking is *not* self-limiting. Equally, however, there is little evidence from British land use planning to suggest that the absence of restraint in rent-seeking behaviour leads down a road to total state control. The most plausible explanation for this is that there are *always* likely to be *some* majority coalitions of interest groups that favour at least a degree of private ownership in certain areas. The latter does not require some collective recognition of the need to exercise restraint, as the Barry thesis would seem to imply. Rather, it may occur because certain acts of rent seeking may actually involve an attempt to *defend* private ownership rights *against* demands for further state encroachment.

In the instance of British land use planning the classic example of the above is witnessed by the actions of the land-owning segment of the agricultural lobby. The latter have vociferously resisted any attempt to extend the provisions of the post-1947 planning legislation to cover agricultural as well as urban land uses. Environmental interest groups have frequently sought an extension of planning controls to cover agriculture in order to limit the effects of subsidised farming on sensitive habitats. The farm lobby has, however, succeeded in resisting such demands and has managed to obtain an additional raft of subsidies to encourage conservationist measures, *on top* of the existing level of farm support (Evans, 1991; Pennington, 1996, 2000). Thus, while the process of interventionism is not, strictly speaking, self-limiting, neither does it necessarily lead down a road to complete state control.

4. CONCLUSION

This paper has sought to explore the dynamics of interventionism in the case of British land use planning from a combination of 'Austrian' and public choice perspectives. In doing so, the analysis offers support for the basic propositions of the classical liberal account. First, it suggests that intervention, however benevolent in intent, is fraught with systematic co-ordination problems. Second, it suggests that the incentives created by the instigation of an interventionist regime facilitate a process of special interest capture. Where the analysis, does however, part-company with existing theories is in questioning the dichotomy between those accounts that emphasise the self-limiting character of the interventionist process and those that suggest an inexorable tendency towards total state control. British experience of land use controls would seem to suggest that interventionism is *not* a self-limiting process, but neither does it necessarily lead down the *'road to serfdom'*.

From a classical liberal perspective, however, the implications are scarcely less depressing. They imply that in the absence of a massive ideological shift the inefficiencies associated with interventionist politics may persist indefinitely.

NOTES

1. The empirical evidence on which much of this section is based, draws on a comprehensive book-length analysis of the British land use planning completed by this author (see Pennington, 2000) as well as the other sources referenced in the text. See also Pennington (2002).

2. For a more detailed account of the incentives and motivations which enable different types of environmental interest groups to overcome the 'logic of collective action', see Pennington (2000, pp. 72–81).

3. This pattern has also been evident under the 'New Labour' administration elected in 1997. While less radical in its approach than the previous Conservative government, the Blair administration's reform efforts have focused on the remaining state monopoly preserves of education and health, where some attempt is being made to introduce an element of competition into service delivery. Elsewhere, however, regulation continues to grow apace, while a substantial expansion of welfare payments has occurred.

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HARM REDUCTION AND SIN TAXES: WHY GARY BECKER IS WRONG

Mark Thornton

1. INTRODUCTION

Much progress has been made in public opinion regarding drug prohibition. The policy has been an utter failure, very expensive, and increasingly disliked by people around the world. As a result, several states have passed drug reform legislation that reduces penalties for the production, distribution, and consumption of previously prohibited substances such as narcotics and marijuana. Other states have placed more resources in drug treatment programs (demand reduction) instead of drug interdiction efforts (supply reduction). In North America, several states in the US and Canada have passed medical marijuana legislation to take advantage of the well-known medical benefits of marijuana (Piper, Matthew, Katherine, & Rebecca, 2003).

The advocates of drug policy reform generally promote the idea of "harm reduction." This approach to reform rightly sees prohibition as a failed and highly destructive policy. Their "harm reduction" approach involves removing some elements of prohibition and replacing them with a variety of other policies, with the goal of reducing both the harm of drug prohibition and drug abuse. Their proposals typically include such measures as anti-drug education in the public schools; public service announcements warning

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against drug use; subsidies for drug treatment; drug maintenance and substitution programs (e.g., methadone); regulations on production, distribution, and consumption; restrictions on selling to minors; commercial zoning restrictions; advertising restrictions; and heavy excise or "sin" taxes.[1] Harm reduction proposals replace one set of government interventions with another and are sometimes referred to as *neoprohibition*.[2]

A prominent advocate of drug law reform is Gary Becker, a leading authority on the economics of addiction and proponent of the "legalization" of drugs. As a member of the prestigious Department of Economics at the University of Chicago, he is certainly one of the most innovative economists of his generation and is now considered a leading representative of modern mainstream economics. Becker was awarded the John Bates Clark Medal by the American Economic Association in 1967 and the Nobel Prize in economics in 1992 by the Royal Swedish Academy of Sciences and the Swedish Central Bank for his research extending economic analysis to non-market behavior.[3]

Addiction is a major challenge to the Chicago School's view of rationality. Building on his work with George Stigler, Becker's theory of rational addiction attempts to model compulsive consumption behavior within the confines of rational economic man. Drugs are not rational in the sense that drug abuse is the correct thing to do; they are rational in that their behavior can be understood and explained. Here price determines consumption, present consumption determines future consumption, and high-time preference leads some individuals to heavily discount the future and the resulting harm that comes with long-term drug abuse (Stigler & Becker, 1977; Iannaccone, 1984, 1986; Becker & Murphy, 1988).[4]

This theory of addiction cleverly encompasses such phenomena as drug tolerance (addicts need more of the good over time), reinforcement (present consumption increases future consumption), binging and abuse, and going cold turkey (cessation). Becker's approach is far more scientifically satisfying than other views of addiction, and his theory of rational addiction has been applied to a variety of markets, from cigarettes to opera. This model of addiction has been criticized on a variety of fronts, but on a positive note, Becker's analysis of addiction as rational behavior incorporates the role of individual time preference and taste and thus helped reestablish them in economic analysis. Mainstream economists prefer to work with the homogeneous and perfectly rational version of economic man, but with addiction we are faced with "lumpy" consumption where one individual consumes large amounts of a good, while a person with similar economic and demographic characteristics consumes none at all. Even more realistically, "unstable steady-state consumption levels" must be considered (binge → cold turkey → binge), where individuals can drastically rearrange their consumption decisions. And then we are forced to realize that this pattern actually applies to a large percentage of individuals and goods, including such widely disparate items as drugs, ice cream, sex, religion, and opera. Thus, rational addition helps make mainstream economics more realistic.

In magazine articles Becker has long advocated drug legalization, but what is clear in both his popular articles and academic work is that he does not provide an argument for true legalization. Rather, he advocates replacing prohibition with decriminalization and high excise taxation. The excise tax simply takes the place of the other, more cumbersome government interventions designed to discourage consumption. His recommendations are essentially an economist's perspective on harm reduction approaches to drug policy reform, not true legalization or a return to free market policies. This article will demonstrate that Gary Becker, and the harm reduction approach in general, are wrong.[5]

We begin with a comparable example of the harm reduction model in a different market to show that it does not reduce harm. Next, evidence of Becker's specific proposal will demonstrate that it has already been shown to be a failed and politically unstable policy. Finally, the theoretical flaws of Becker's approach will explain why he is wrong. This investigation demonstrates the utility of the Austrian model of progressive interventionism and the value of the Austrian school's guidelines to policy espousal.

2. HUMAN BODY PARTS

Attempts to transplant human organs have led to advances in medical knowledge and technology that have stimulated the discovery of successful transplant operations. The first successful kidney transplant occurred in 1954 involving identical twins. Other procedures involving hearts, livers, lungs, pancreases, and other organs from recently deceased ("cadaveric"), as opposed to living donors, have been discovered along with a multitude of new procedures, instruments, and techniques. These advances have greatly improved transplant success rates, reduced human suffering, and decreased mortality.

One of the most important discoveries was immune suppressant drugs, which prevent the transplant recipient's immune system from attacking or "rejecting" the transplanted organ. The drug Cyclosporine was first approved for use in the US in 1983. This not only improved success rates, it permitted the transplantation of organs beyond the confines of traditional matching criteria, such as identical twins, siblings, and between parent and offspring.

The combination of immunosuppressant drugs and the use of cadaveric organs has greatly expanded the potential use of organ transplant operations, and these operations have experienced growing acceptance by patients, doctors, and insurance companies. The rates of successful operations are high and thereby permit most patients to eliminate their medical suffering and return to a normal life. Organ transplantation is one of the miracles of modern medical practice and promises to both improve and extend life in the future.

There were nearly 25,000 successful transplant operations in the US in 2002. By far and away, the biggest problem is a severe shortage of transplantable organs. There are currently almost 90,000 people registered to receive transplants. Of these official registrations, 80% have been on the waiting list for more than one year and 28% have been on the waiting list for more than three years. The pain and suffering of those waiting for a transplant, however, is just the beginning. Since 1988 nearly 50,000 people have died while on the waiting list and more than 10,000 have been removed from the list because they became too ill for a transplant operation.[6]

The reason for the intense shortage of transplantable organs is a price control. The government effectively keeps the price of organs at zero by establishing a *prohibition* on the buying and selling of transplantable organs. The National Organ Transplant Act (NOTA) was passed in 1984 by the US Congress and signed into law by President Ronald Reagan. The law prohibits payments to individuals or the families of possible cadaveric donors to encourage donations. This prevents a market from forming, creates the shortage, and could even induce black market activity and all its related problems.

NOTA was intended to encourage the supply of organs, provide fairness in the distribution of organs, thwart exploitation of potential donors, and prevent unethical behavior connected with a commercial marketplace in human organs. As such, NOTA is a government intervention designed with the intent to both take the place of the market and to reduce the perceived harms of the marketplace. However, there was no evidence of problems in the areas of fairness, exploitation, and ethics prior to its enactment.

In place of the market, the US government instituted a variety of policies and organizations, including the Division of Organ Transplants in the Department of Health and Human Services. It also provides funding for various public–private partnerships such as the Organ Procurement and Transplantation Network, the Scientific Registry of Transplant Recipients, the United Network for Organ Sharing, and more than 50 organ procurement organizations around the US. These procurement organizations are essentially private, non-profit monopolists. The government thereby controls directly or indirectly almost every aspect of the production, distribution, and consumption of transplantable human organs.

This policy approach does not work and, in effect, has killed tens of thousands of people, left tens of thousands more suffering for years at a time, all the while limiting and distorting advances in transplantation procedures. This approach does not reduce harm; it creates harm that could easily be eliminated by the market. While the policy strives to achieve ethical superiority over markets and commercialism, and fairness in distribution, in reality this scheme is subject to systemic problems of misallocated resources and favoritism (e.g., Mickey Mantle). It has undergone several legislative and structural changes, a clear indication that this policy approach is both ineffective and unstable.[7]

Kaserman and Barnett (2002) provide a comprehensive economic analysis of the current "market" for human organs and they find:

> Organ transplantation holds the potential to restore the health of many otherwise terminally ill patients substantially. That potential, however, is currently being denied full realization by a chronic and severe shortage of cadaveric organs that are made available for this use. Importantly, that shortage is not due to an inadequate number of deaths that occur under circumstances that would allow transplantation of the deceased individual's organs. Rather, it is directly attributable to a public policy that legally proscribes reliance on market forces to call forth the additional supply that is potentially available. That policy currently results in a collection rate of less than 30 percent of the available supply of cadaveric organs (Kaserman & Barnett, 2002, p. 115).

They show that the government's approach to organ procurement has not worked and despite several attempts to reform, it continues to fall far short of success. They found that the only realistic solution is to turn to economic incentives. Based on their evidence, they conclude:

> Significantly, our findings indicate that payment of positive prices has the potential to *eliminate completely* the organ shortage at very modest levels of remuneration. Specifically, payments of such prices would not cause a substantial shift in the quantity intercept, and positive (but relatively modest) prices would call forth a substantial increase in the number of organs supplied. As a result, the equilibrium, market-clearing price per organ would be quite low – substantially less than $1000 (Kaserman & Barnett, 2002, p. 115, emphasis added).

The institutions of government organ transplants are a comparable example of what most drug law reformers envision for drugs. In the view of these reformers, currently prohibited drugs will be "legalized," but remain controlled, restricted, and highly regulated. Likewise, most reformers advocate that drugs should be produced under controlled and regulated conditions, preferably by licensed and government-approved contractors. Distribution would also be monitored, if not conducted, by government. Limitations would also be established on when, where, and how these drugs could be consumed. Purchases and consumption would be limited to specialized licensed establishments, with limited hours of operations, and, of course, all agree that minors would not be allowed to purchase or consume drugs.

In addition, harm reduction advocates also tend to support a wide variety of demand-reduction policies. These would include such items as public education against the dangers of drug use, public service announcements, prohibitions against advertising, heavy taxation, drug treatment programs, drug treatment facilities, subsidies for drug treatment and rehabilitation, drug maintenance programs, drug substitution programs, as well as a wide variety of government-funded research. All efforts would be made to eliminate the profit motive and to limit commercialism in this new era. Harm reduction policy is neoprohibition.

Although it is far from a perfect analogy, the conditions surrounding the transplantation of human body parts have much in common with the "legalization" visions of drug law reformers. Both would permit the activity to take place, but control every aspect of the process. In both cases, either the government or some tightly controlled contractor would be in charge of each step. Virtually, the entire gamut of government interventions is exhausted in each. In many cases they employ the exact same type of interventions (e.g., public service announcements), while in others the connection is less direct (e.g., drug treatment centers and organ transplant centers). Only in normative terms is there a substantive difference. However, it is largely irrelevant that virtually all informed observers would like to see an increase in organ transplants but a decrease in certain types of drug consumption. What does matter is whether the means of government intervention achieve policy goals better than an unrestricted market process.

Kaserman and Barnett (2002) found many other subsidiary inefficiencies and distortions in this area of health care, but their primary finding that price control causes shortages is a good starting point because it is one that economists can understand and accept (market prices eliminate shortages). Becker (1997) accepts this basic reasoning between market incentives and human organ shortages. This is particularly helpful when we move to the case of non-price government interventions that are included in harm reduction proposals and it will also be helpful in diagnosing Becker's proposal to distort prices via the power to tax.

Upon reflection, common sense tells us that the harm reduction approach is problematic, as illustrated with the case of human organ transplants. Government interventions do not work. Government bureaucracy is wasteful and costly. All these interventions create red tape, not consumer satisfaction. The economic and ethical goals are generally not achieved and new problems are created. The general public implicitly recognizes many of these problems, but in the cases of human organ transplants and narcotic drugs, they know of no alternatives. They have never seen a fully functioning market in these goods and have only been exposed to horror stories of abuse and unethical behavior based on fabrication, exaggeration, and misconstruction of cause and effect. Without a known alternative, government bureaucracy wins by default. When it comes to markets, most people are from Missouri, the "show me" state.

Gary Becker shares the general public's intuition when it comes to being skeptical of government intervention and bureaucracy. However, he is not from Missouri. He has the Chicago faith in economics – markets do work. The Chicago faith requires public pronouncements that all economic hypotheses have to be tested with real-world data. However, in private, if your tests come back with the wrong message, then the tests are wrong and have to be reconfigured and redone until you get the right answer. In the profession's lingo, the data must be tortured until it confesses.

The curious thing about the Chicago faith is that certain big markets cannot work, or do not work well enough. Justice, law enforcement, and property rights enforcement cannot be left up to the market. Markets do not work in the case of money and cannot exist in the case of national defense. In fact, markets in general do not work well enough, so there must be antitrust enforcement to ensure competition within and between markets. Their faith seems to weaken as you move beyond simple supply and demand in a single market. It appears that if a problem extends beyond a single market, then it is likely beyond the control of the market economy.

From this perspective, the "sin tax" approach of Gary Becker makes a great deal of sense. Individual markets in goods and services are to be preferred over government interventionism and bureaucracy because they are more efficient. For example, private drug treatment services are better and less costly compared to government programs. Privately produced marijuana and cocaine are better and cheaper than government-produced products. However, the problems of drug abuse and addiction are too large and complex and therefore they are beyond the scope of the market. How could the market solve addiction? Might not profit seeking and efficiency increase addiction via advertising and reductions in price? Something needs to be done to correct for this – to reduce abuse and addiction and all their associated problems. While drug policy reformers seek governmental oversight, the economic theorist's solution is to increase price to reduce consumption – forcing drug users up their demand curve. The solution is to tax the product with an excise or "sin" tax, similar to the markets for alcohol and tobacco.

This approach seemingly eliminates most of the bureaucracy and intervention while distorting economic incentives to reduce consumption. Is the approach a successful one? Does it reduce harm and, if so, is it a stable, sustainable policy? According to both theory and evidence, this approach is not successful, it does not reduce harm, and neither is it a stable or sustainable approach. One possible advantage is political in that the sin tax approach increases government revenues, but increasing government revenue is not an independent element of the social welfare function and has much to recommend against it. Normative issues aside, the only way to truly reform and achieve substantive harm reduction is through a laissez-faire approach to drugs, just as with organ transplants.

3. DO SIN TAXES WORK?

Becker, Grossman, and Murphy (1991) argues that legalization would reduce price and stimulate consumption by a significant amount, contrary to other hypotheses which argue addiction implies inelastic demand and therefore a decrease in price would not overly stimulate consumption. The poor, the uneducated, and the young would be particularly affected by the reduction in price, but government drug education efforts would have little effect on them. In contrast, the excise tax would have a significant deterrence on the poor and young. Therefore, according to Becker it might be possible to achieve the benefits of legalization without incurring the costs or "sins" of addiction.[8] However, Thies and Register (1993) provide evidence regarding marijuana that would seem to undermine Becker's hypothesis regarding the recent elasticity of demand for drugs.

Do excises taxes actually create socially desirable results? Here, we would have to cast grave doubt that any excise tax could ever achieve a reduction in sin or harm. First, excise taxes do not eliminate consumption of the targeted good. Second, like prohibition, excise taxes encourage the production and consumption of more potent and potentially more dangerous drugs. Third, the singling out of a good as "sinful" creates an attractive nuisance in the marketplace that appeals to male teens and young adults, who are often considered the most "at risk" of demographic groups.[9] Fourth, legitimate uses of the product are discouraged and some consumers pay an unnecessary and misplaced tax. Fifth, excise taxes provide incentives for consumers to switch to untaxed goods that are potentially less desirable and more harmful. Sixth, sin taxes encourage the development of black markets. Seventh, organized crime, corruption, and violence are used to facilitate black market production and distribution. Eighth, there is no way to calculate the proper good to tax. Ninth, there is no way to calculate the proper tax rate. Tenth, the tax rate and the policy itself are politically unstable.

Therefore, the sin tax approach is unstable, does not reduce harm, and does not lead to solutions of the problems involved. To the extent that sin taxes reduce the costs and unintended consequences of prohibition, they would do little or nothing to discourage consumption. If sin taxes are high enough to discourage problematic consumption, the problems of prohibition and black markets reestablish themselves. They are also a failure because they are unstable, lead to increasing government intervention, and often lapse back into prohibition.

This failure of sin taxes can be illustrated with the history of sin taxes on alcohol in the US. Excise taxes on alcohol were established at the very beginning of the federal government and when the federal excise tax on alcohol was increased, it led to a large open insurrection known as the Whiskey Rebellion. President Thomas Jefferson repealed the excise taxes only to have them reinstated during the War of 1812. Those excises were likewise repealed after the war and were not reenacted until the Civil War and the rise of the Republican Party to power. The Republican coalition included the prohibitionists, and their political dominance ensured that the heavy excise tax on alcohol would continue in force into the 20th century.[10] The establishment of the Income Tax quickly made alcohol taxes less important, and Boudreaux and Pritchard (1994) used a public choice model to analyze the passage of the 18th and 21st Amendments, which established and then repealed alcohol prohibition (1920–1933). Thornton (1996, 1997) showed that prohibition was preceded by a long history of government interventions into alcohol markets, including heavy taxes, licensing, local option, and state prohibitions. He showed that these policies were ineffective and that as a result alcohol policy was unstable and tended to cycle. The repeal of alcohol prohibition led to the reestablishment of excise taxes on the federal and state level, while prohibitionists turned their attention to narcotics and marijuana. Have excise taxes on alcohol been helpful in reducing sin?

Research and advocacy related to alcohol and alcohol taxes have been biased against alcohol. This bias is based largely on three factors. First, there is professional bias, especially with health care and social science researchers.

Economists appear less biased, but they exhibit a fixation regarding the price effect of taxation (reduction of consumption) that clouds their analysis. Second, there is a bias based on the "puritan instinct" in America. This instinct combines a compulsion to solve perceived problems and a belief that sins have objective causes, like in the cases of guns and sex toys. Here, alcohol itself "causes" a variety of well-known sins and the solution is to remove, or at least greatly diminish, access to alcohol. Third, there appears to be strong rent-seeking bias in favor of excise taxation and other government interventions related to the inevitable research grants and consulting opportunities that go along with such interventions. However, none of these biases would be of much concern if the sin tax approach were valid.

Economists have studied a variety of issues related to alcohol and sin. Does alcohol consumption harm health, especially cirrhosis and heart disease? Does alcohol reduce human capital and family formation, increase absenteeism, or reduce productivity? Does alcohol increase automobile accidents, crime, violence, or suicide? These questions have simple, straightforward answers, at least for those with the puritan instinct. Unfortunately, the empirical answers to these questions have been far from clear and in many cases have contradicted the preconceived puritan notions. In particular, while it seems clear that excise taxes reduce average consumption, it remains unclear whether such taxes actually promote reductions of sin. It is clear that such excises rank very low in terms of equity considerations.

The most important consideration for alcohol policy, or aspirin policy for that matter, is not how much is consumed, but how it is consumed. Alcohol can be beneficial, benign, or dangerous depending on how it is consumed. Binge drinking is the type of drinking that leads to intoxication, accidents, economic and social problems, and health consequences. Moderate drinking need not lead to any of these problems. For example, French, Roebuck, and Alexandre (2001) found that chronic drug use was negatively associated with employment, but found no impact from light or casual use on employment or labor participation. Indeed, moderate drinking has long been known to improve health and to contribute to a successful and happy life. From the historical perspective, alcohol was an important reason for the civilization of humanity, a critical food, and one of the cornerstone of medicine. The most common result of alcohol consumption is a benefit to the individual and society in terms of health and economic impact (Ford, 1988). Heavy excise taxes limit our ability to exploit these benefits.

The type of consumption that is of concern is binging and the resulting intoxication, accidents, and health consequences. Is the governmental approach of excise–sin taxes and other interventions the correct policy to address binge drinking and associated sins? One area where empirical studies have found some consistency is that excise taxes on alcohol have long been associated with reduced traffic accidents.[11] This is a somewhat curious consensus given that variations in alcohol taxes have a limited effect on price and consumption, and more so given that heavy drinkers tend to be the least responsive to changes in price. Even more suspicious, forecasts by Chaloupka, Saffer, and Grossman (1993) of reduced highway fatalities due to higher excise taxes failed to materialize.

Mast, Benson, and Rasmussen (1999) found that the relationship between excise taxes and highway fatalities could not be replicated using more recent data with standard models. Using a more comprehensive approach, they were able to reestablish the relationship by using an alternative dependent variable (drive-involvement rate). However, they found the relationship to be sensitive to model specification and that in a fully specified model (such as including religious affiliation) the correlation becomes much smaller and insignificant. They conclude:

> The point is that the relationship between beer taxes and alcohol-involved traffic fatalities is very sensitive to specification … because beer taxes clearly are correlated with other variables that can reasonably be hypothesized to influence beer consumption. When this is the case, a scaled down model that includes taxes but not the other variables implies that the coefficient on the tax variable cannot be interpreted as a pure tax impact, as it may be picking up the causal effects of left-out variables. Therefore, if a leaner specification is appropriate, the question becomes which variables should be omitted, and any procedure that excludes some variables simply because they are correlated with taxes is clearly ad hoc. In fact, the arguments made above suggest that there are reasons to expect that taxes may not be a particularly important determinant of fatalities and therefore that the tax variable should be the one that is dropped. Furthermore, taxes appear to be the only policy variable in the recursive model that is highly sensitive to specification, suggesting that in some models it has drawn explanatory power from left-out variables (Mast et al., 1999, p. 246).

Their results show that the relationship established in the economics literature between excise taxes and sin is far less robust than previously thought and is probably a wholly fallacious one. As a result, common sense about the effectiveness of sin taxes wins out over more than a decade of statistical research by mainstream economists. More encouraging in their findings is that there are other causes and cures of sin that need to be further examined.

Excise taxes do not work to reduce sin precisely because the tax does not target the actions in question (e.g., drunken driving, highway accidents, violence, and crime). A tax on gasoline or restaurant meals at night might have a similar, extremely low level of deterrence. In order to reduce sin, it must be more directly targeted. A tax high enough to deter sin via reductions in alcohol purchases would simply reestablish the black markets and inferior substitutions that take place under prohibition.

Some advocates of neoprohibition model alcohol taxes as an insurance premium. Taxes are collected on all users and then the government spends the money on those who are harmed (e.g., hospitals, disability payments, and social services). In this view, taxes should be used to deter sin, but more importantly they should at least cover the "social cost" of alcohol use. Actually, most estimates of the "social cost" of alcohol have been found to exaggerate the true cost drinkers impose on the government, and provide further evidence that states set tax rates to maximize government revenue, not solve social problems. But even if they did, excise taxes are not real insurance premiums; they are "social insurance" premiums. Real insurance does deter bad driving, drunken driving, and accidents because insurance rates are increased for those with a bad driving record, and those with a history of alcohol-related incidents might lose their insurance and driving privileges altogether. Insurance companies also give positive incentives for good behavior. The excise does neither. In fact, the financing of the social safety net only provides a subsidy for bad behavior. This social safety net is a true moral hazard and therefore a primary source of sin. Fix or eliminate the net and you reduce a true cause of sin, and probably a significant one.

With the case of alcohol and drunken driving, another obvious area to examine is the highways. Management of the roads is clearly at issue here although it is seldom even mentioned in the literature. Private ownership of roads would require sufficient control of access and usage to prevent the type of wide-scale slaughter that the government permits on today's highways. Road owners would be subject to negligence law, tort laws, and wrongful death lawsuits. Clearly, owners would have to do everything on their part to prevent accidents of all types, and drivers incapable of paying for their own accidents would have to be filtered out. Surely this would subject all drivers to insurance requirements and greatly reduce the number of drunks, teens, and the elderly from the roads. Privatization of the roads seems like a remote possibility, but it should be considered in the negative when casting about for variables to model statistically. Evidence from Benson, Mast, and Rasmussen (1999) and many other sources suggest great potential for entrepreneurial control of the roads.[12] However, government efforts thus far have only imperfectly mimicked the market and are often carried out in limited and haphazard fashion.

Finally, some of the specific variables Mast et al. (1999) introduced also hint at a very important source of sin reduction. Religion is one factor that has an important connection with alcohol consumption and reckless driving, and this implies that issues such as family upbringing, culture, and social influence do indeed play an important role in sin and sin control. The anecdotal evidence certainly seems to suggest that societies that treat alcohol as a regular food and normal social device, rather than a sin, have much fewer problems despite higher levels of consumption because children are taught that moderate alcohol consumption is normal while binge drinking and drunkenness are not. With this grounding, individuals can generate large economic benefits and widespread health benefits from moderate alcohol consumption, rather than social costs.

Societies that attempt to stigmatize and marginalize alcohol via prohibitionist policies tend to have greater problems with drugs and alcohol.[13] Children are not taught how alcohol should be consumed and the social marginalization of consumption only encourages binge drinking, drunkenness, and problem drinking. Drug addicts tend to hide their problems rather than seeking help because of the legal sanctions they face and prohibition restricts the types of therapies that treatment facilities can offer. In this light, sin taxes and other prohibitionist policies in effect create an attractive nuisance for teens, the poor, and the disaffected. Complete parental responsibility (and liability) for children, rather than the schools and government, could provide some remedy for a problem that mostly everyone agrees is the seed of most alcohol and drug-related problems.

A second category of variables examined by Benson et al.(1999) is related to various forms of government intervention. Some government interventions such as "dry county" or local prohibition try to reduce sin by reducing consumption. Such measures can indeed reduce consumption of targeted products, but often increase the number of accidents and highway fatalities. In the case of alcohol and drug prohibition, consumption does decrease, but the drugs that are consumed are much more potent and dangerous to consume because of prohibition (Thornton, 1991, 1998a). Other types of government interventions that attempt to mimic private management of roads, such as the size of the police force and open-container laws, seem to actually reduce alcohol-related problems on the road. In addition to mimicking the private sector in roads, a private model of law would emphasize restitution, where criminals directly paid victims and their families the full value of their loss. This would surely be more effective than the present model of punishment and rehabilitation.[14]

This section has shown that the sin tax approach does not work, does not reduce harm, and has much to recommend against it. A number of policies have been added to sin taxes, such as regulations, in attempts to bolster its effectiveness, without success. The empirical literature on the economics of excise taxes was found to be hopelessly inconclusive, and where it has been conclusive it is both wrong and misleading. What does result, however, is a substantive list of issues that hold great promise in the reduction of harm associated with the consumption of alcohol.

4. WHY BECKER GOT IT WRONG

The adoption of sin taxes – or in Becker's case, the advocacy of sin taxes – is evidence of ignorance of the market's discovery process – *the undiscovered discovery process*. It is the market, along with social organizations and other voluntary and legal institutions, which can solve the sins associated with alcohol. Economists recognize this discovery process in certain well-established cases, such as computers and stock prices, but tend to be ignorant of the general nature of the discovery process and how it works. Therefore, when faced with new conditions, unusual cases, or problems that span outside the confines of a single market, they cannot fathom how the market will work to solve the problem. Thus, the case for government intervention is built on ignorance. As noted above, the Chicago School of economics has a schizophrenic view of markets and competition, and much of their problem is a failure to understand the market's discovery process.[15]

Once the sin tax has been put in place, a bureaucracy is established and revenue is collected. However, there is no process in a sin tax regime that corresponds with addressing the sins associated with alcohol consumption. There is no mechanism, like profit and loss, that permits government bureaucrats to solve social problems or to adapt their operations to solve problems in a dynamic world. There is no "optimal level" of sin tax, because sin taxes are not part of the solution. As shown in the previous section, they are actually part of the problem, but the practical issue is that government intervention and bureaucracy cannot simulate the discovery process of the market – *the unsimulated discovery process*. As conditions fail to improve, or even worsen, the perceived need for a policy response increases. At that point the tax could be repealed and a true free market established, but more likely, there will be louder and politically stronger calls to increase the sin tax, regulate production, distribution, and consumption, establish minimum drinking age laws, and other such interventions.

As the result of taxation, firms and other market institutions will also experience increased government intervention. They become tax collectors for government and must seek out government licenses and permits to participate in the market. Even in mild cases, such interventions establish new costs of operation, regulations, reporting requirements, and auditing. This creates a barrier to entry and limits the extent of the competition. This also distorts competition and the discovery process from what it would have been in a free market. Firms now have certain things that they are required to do and other things that they are prohibited from doing, and thus the range of their options has been limited, as has their ability to discover new solutions – *the stifled discovery process*. With the government failing to solve the problem, and the market with "one hand tied behind its back," the perception of the need for policy response and more government intervention grows even stronger.

As more government intervention is introduced into the market, the margin between market participation and non-participation is crossed by some participants. Some consumers will drop out and take up new habits, but we should hardly expect the alcoholic or drug addict to be the first one to drop out. Producers will also drop out, either to seek different employment or to participate in the same industry via the underground economy, or black market. Without all the taxes and regulations, business in the underground economy comes with a greater accounting profit margin. As the black market develops, the perception of lost revenue will undoubtedly call for a policy response to prevent black market sales and to police the market: more government intervention.

In response to enforcement efforts, black marketers will have to find ways to avoid detection. This will mean that firms in the underground economy will have to run their businesses in a completely different manner than the market economy. They will have to discover new ways to conduct production, wholesaling, and retailing – *a wholly superfluous discovery process*. This is what causes products such as illegal drugs and alcohol to be so potent and dangerous to consume. This is where organized crime and street gangs come from and this is what causes the violence, crime, and corruption associated with drug prohibition, but it also happens in markets with high excise taxes and government intervention.[16] Naturally, all of these negative results create the perception that policy needs to be reformed. Most often, this only results in greater levels of government intervention. The result is a *process of progressive interventionism* where interventionism increases, government grows in size and power, and social problems worsen.

This process of progressive or increasing intervention has been recognized most famously by Hayek (1944), but it was established earlier by Mises [1929] (1996) and more recently confirmed by McKie (1970). In the case of drugs and alcohol, the model has been accepted and documented by Anderson (1997), Thornton (1997), and Weise (1998). Excise taxes have been particularly unstable and subject to political manipulation. Any proposal to enact sin taxes should therefore recognize not only their general ineffectiveness, but also the general tendency for such taxes to lead to additional government interventions and for this process to eventually result in de facto or official prohibition, as was the case with alcohol, narcotics, and marijuana. Tobacco is currently in that same process. The sin tax approach is an unstable policy because people adapt to the sin tax and policy makers react by making adjustments in tax rates, collection methods, enforcement techniques, and bureaucratic mechanisms. Policy failure generates a demand for policy innovation and this generally leads to an expansion of policy in the direction of bigger, more intrusive government. For a full discussion of the public choice aspects of prohibition, see Thornton (2003).

5. CONCLUSION

Sin taxes are not an effective means of reducing the harms associated with drug use and drug abuse. If sin taxes are set very low, the policy approaches true legalization, but such taxes would have no beneficial effect on drug abuse and potentially some negative effects. If sin taxes are very high, they would reduce legal consumption, but would have little beneficial effect in reducing the harms of drug abuse. Punitive taxes would, however, lead to underground economic activity, smuggling, black markets, and many of the problems of prohibition, such as crime, corruption, and violence. As described above, any excise tax between the two extremes can generate a process of progressive interventionism that is likely to degenerate into de facto or official prohibition and all its related problems.

The sin tax approach is therefore not a viable alternative to prohibition. It might be a policy worth voting for, but in terms of policy espousal based on economic science it is highly flawed and must be rejected. The Austrian theory of progressive interventionism, as developed by Mises, Hayek, and others provides a more holistic perspective on policy analysis because it clearly shows these interventions do not work and are unstable.

The Austrian approach to policy espousal provides a stronger ground for policy development. Here, the ideal policy is championed, while transitional issues and political acceptability are considered only secondary or eschewed altogether. If the policy of prohibition does not achieve its goals and imposes high costs, then it should be replaced. The default position is generally the free market. Does the market achieve the goals of prohibition? It certainly does not in terms of eliminating consumption, but it does provide various mechanisms that directly target the harms of drug abuse, such as employment rules and incentives, insurance, negligence and liability law, and the basic rules of business law, which, for example, disallow valid contracts with minors. When more specific problems with alcohol and drugs are addressed, such as drunk driving and burdens on social services, the reasons for these specific problems need to be investigated and analyzed. For example, the problem of drunken driving is one of many problems on the highways that are related to government management of the roads. Drunkenness and drug abuse also increase burdens on the social safety net, but they are among many types of behaviors that increase the burden on taxpayers, because government programs generate a huge moral hazard that has gone uncorrected. I have argued elsewhere that ''perfect legalization'' requires not only true legalization in the market in question, but similar reforms in related markets and institutions, such as the ''social safety net'' (Thornton, 1998b). Problems such as addiction and highway accidents are not confined within a single market; they traverse many markets and institutions and the full impacts of both prohibition and legalization are difficult to foresee.[17] As noted above, this larger perspective seems to be a flaw of the Chicago school approach.

Only when things get so bad, as they did in the 1920s and as they have now gotten in the war on drugs, is there a public outcry for a different tack in policy. If the sin tax regime is chosen, then the cycle will only repeat itself. Alternatively, true legalization could be chosen. This would establish real reform that would relieve us of both the destruction of prohibition and the harms or sins that result from drug abuse by freeing up the market process to address the genuine problems of drug abuse. This will require the discovery of the market's discovery process, a result more difficult to attain when economists share the general public's ignorance and make policy recommendations based on that ignorance. This approach should not be considered utopian, Pollyannaish, or politically naïve because it fully recognizes all the difficulties involved. More importantly, it recognizes a particular role for the economist in policy espousal, and in particular how economists can best help their societies to employ their resources to achieve their ends.

NOTES

1. See Fish (1998) for a representative survey of the literature.
2. See Cass (2000) for a description of neoprohibitionism. Ford (1988) uses the label ''new temperance'' for the same phenomenon.
3. www.src.uchicago.edu/users/gsb1/.
4. Becker supervised Iannaccone's dissertation, Stigler was a member of his dissertation committee.

5. See, for example, Becker (2001), where he endorses legalization and sin taxes, along with virtually the entire gambit of neoprohibitionist government interventions including minimum age laws (prohibition) and government-financed drug treatment and anti-drug education. Also see Becker (1987).

6. Based on Organ Procurement and Transplantation Network (OPTN) data as of August 16, 2003 [http://www.OPTN.org].

7. Becker (1997) has suggested that the federal government become the monopoly buyer and altruistic distributor of transplantable organs.

8. The term sins will be used to indicate all the social and individual problems associated with the consumption of alcohol and drugs.

9. This result is certainly discernable from Becker's own theory of rational addiction.

10. Of course there was an ongoing battle throughout much of Appalachia between the moonshiners who were attempting to avoid the alcohol excise tax and the revenue agents of the federal government who were trying to enforce the tax. See Miller (1991).

11. See, for example, Grossman, Sindelar, Mullahy, and Anderson (1993) Grossman et al. (1993) and Chaloupka, Henry, and Grossman (1993).

12. See, for example, Block (1979, 1980, 1983), Gunderson (1989), and Klein (1990).

13. See, for example, Morgan (1974) and Rorabaugh (1979).

14. See Benson (1998) for a full description of the superiority of restitution over punishment and rehabilitation.

15. See the "Symposium: Chicago versus the Free Market" in the special issue of the *Journal of Libertarian Studies*, Vol. 16 No. 4 (Fall 2002).

16. See Thornton (1991, 1998a).

17. See Beil and Thornton (1998, 2000).

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GOVERNMENT REGULATION OF BEHAVIOUR: IN PUBLIC INSURANCE SYSTEMS

Rolf Höijer

1. INTRODUCTION

In *The Road to Serfdom*, Hayek argued against planned economies that "the close interdependence of all economic phenomena makes it difficult to stop planning just where we wish … once the free working of the market is impeded beyond a certain degree, the planner will be forced to extend his controls till they become all-comprehensive" (Hayek, 1944, p. 79). According to Hayek, and especially Mises, there exists no stable condition in-between laissez faire capitalism and the planned economy. Once politicians engaged in acts of interventionism further interventions would successively lead them towards a condition where the state fully planned and controlled the economy and civil society. According to Austrians, 'interventionism' thus represented an unstable and self-reinforcing condition (Burton, 1984, p. 110). In John Gray's words "whenever an interventionist policy … fails to achieve the desires result, the practical and theoretical response of the interventionist ideologue is to demand an extension of the policy to new fields … interventionist policies will always interpret the failure of any such policy, not as a reason in favour of its abandonment, but rather as one supporting its wider application"(Gray, 1984, p. 32).

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This paper addresses the broad question whether one act of intervention by a government in itself provokes it to again intervene further in the economy and society at some subsequent time?

Mises wrote about the self-reinforcing nature of interventionism in the context of price fixing. Assume that a government by law fixed the price of a good, (or service), at some level lower than the price set by the intersection of demand and supply curves. Suppliers will then supply a smaller amount of that good, while a higher amount will be demanded. Since excess demand exists not all consumers can buy the good at the stipulated price, and the government will have to introduce some further interventionist scheme of rationing to determine which consumers should be able to buy how much of the good. Furthermore, Mises argues, if a government desires that the good should be available at the low price determined by itself, then that government will need to legally compel suppliers to continue supplying the good in large quantities. As such it will also need to engage in further interventionist activities determining that the relevant factors of production (raw materials, capital inputs, labour, etc.) should be devoted to the production of the primary consumption good. As such the first act of intervention would need to be followed by further government interventions that regulated the price and supply of all the products devoted to producing the primary consumption good. (Mises, 1978, Chapter 2, Section 5). Intervention breeds further intervention.

While Mises' argument here is important, it does perhaps not extend to other forms of intervention than price fixing. And such price fixing is (with the exception of minimum wages) probably a less important attribute of modern economies than it was in Mises' day. Therefore, it is interesting to consider other reasons why interventionism might be self-reinforcing.

In this paper I suggest that frequently initial government interventions intended to promote social security may by themselves provoke subsequent interventions, (that more obviously limit the freedom of individuals in society). I will primarily limit myself to speculating about a specific reason why we might think that government intervention will in itself lead to further acts of intervention. I will also illustrate this by reference to empirical examples from the Swedish welfare state.

The hypothesis I wish to present is, briefly, the following. A main activity of modern welfare states is to provide some kind of 'insurances' for individuals, to protect them against the uncertain vagaries of life. As an insurance provider, such governments assume a liability to make payments to the insured individuals, i.e. citizens, when they need to make claims against the insurance (perhaps due to sickness, unemployment, etc.). But it is largely the decisions and actions of the insured individuals that determine how often they will face such situations and therefore need to claim such payments from the government. As such the insurance provider cannot directly control the expenditures it will face. I suggest that as a result of this, welfare states, just like private insurance companies, will often need to restrict their coverage of individuals and introduce measures to limit the extent to which individuals may expose themselves to 'risky' situations. As such the hypothesis introduced here suggests that a prior event of government intervention – the acceptance of a responsibility to 'insure' its individual citizens, will frequently lead such governments to undertake subsequent acts of intervention aiming to regulate how individuals may act in regard to placing themselves in risk of claiming from the insurance system.

I will not empirically test this hypothesis. As an empirical research question I do not think it is easy to answer the question whether one event of government intervention will itself cause subsequent events of government intervention. One reason is that it is not easy to operationally specify what 'one act of government intervention' is, and therefore not easy to empirically recognise when one occurs. Another reason is that many social events – including acts of government intervention – are causally over-determined, i.e. several causes interact to cause any one specific event to occur. As such it is difficult to establish whether any one specific event of government intervention has been the cause of any subsequent event of government intervention, or if instead some other societal process has caused the later act of government intervention to be performed.

For these reasons, I will not in this paper attempt to provide any empirical measurement of the frequency of series of events where one act of government intervention will cause a subsequent act of government intervention. The paper is thus strictly limited in ambition. To empirically illuminate the relevant hypothesis the paper only provides brief narratives of two cases where one performed act of intervention have apparently provoked further acts of intervention. The related cases present the Swedish welfare state's sterilisation campaigns and the Swedish seat belt laws. These cases are presented in Sections 2 and 3 of the paper. In Sections 4–8 I offer some theoretically informed speculations, which elaborates further on the hypothesis outlined above. These sections also discuss the relation between 'social security' as a social value, and the alternative value of 'freedom'. I also briefly discuss the importance of imperfect information and unintended consequences.

2. THE SWEDISH STERILISATION CAMPAIGN

The first empirical case to be discussed concerns the Swedish sterilisation campaign. Between 1935 and 1974 some 63,000 persons were sterilised in Sweden, i.e. 63,000 persons were through surgery deprived of their ability to procreate and have children. Similar sterilisations also occurred in Norway and Denmark, but only in Nazi Germany were more persons sterilised than in Sweden, counted as a percentage of the total population. Not only Nazis propagated these sterilisations, by also such prominent socialists as Gunnar and Alva Myrdal.

These sterilisations took place in the context of a Swedish 'population crisis'. The birth rate in Sweden was very low in the 1930s – possibly the lowest in the world – leading to fears that in the future 'the Swedish people' would die out. Accordingly, an official government 'population commission' was instituted to report on the issue. When considering how to save the Swedish people from dying out, the Swedish legislators also considered how 'the Swedish people' could be purified for the future, so that problematic elements in the population would be minimised. Sterilisation was recommended to alleviate these problems. Many of the victims of the sterilisations were therefore the psychologically impaired and weak, but other victims also included vagrants, gypsies, alcoholics, and poor persons considered to be leading 'asocial' lives.

The sterilisations were authorised through two Swedish laws, enacted in 1935 and 1941, respectively. Social democrat governments led these legislative efforts, but received broad cross-party support. Overtly, the laws specified that individuals could only be sterilised if they voluntarily agreed to the procedure. In fact, however, many of the sterilised individuals apparently did not consent to the sterilisations (Andrén, 2000, p. 8). This occurred especially before 1950. Some individuals were explicitly sterilised without consent, which the laws allowed when the person was sufficiently psychologically impaired to be unable to reasonably give or withhold such consent. Many more victims agreed to be sterilised only under duress. For example, some patients were only granted release from mental hospitals on the condition that they agreed to undergo sterilisation, in other cases pregnant women were granted the right to undergo abortions only if they agreed to be sterilised, and in some cases poor persons would only be granted government social welfare benefits if they agreed to be sterilised. Accordingly, a government report in the year 2000 found that around 27,000 (or 42.8%) of the individuals who had been sterilised had either been compelled, or exposed to undue influence, when agreeing to undergo the sterilisation procedure (Andrén, 2000, pp. 16, 33).

In 1974 the Swedish sterilisation laws were repealed, and the matter was forgotten. In 1997, however, a newspaper article by Maciej Zaremba revealed the history of sterilisations to a wider audience. Public outrage followed, and as a response the government commissioned the above-mentioned report (Andrén, 2000), into the matter. Following this report, the Swedish parliament decided that the involuntary sterilisations had represented an unacceptable breach of individual rights, and that monetary compensation should be paid to surviving victims.

The sterilisation campaign clearly constituted an act of government intervention into the civil society of Sweden. This particular act of intervention also deprived many individuals of one of their most basic freedoms, the freedom to themselves decide whether to procreate and have children.

For the purposes of the present paper, however, the most important question is whether this act of intervention was itself caused by any other previous act of intervention? In fact, several causes interacted to motivate Swedish parliamentarians to enact the sterilisation laws, but I will here focus on only one *economic* reason since it is most salient for the proposition advanced in this paper. This reason focuses on the Swedish welfare state's support of impoverished individuals and children.

At the time that the Swedish sterilisation laws were introduced local government boards – 'poverty care boards' – financially supported individuals and families who could not support themselves. Alternatively, local government 'childcare boards' assumed the financial responsibility for children who did not have parents who could support them. The early Swedish welfare state (or at least the different boards representing the local governments of that state) therefore assumed responsibility for bearing the costs for supporting individuals who could not support themselves. The Swedish welfare state accepted a substantial cost to fulfil its duty of care towards such individuals.

There exist no reasons to assume that these welfare programs had not been instituted for benevolent reasons. Politicians recognised that some poorer individuals were sometimes unable to support themselves, and decided that the government should alleviate their plight by different measures. The welfare state simply tried to 'insure' individuals against the uncertain, and sometimes unfortunate, vagaries of life. In the context of the sterilisation debates, however, the obligation which the government thus undertook lead to an unintended – and undesirable – consequence.

It was often the mentally impaired, alcoholics, vagrants and other poor persons leading 'asocial' lives who constituted the poor individuals who received government support. Such government expenses needed to be limited. At the time, it was also noted that very frequently the children of such individuals in turn also proved incapable of supporting themselves. In addition to supporting the parents, the local governments therefore often had to accept the financial responsibility for their children as well (at the very least until they reached adulthood) and this represented a draining cost for the early welfare state. In small local councils, which had a very limited tax base, the financing of such poor individuals could prove a very substantial and draining financial commitment for the local government.

Already in the 1920s, the Social Democrat parliamentarian Alfred Petrén thus argued for the introduction of a sterilisation law partly on the economic grounds that 'it was too expensive for society to provide for the offspring of the mentally impaired.' In cases where an individual was incapable of fulfilling a parent's duties this suggested that the person should be sterilised, since he/she would not be able to care for any offspring. This would ensure both that children would not grow up in unsatisfactory conditions, and that local governments would not be unnecessarily burdened by having to care for such children. It therefore appears that the introduction of the sterilisation laws was regarded, at least in part, as a measure to limit the costs imposed on the Swedish welfare state for insuring unfortunate individuals.

The importance of this fiscal motive was also borne out by the implementation of the laws, (once they had been introduced). The 1941 law identified three 'indicators', which could suggest that a given individual should be sterilised. (1) 'Medical indicators' suggested that a person might be sterilised if the person would otherwise suffer dangerous medical conditions. (2) 'Eugenic indicators' suggested that a person might be sterilised if one could suspect that any children parented by the person would inherit 'inferior genes', such as a predisposition for psychological illness. (3) 'Social indicators' suggested that a person might be sterilised if 'someone was unsuitable to care for, and assume responsibility for the upbringing of, a child either due to mental illness or because they led an asocial kind of life' (Andrén, 2000, p. 30). (Sterilisations due to medical indicators dominate between roughly 1950 and 1974, but for the period 1935–1950 social and eugenic factors appear to have been prevalent.)

The 'social indicators' are most important here, since these concerned cases where the government would need to accept financial responsibility for any child that was conceived by the unsuitable parent. Who then, could apply for the sterilisation of such an unsuitable individual? Among others, the local 'poverty care boards' were entitled to submit applications for the sterilisation of individuals who partook of government 'poverty support.' The local 'childcare board' was similarly entitled to apply for sterilisation of children who the government cared for (Andrén, 2000, Appendix 4, p. 171). In fact, during the 1930's such boards were the most frequent applicants for such sterilisations to be performed, and the individuals who were actually going to be sterilised only submitted about one in every five of such applications.

The commission instituted in 1997 did not estimate precisely how frequently sterilisation applications concerned individuals who received economic support from the government. It does note, however, that very frequently the concerned individuals or families were very poor, that they lived on the limits of subsistence, and that many received public support (Andrén, 2000, Appendix 4, pp. 199, 239). A number of applications to have individuals sterilised also involved 'judgements regarding the costs that might otherwise be imposed on the economy of the local government' (Andrén, 2000, p. 30). Applications for sterilisation that had been submitted by the government's 'poverty boards' and 'childcare boards' emphasised this need for economic support to the families, and the 2000 commission found that it was clear that the government boards requesting sterilisation had been concerned with avoiding further economic obligations in the form of further children they must provide for (Andrén, 2000, Appendix 4, p. 200).

It therefore appears that the decisions both to first introduce the sterilisation laws, and subsequently to implement them in individual cases, were at least in part driven by the welfare state's desire to limit its costs for supporting individuals who could not support themselves.

One could not say that this cost limitation exercise was the only motive for introducing the sterilisation laws, however. Among other reasons, some debaters emphasised the need to limit the cases of children that had grown up in strongly unsuitable conditions such as families suffering from heavy alcoholism. Sadly, there was also a genuinely 'eugenic' thought that convinced many to support the sterilisation legislation, since this ensured a 'suitable selection of candidate parents', and therefore could prevent the further 'racial degeneration' of the Swedish population. Furthermore, some sterilisations were conducted for medical reasons. Nevertheless, the need to limit the financial obligations of the early welfare state was at least *one important cause* of the sterilisation campaigns, even if other causes also existed. Many proponents of the sterilisation campaign – apparently including the Myrdals – did not support the sterilisations on eugenic grounds, but instead supported the sterilisations because of the social and economic gains from avoiding having children parented by adults who were incapable of caring for them. Even if the economic motive was only one of several it is therefore unclear whether a 'coalition of the willing' could have been gathered to support the sterilisation campaigns unless the economic motivations had played an important role.

One could therefore argue that the need to limit the financial obligations of the early Swedish welfare state was one cause for the Swedish sterilisation campaigns. Of course, had not the welfare state initially agreed to assume any financial responsibility for the impoverished poor, then it would not later have had any such need to conduct sterilisations to limit the number of welfare recipients. To this extent one could therefore argue that the sterilisations of the 1930s and 1940s were caused by the prior political decision that the welfare state should accept the financial responsibility of the impoverished Swedes. As such, it appears that this constituted one case where a prior event of government intervention – the political decision to extend welfare benefits to poor Swedes – caused a subsequent of government intervention – the sterilisation campaigns to occur (or at least it appears as one of the causes).

3. SWEDISH SEAT BELT LEGISLATION

One might think that the Swedish sterilisation campaigns are so atrocious that they are obviously unrepresentative of any ordinary activity that welfare state governments engage in. Yet, a much more trivial example – seat belt legislation – seems to be driven by similar concerns, which suggests that there exist a more general underlying theoretical principles, and that similar events may occur in many welfare state systems.

The Swedish government in 1975, introduced a law stipulating that the drivers of cars, and passengers in the front seats, must wear seat belts. Further laws specified that adults in the backseats of cars must also wear seat belts (1986); that children must wear seat belts (1988); and that drivers of taxis and heavy transport vehicles must also use seat belts (1999). Thus, virtually every person riding in common motorised vehicles in Sweden is today legally compelled to wear seat belts.

Without doubt this legislation constituted an act of government intervention in Swedish society, and it considerably changed individual motorists' behaviour. Statistics suggest that while only 35% (of persons in front seats) choose to wear seat belts in 1974, as many as 84% wore seat belts when the legislation had been introduced in 1975, i.e. an increase of some 50 percentage points! (see Norin, Carlsson, and Korner, 1984, p. 15). This remarkable change in behaviour probably suggests that many persons would have preferred to not wear seat belts, but were legally compelled to do so from 1975. As such the law arguably restricted individuals ability to themselves choose how they preferred to act – to ride cars without seat belts, rather than with seat belts.

The main function of seat belts is to reduce the incidence of personal physical injury when individuals are involved in car accidents. Using seat belts reduces both the risk of suffering any injured at all in car accidents, and also the severity of any injuries sustained. For example, if a car is involved in a direct frontal collision then some Swedish figures suggest that the use of seat belts reduces of sustaining any injury by around 50% (Folksam, 2001). The risk of being mortally injured in a car accident is estimated to be reduced by 40–50% for individuals who use seat belts, and the risk of mortal head injuries were reduced by some 63% after the introduction of the seat belt law (Norin et al., 1984).

The Swedish government's purpose with introducing seat belt legislation was therefore to reduce the number and severity of personal injuries suffered in car accidents. But behind this two different motives in fact hide. The first motive was quite clearly a genuine desire to spare individual motorists all the problems and pain involved in suffering injuries from car accidents. A second explicit motive, however, was to reduce the costs to the Swedish medical insurance system. Victims of car accidents had to be medically cared for, and the publicly financed medical system provided almost all such care in the Swedish welfare state. As such, politicians argued that motorists needed to use seat belts, because if they did not do so they imposed avoidable treatment costs upon the public medical insurance system. Persons who did not use seat belts were not considered to take their responsibility vis á vis that system.

One cause for the introduction of seat belt legislation in Sweden was therefore the desire to reduce the costs of the public medical insurance program, which ensured that all Swedes got access to medical care at very low marginal costs. Of course, had not the government earlier decided that such a medical insurance should be provided by the government, than it would not have needed to introduce seat belt legislation in order to reduce the costs imposed by any such insurance system. Therefore, one could well argue that it was the prior government intervention of introducing a publicly funded medical insurance system that (partly) caused the subsequent intervention when the government introduced the seat belt legislation. While the Swedish seat belt legislation is in itself relatively trivial it therefore at least seems to document the two thesis that (1) one act of government intervention sometimes in itself causes a further act of government intervention, and (2) government intervention sometimes aim to regulate the behaviour of individuals so as to limit the costs they can impose on publicly provided insurance systems.

4. THE GROWTH OF THE INSURANCE STATE

The two Swedish examples of sterilisations and seat belt legislation both drew attention to an *economic motive* for governments to intervene in the civil society – to limit the government's costs for welfare and insurance provision.

Even if these particular Swedish examples were not selected to be representative there exist some reasons to think that cases such as these might not be uncommon. If we consider modern western welfare states they increasingly appear as 'insurance states'. Typically two items allegedly dominate government budgets. The first are overtly redistributive transfers, from one individual to another, usually with the alleged aim to increase equality in incomes and consumption in society. The second are different kinds of 'insurance' provisions, which grant the individuals' access to different kinds of welfare benefits when the individuals find themselves in specific difficult situations. (Frequently the two are conflated.)

West European welfare states still are somewhat socialistic in the sense that the government owns important means of production. Frequently, government production of services is nowadays being exposed to competition from private firms, however. What remains the same, meanwhile, is that the welfare states largely retain the public *funding* of these activities. For example, whether or not a private or a public hospital is hired to perform a certain kind of surgery, the individual patient's treatment costs will normally be paid for by the government's social insurance scheme. If welfare states are no longer necessarily the producers of a range of services they appear at least to be the *funders* of these services, in the sense that they pay for any services delivered, (while it is individual citizens who actually consume the different services).

The welfare state's funding of public service normally occur through some kind of 'social insurance scheme', where the individual pays taxes today against the expectation that he/she will be in receipt of government benefits and subsidies if he/she ever faces a difficult situation in the future. Nominally, such provisions are denoted 'insurances', but in fact they are rather pure transfers, or pay as you go schemes. Government 'insurances' is not a funded system in which my own individual contributions pay for my own (say medical) expenses in the future. Instead, the tax payments of the current generation of taxpayers pay for the current outgoing costs of medical treatment, whether or not this treatment is undergone by those presently paying taxes, or anyone else. It is in fact a transfer from those who are able to pay, to those who are temporarily less able to pay.

The important trend to note, however, is that modern welfare states seem increasingly to resemble 'insurance states' and that the costs of financing these insurances will appear as an increasingly important challenge for such states.

5. PRIVATE AND PUBLIC INSURANCE SCHEMES

Since '*insuring*' is a major activity of contemporary welfare states, we can clearly recognise the importance of limiting the costs of such insurances. From this simple theoretical perspective we can easily and clearly analyse the cases of Swedish intervention mentioned above.

A comparison between private and public insurance systems facilitates the analysis. In a private insurance scheme, an individual normally insures himself by paying a relatively small monthly premium to an insurance provider. If the individual then falls into a difficult situation of a predefined kind (such as suffering an accident which requires hospital treatment) then the insurance provider pays the individual a larger sum of money to finance the individual's need in that particular situation. This is beneficial to the individual in two respects; first, he spreads his payments over time so that he does not at any one time need to meet the large lump sum cost that he might incur in the situation when he needs hospital care. Second, all individuals paying into the insurance scheme share the risk, but since not every individual will suffer from the relevant accident each individual will not need to pay the full amount necessary to treat each accident. Thus individuals who actually claim from the insurance will not need to themselves pay the full amount claimed.

The provider of a private insurance basically tries to make a profit by ensuring that he receives more in premiums paid into the scheme than the costs for claims paid out of the scheme. Both to enable himself to make a profit, and to be able to offer low, competitive rates to his customers, the insurance provider will therefore need to limit the amounts that are paid out of the system. Insurance providers therefore frequently resort to some combination of any of the three different methods for limiting the costs that they will have to meet:[1]

- Exclusion
- Risk adjusted price differentiation
- Limitation of risky behaviour

Exclusion means that high-risk individuals will not be accepted as customers into insurance schemes. For example, elderly persons are frequently not granted access to private life insurances, for the simple reason that the insurers know that it is likely that an elderly person will die in the near future and would force the insurer to pay out whatever amount the person is ensured for. Such exclusion of 'costly individuals' limits the total costs imposed on the insurance scheme.

Risk adjusted price differentiation means that the price of insurance, i.e. the premium, is individually adjusted to account for different degrees of risk. For example, safe female drivers might be granted cheaper car insurances than young males that are more prone to have accidents. Similarly, life insurances are frequently price differentiated so that smokers and other groups who are at higher risk of suffering ill health will be required to pay a higher premium than others. In this case, the higher premiums paid by the high-risk individuals compensate for the higher costs they impose on the insurance scheme by claiming more from it.

Limitation of risky behaviour means that insurance providers may demand that insured individuals abstain from risky behaviour if they desire to be covered by the insurance policy. For example, insurance providers may demand that homeowners keep their properties locked before agreeing to provide home insurances. Similarly, some travel insurances may demand that individuals abstain from risky pursuits such as sky diving etc. before agreeing to ensure them. (Price differentiation and limitation of risky behaviours represent two sides of the same coin since the insurer may allow an individual to engage in risky behaviour if and only if he pays higher premiums, etc.)

Through these different means private insurance companies can attempt to reduce the costs that the ensured individuals may impose upon them. Meanwhile, we have noted that a government's public insurance scheme is normally not at all an insurance scheme in the ordinary sense, but rather a transfer system of the pay as you go type. Furthermore, the *public insurance systems* of modern welfare states are typically governed by their aspirations to:

- Universality in coverage
- Financing through (progressive) taxation.

Universality in coverage means that the 'insurance schemes' provided by welfare state governments usually aspire to ensure all relevant individuals – i.e. all citizens.[2] Indeed, the motivation for such schemes is frequently that they should cover all individuals, including those believed to be too poor, or too risk seeking, to individually ensure themselves. Government provided insurance schemes are even so universally covering that they are normally impossible to opt out of, since they are financed through mandatory and compulsory taxation.

Financing through (progressive) taxation means either that the payments of contributions towards the insurance schemes are equally large for all the insured individuals, or that the size of these 'fees' are determined through ability to pay, where higher income earners pay more, (i.e. progressive taxation). The motivation for this is usually some kind of concern with equality, and constitutes some attempt to transfer resources from the rich to the poor, and to equalise post-tax incomes. "Tax the rich and spend the revenue for the improvement of the condition of the poor" is thus the principle of interventionist government budgets, as Mises would express it (Mises, 1949, Chapter 36, Section 2).. Importantly, this means that an individuals' payments into the insurance scheme is disconnected from how much he/she might expect to individually claim back from it. Furthermore, the mandatory nature of taxation means that individuals cannot choose to not ensure themselves.

Even a superficial comparison of the private and public systems now reveals what contradictory principles govern them. The *universality of coverage* of government insurance systems would supposedly mean that it is in principle impermissible to *exclude* individuals who run high risks of falling into whatever situations qualify them for payment of insurance benefits. These 'costly individuals' could incur large costs on the insurance scheme, and one would presume that there is no way that the public insurance schemes of a welfare state could avoid these costs. One could further assume that the *universality of coverage* would also mean that a welfare state is not able to reduce costs by *regulating risky behaviour*, because even individuals who engage in such risky behaviour should presumably be covered by the universal insurance schemes of the welfare state. Furthermore, the *financing through progressive taxation* implies that the welfare state should not be able to reduce its insurance costs through *risk adjusted price differentiation*. Financing through progressive taxation means that an individuals' costs of the insurance provided is based on that individuals ability to pay, rather than any estimate of how likely he or she is to incur costs on the insurance system.

6. THE SWEDISH CASES REVISITED

From the simple theoretical comparisons introduced above it becomes easy to interpret the two discussed events in the history of the Swedish welfare state.

Consider the sterilisations. The Swedish welfare state had early on accepted the responsibility of 'insuring' individuals so that they might not be exposed to extreme poverty, by granting financial support to low-income earners and the unemployed. This obligation represented a, sometimes substantial, cost to the welfare state. In this case the Swedish citizens were insured against poverty, and one would have thought that the universalist aspiration of the Swedish welfare state would have ensured that no individuals were excluded from such insurance. Yet the evidence suggests precisely that through the sterilisation campaigns the welfare state government was (partly) attempting to *exclude* costly individuals from the insurance system in order to limit the costs imposed on that system. *Sterilisation* was used to reduce the number of births of children whom the welfare state would have to support. The exclusion here took a very extreme form. Since the system was universalist in inspiration it was not possible to exclude any existing individual from coverage by the system. Instead, the use of sterilisation could ensure that further individuals who were likely to impose high costs on the system *would simply not come into existence*.[3] This drastic measure ensured that excess costs would not be imposed upon the insurance system of the Swedish welfare state.

We should remember that several objectives – medical, eugenic, economic – were served through the sterilisations. However, to the extent that the desire to limit the costs of social insurance constituted the reason for conducting the sterilisation campaign, it appears that the prior decision to provide a social insurance system, which insured against poverty, constituted a *cause* of the subsequent sterilisation campaigns. It was a cause at least in the sense that it would have constituted a necessary condition, i.e. had the social insurance system not already existed, then there would have been no reason for the government to engage in the sterilisations. The prior event of government intervention involved in the creation of the social insurance system therefore arguable caused a second event of government intervention, the sterilisation campaigns.

The seat belt laws also make immediate sense within the theoretical framework of insurances. Motorists travelling without seat belts imposed an unacceptable cost upon the government's medical insurance system, since they incurred grave injuries when they were engaged in car accidents, and must be treated in publicly funded hospitals at great expense. As such the government eventually decided to impose legislation, which prohibited travelling in cars without using seat belts. The government therefore regulated risky behaviour, at least in part in order to limit the costs that might otherwise be imposed on the medical insurance system. Again, the seat belt laws might not have been imposed had not a prior decision been taken to introduce a publicly funded medical insurance system, with all the costs such a system entailed. It could thus be argued that the government's prior act of intervention – the decision to provide a publicly funded medical insurance program – constituted a cause of the subsequent event of government intervention, when seat belt legislation was instituted.

The Swedish cases outlined here arguably represent two sets of events when prior government interventions in themselves caused the government to undertake further acts of intervention at a subsequent time. In both cases, the welfare state initially agreed to provide some social insurance cover for individuals, subsequently they intervened further, in order to control the behaviour of these individuals so as to limit the costs imposed on the social insurance system.

Perhaps it could be argued that the case of Swedish sterilisations is so extreme that it does not represent any normal activity that welfare states might ordinarily engage in. This is possible, and I am even willing to admit that the two cases are not selected to be statistically representative. Yet I would claim that they do indeed illustrate important tendencies in ordinary welfare states, because the underlying logic of insurance systems remains the same, and for theoretical reasons we might therefore suspect that they represent recurrent tendencies in the practices of most welfare states.

On the theoretical grounds outlined in Section 5 one would have thought that the principle of *universality of coverage* in welfare states would have ruled out all the attempts at *exclusion* and *regulation of risky behaviour*. Yet it would be nearly impossible to consistently rule out all such attempts. Every insurance provider will need to employ some method for limiting the costs that might be imposed in the forms of claims against his insurance scheme, because if these costs are not at all limited they might indeed become infinitely high (and as such would bankrupt any – public or private – insurance system). Furthermore, rational insurance holders will themselves demand that costs be limited, because otherwise they will need to pay excessive premiums.

Unfortunately for the insurance provider it is not his own decisions, but decisions made by the insured individuals, that determine how frequently the insured individuals will claim against the insurance. By choosing how frequently to engage in different kinds of risky behaviours these insurance holders will determine the frequency with which claims will be made against the insurance scheme. Limiting the costs of an insurance scheme will therefore require that the behaviour of individuals can be somewhat regulated, so as not to impose excessive costs. As an insurance provider a welfare state's government will therefore normally have to engage in at least some attempts to either *regulate risky behaviour* or *exclude* costly individuals.

Unfortunately the welfare state's principle of financing social insurances through progressive taxation means that the insured individuals will have no financial incentives to themselves regulate their behaviour so as to minimise their claims on the insurance system. Since the size of their claims out of the system is not at all related to the size of their payments into the system they have no reason to minimise their claims from the system. Insured individuals will not have appropriate incentives to limit costs, when they do not bear the costs of accidents themselves (and they do not in public insurance systems). Nevertheless, these costs must be limited somehow, and granted that appropriate *price differentiation* is not permissible this can only occur through attempts at either *exclusion* or *regulation of risky behaviour*. As such it is not surprising that this occurred in Sweden, and neither should we be surprised if it occurs in other welfare states.

7. SOCIAL SECURITY AND FREEDOM

In political debates it is sometimes alleged that there is some contradictory relation between 'social security' provided through the welfare state's insurances, and the freedom secured by a more minimalist state. Proponents of welfare states then often argue that this is a false contradiction, and that only people who feel reasonably safe and secure are able to enjoy any freedom they might experience. As such they argue that there is no trade-off between social security and freedom, and that the welfare state maximises both.[4]

Considering the examples and arguments outlined above should serve to refute the proposition that there need be no trade-off between freedom and social security, i.e. the introduction of social insurances need not limit the freedom of choice of ordinary individuals. If we first consider the (non-voluntary) sterilisations it appears overtly clear that these individuals had been deprived of one of each man's (and woman's) most important liberties, the opportunity to themselves choose whether or not to have children. Similarly, the introduction of seat belt legislation clearly limited the (less-valued) freedom of individuals to choose to travel in cars without wearing seat belts.

On the theoretical plane, the contradiction between social insurance and freedom of choice becomes even more explicit. In order to limit the costs that might be imposed on an insurance scheme, the provider of that scheme must be able to prohibit the insured individuals from systematically engaging in high-risk behaviour that impose excessive costs on the insurance provider (such as driving without seat belts …). This will lead to a decrease of the freedom of choice since such regulation entails limiting the range of activities that individuals might engage in.

I can therefore not fully agree with Hayek's argument that sometimes "the case for the state helping to organise a system of comprehensive social insurance is very strong … there is no incompatibility in principle between the state providing greater security in this way and the preservation of individual freedom" (Hayek, 1944, p. 9). It might perhaps be worthwhile for individuals to sacrifice some freedoms in order to gain more security (in the form of insurance cover) but the two do appear incompatible, at least to the extent that some such sacrifices needs to be made.

The decrease in freedom of choice that is imposed by the regulation of risky behaviour is relatively unproblematic what regards insurances that are provided by *private* insurance companies on competitive markets. Each person can then individually decide to not insure themselves, if the specific insurance scheme would circumscribe their liberty in manners that are unacceptable to them. By foregoing the safety provided by insurance cover they could retain their liberties. The losses of security (in terms of insurance covers) are the sacrifice these individuals must make in order to retain their liberties to act as they wish. Conversely, one could say that the perceived value of security provided by these insurances is the *price* that individuals must pay in order to retain their liberties to act as they wish. Under a system of private insurance provision, individuals could themselves choose what price they are willing to pay for these liberties, by deciding what trade-off they want to make between insurance cover and liberty. The most explicit solution along these lines is clearly to adopt insurances with risk adjusted price differentiation, in which case the insurance holder may himself overtly decide what price he is willing to pay to engage in dangerous activities (and still remain insured). Unfortunately, this solution is not available to the welfare state's social insurance system, since it conflicts with the notion that the insurances should be funded out of (progressive) taxation.

Neither is it possible to retain your freedom by opting out of insurance schemes in welfare states, since their publicly provided insurance systems aspire to universal and mandatory coverage. Since individuals cannot choose to remain uninsured they cannot choose to avoid being limited by the behavioural restraints entailed by the relevant insurance schemes. As such they do not relinquish their freedoms voluntarily. Once the government has decided that some individuals should enjoy the mandatory insurance scheme they will simply lose whatever behavioural liberties are demanded by that specific insurance scheme.

8. IMPERFECT INFORMATION AND UNINTENDED CONSEQUENCES

The question of imperfect information, so central for Austrian economics, also has some implications for the analysis of the forms under which government intervention breeds further acts of information.

Say that some legislators consider enacting some act of intervention called i_1 (perhaps introduce a medical insurance scheme), which might in turn provoke problems that would necessitate a further act of intervention i_2 (say seat belt legislation). Following Oliver Williamsson's (see Williamsson, 1975, Chapters 1–2) work on incomplete contracting we could assume that if the legislators had perfect information – so that they could predict every contingency and every possible outcome – then they would immediately specify responses to every possible outcome that might arise in the future, and thus a governments intervention at time t_1 would never necessitate further intervention at time t_2. If, for example, a public medical insurance scheme demanded the introduction of seat belt legislation, then these two measures would both be introduced as parts of the same legislative package, at the same time.

If instead the environment is unpredictable and human rationality bounded – as Austrian economists would insist – then legislators could not immediately specify responses to all possible contingent events that might occur. Legislators might later have to again intervene in the civil society/economy in order to address problems that were not clearly envisaged at the time the original intervention was introduced. Thus an intervention i_1 at time t_1 might well provoke a further intervention i_2 at time t_2.

In both situations discussed both acts of intervention (i_1 and i_2) will in fact be carried out, the main question is whether act i_2 will be carried out at time t_1 or t_2. Nevertheless, the question whether or not perfect information is available is important, because *in situations of imperfect information the second act of intervention may be an unintended and undesirable consequence of the first act of intervention*. It may well be that a legislator who considers intervention i_1 would refrain from enacting this intervention if he knew that it would demand that he also perform the concomitant act i_2 (i.e. that he would need to perform both i_1 and i_2). Under perfect information he would in such case choose not to perform i_1 or i_2 An *imperfectly informed* legislator might instead perform i_1 because he does not believe that he will later have to perform i_2 as a consequence. Once i_1 has been performed, however, the legislator might be locked into some situation where he will also perform i_2 (rather than backtrack on i_1 which has already been implemented). In this case these interventions will have been sub-optimal, even for the legislator who initiated them.

Perhaps what appears so intuitively morally objectionable about the Swedish sterilisation campaigns being brought in to remedy social insurance problems is indeed the fact that it (partly) constituted an unintended consequence of the social insurance legislation? My moral intuition at least, suggests that we would simply not want to engage in sterilisations merely because some social insurance scheme demanded it. The Swedish sterilisation campaigns do not appear as an action that has been appropriately mandated, merely because a social insurance scheme against poverty had earlier been approved. When a legislator approves of a social insurance scheme it does not normally seem to mean that he approves of mass sterilisations. Indeed, the involuntary sterilisations of many individuals intuitively appears as such a gross breach of basic human rights that many politicians and citizens might well have chosen to do without a social insurance scheme at all if they had believed that the price of such an insurance scheme would be mass sterilisations. In such cases, Mises is correct that government interventions "not only fail to achieve the ends aimed at by their authors and supporters, but bring about a state of affairs which – from the point of view of their authors' and advocates' valuations – is less desirable than the previous state of affairs which they were designed to alter" (Mises, 1949, Chapter 36, Section 3).

9. CONCLUSIONS

This paper has put forward the proposition that one act of government intervention may often cause the enactment of further acts of government intervention, especially if the first act is the adoption of some kind of publicly provided social insurance system. The reason is simple. All insurance systems must try to limit the costs they face in terms of claims being made against them. To avoid that insurance holders make too many costly claims the insurance provider may attempt to engage in activities like excluding risky individuals from signing insurances with them, regulating risky behaviour on the part of insurance holders, and price differentiating between 'risky' insurance holders and less-risky insurance holders. Once a government has decided to provide some kind of insurance system (be it a medical insurance system, an unemployment insurance, a social welfare insurance, etc.) then that government will almost unavoidably have to get involved in some such activities in order to limit the costs imposed on the insurance system.

If insurance provision becomes an increasingly important activity of welfare states we will presumably only see an increasing concern with the limitation of costs. Let me just mention one obvious case where we could see such developments. Obesity appears to become an increasingly common medical problem in modern western populations, and will probably lead to a need for costly medical treatment for many individuals. Obesity can usually be avoided by adopting appropriate dietary and exercise regimes, however. Thus, only individuals who live risky lifestyles in terms of overeating and under-exercising are at risk of suffering from obesity. By regulating such behaviour the government who provides the relevant medical insurance would be able to limit the costs imposed on the medical insurance systems. Should we therefore assume that the state in the future will control individual's eating habits in order to avoid the problems of having an obese population?

In this article, I have outlined three methods that insurance providers might employ to limit the costs imposed on their insurance schemes: *exclusion, price differentiation,* and *behavioural regulation*. Since welfare states government' purpose with introducing social insurances is often precisely that no one should be left uninsured I predict that in the future we will see relatively few attempts to limit costs by *excluding* individuals from the insurance systems. Since welfare states also aim to 'solidarically' finance the provision of social insurances through progressive taxation I also predict that there will be relatively few attempts to introduce *price differentiation* such that more risky insurance holders will need to pay more for their insurances. Instead, I believe that it is most likely that welfare states governments will in the future attempt to limit the costs imposed on their social insurance systems by increasingly prohibiting individuals from engaging in 'risky behaviours' that might put them in need of claiming from the social insurance systems. To save the social insurance system individuals may therefore be denied the choice to engage in whatever 'risky' behaviours that they might themselves desire. More government intervention in the form of more governmentally provided insurance system would itself necessitate more subsequent government intervention aiming to regulate the behaviour of individuals. The more extensive the mandatory social insurance system of the welfare state becomes, the more will such governments have to reduce each individuals' personal liberty to choose to act as he would wish.

NOTES

1. This list need not be exhaustive.
2. Indeed, one might well argue that the inability to opt out of the governments 'insurance program' disqualify these from being called 'insurance' in any stricter sense. Similarly, these programs are strictly speaking not financed through 'fees' or 'premiums', since the tax financing of the system means that there is no strict relation between what an individual pays into the system and what benefits he might expect to receive from it.
3. Alternatively, one could argue that the state instead tried to use sterilisation to *regulate the risky behaviour* of individuals by limiting the extent to which they could provide offspring in need of public support. This seems more far stretched, however.
4. Alternatively, one could argue that freedom might be a precondition for feelings of security.

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INTERVENTIONISM AND THE STRUCTURE OF THE NAZI STATE, 1933–1939

Oliver Volckart

1. INTRODUCTION

It is frequently claimed that the interventionist economic policies which the Nazi government began to pursue as soon as it had come to power were ideologically motivated (cf. Barkai, 1990). There is undeniably some truth in this hypothesis – after all, an important strand in German political and economic thought, which goes back to the age of absolutism and which flourished in the post-World War I period, favored state power and state control of society (Mises, 1944b). Still, Nazi interventionism may have had stronger foundations than just ideology. It is the hypothesis of this article that it was rather grounded in the structure of the state erected by the Hitler regime. Far from being the monolithic power bloc proclaimed by its propagandists, the Third Reich was in fact composed of a plethora of political authorities, government offices, and bureaucratic departments supplemented by an increasing number of "Reich-Plenipotentiaries", "Special Representatives", and other satraps of Hitler who were appointed to solve specific problems and were never recalled. It is claimed here that it was the power struggles waged by these individuals and bureaucratic agencies which boosted the increasingly interventionist policies of the Nazi regime.

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Recently, these rivalries have received some attention among scholars working in the field of public choice and drawing on Austrian Economics. Thus, Ronald Wintrobe (1998, p. 316ff.) presents an analysis of the Third Reich which interprets the regime's dynamism as the outcome of competition among its bureaucratic agencies. Taking the insight into account that areas of responsibility in the Nazi bureaucracy briefly described above were frequently overlapping and that commands emanating from the top were often imprecise and left much room for interpretation (cf. Hüttenberger, 1976; Kershaw, 1998, p. 529ff.). Wintrobe (1998, p. 329) asserts that "[t]he bureaucratic structure of Nazi Germany […] was extremely competitive, and the bureaucrats […] who were active in the bureaucracy were energetic, entrepreneurial, and competitive – and, except toward the end, they were intensely loyal to their superiors".

In the light of recent historical research (e.g. Kershaw, 1998, p. 529ff.), Wintrobe's hypothesis sounds plausible enough. Still, his analysis has two disadvantages: on the one hand, he presents it in a highly informal way, backing it by purely anecdotal evidence. On the other hand, he does not apply his concept of competition within the Nazi regime to the economic policies pursued in Germany after 1933. In view of this, the present article has a double focus: first, it aims at testing Wintrobe's hypothesis that the heads of the Nazi bureaus competed with each other, and secondly, it analyses how their behavior influenced the regime's interventionist policies.

Because of the large number of agencies involved in economic policies of politics,[1] the paper restricts itself to examining just four of them which had special importance in the pre-war years on the one hand, it analyzes the German Labor Front (Deutsche Arbeitsfront, DAF) – the Nazi substitute for the trade unions – and the Reich Sustenance Corporation (Reichsnährstand, RNS) – a mega-organization which brought together producers and retailers of food. On the other hand, the Ministries of Economic Affairs and Employment are examined. The article thus covers agencies, which were established in the gray area between the state and the party after Hitler had come to power as well as bureaus, which belonged to the traditional central administration. Hence, it can be reasonably assumed that the behavior of the actors working in these agencies was representative of the regime as a whole.

The paper proceeds as follows. In the first section (Section 2), Wintrobe's idea of bureaucratic competition in the Third Reich is presented and made more explicit. This is done by drawing on theoretical elements of Austrian Economics. In Section 3, the hypotheses contained in this model are compared to political processes, which appear in sources from the Third Reich. Finally, in section (4), loose ends are tied up and the arguments of the paper are summarized.

2. RONALD WINTROBE'S IDEA OF BUREAU COMPETITION IN THE THIRD REICH

Although Wintrobe does not make use of an explicit model of competition in his analysis of the Third Reich, in another major work which stimulated his research in dictatorship Albert Breton and Wintrobe (1982, p. 108f.) rejected neoclassical models which focus on price competition. Instead, the authors gave preference to Austrian concepts of competition where creative and innovative individuals play a central role, that is, to concepts like those developed by Schumpeter (1943/94, p. 84f.) and von Hayek (1978). While a similar concept implicitly underlies Wintrobe's analysis of Nazi Germany, his model of competition needs to be made more explicit if his hypothesis is to be tested. For that purpose, a slightly more formal approach based on a recent interpretation of a concept first suggested by Erich Hoppmann (1967, p. 88ff.; cf. Streit, 2000, p. 101) seems to be particularly useful. Hoppmann's model draws attention to the fact that competition is a process where actors on both sides of the market interact in a way, which leads to the discovery of new solutions to the problem of scarcity. According to it, competition is composed of two interlinked processes, namely of a process of exchange which includes the relations between actors on both sides of the market, that is, between suppliers and demanders, and of a parallel process which includes the relations between actors on one and the same side of the market. Graphically, the interplay between both processes can be presented like this (see Fig. 1).

In the process of exchange, demanders choose goods or services provided by suppliers. Here, they must expend transaction costs in order to acquire information about the several offers and to negotiate transactions. For those suppliers not chosen, the decisions of the demanders create negative externalities, which on economic markets take the form of income losses. Externalities, in turn, provide incentives to acquire information about the demanders' preferences. Here, competition becomes effective as a discovery procedure: the substitutional pressure that it exerts forces suppliers to search for ways to satisfy demand better than their competitors, that is, for new solutions to the problem of scarcity. The result is a product- and price-competition, which gives the demanders the chance to choose between several offers.

When this model is applied to conditions prevailing within organizations – like, for example, bureaucracies and dictatorships – one problem becomes immediately obvious. Usually, the contracts which link the actors on both sides of a market and whose conclusion constitutes the process of exchange are supported by universally applicable institutions which protect property

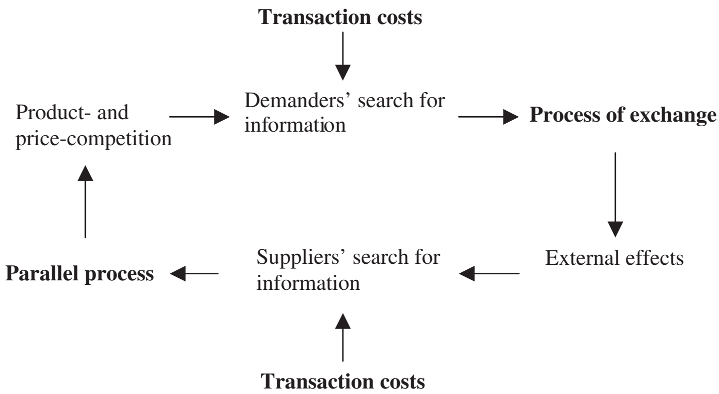

Fig. 1. Competition from an Austrian perspective.

rights, regulate their transfer by consent, and ensure compliance with obligations. Within hierarchies, no such institutions exist. Hierarchies are based on rules which are not universally valid, but different for the different members of the organization according to the different roles assigned to them (Hayek, 1982, p. 49). Consequently, there are no institutional precautions against breaches of contract. In his analysis of competition within the hierarchy of the Nazi bureaucracy, Wintrobe (1998, p. 210ff.) is well aware of this problem. The solution he suggests is based on the idea of networks of loyalty which are formed among the members of the bureaucracy (cf. Breton & Wintrobe, 1982, p. 62ff.), loyalty being, in other words, the factor which prevented the members of the bureaucratic agencies from reneging on the agreements they concluded in the competitive process of exchange.

As for the process of competition itself, Wintrobe (1998, p. 317) points out that in the Third Reich, "[s]chemes were constantly put forward by rival power centers or rival entrepreneurs, and Hitler would choose among them. Some were 'successful,' others not". In view of the model of competition presented above, this suggestive remark can be amended by a number of more explicit hypotheses:

Within the ill-defined hierarchy of Nazi Germany where overlapping areas of responsibility abounded, a kind of political market existed.

One side of this market was taken up by bureaucratic agencies (in Wintrobe's words "rival power centers or rival entrepreneurs"), that is, in the case examined here by the four agencies involved in economic policies which were introduced above.

Opposite them, there was one only actor: Hitler, who had at best potential competitors.

The bureaus put forward programs and concepts ("schemes", according to Wintrobe) for economic policies to Hitler.

What would these concepts have had to look like in order to have been acceptable to Hitler? In other words, what did the dictator maximize? In his theory of dictatorship, Wintrobe (1990, 1998, p. 43ff.) makes a distinction between several types of dictators. Most importantly, he distinguishes "tin pot-dictators" like those common in the post-colonial Third World, who maximize material income, from "totalitarians" like Hitler, Stalin, and Mao, who maximize power over the population under their control. This means that like his totalitarian colleagues, Hitler cannot have had any fixed preferences for economic policies. He was in principle completely indifferent between free market policies, interventionism, and the outright nationalization of the economy. What counted was that in order to be acceptable to him, the programs and concepts offered by the regime's economic policy bureaus had to be designed in a way which maximized his power.

In the context of his analysis of Nazi Germany, Wintrobe mentions only in passing what the heads of the bureaus were maximizing: He speaks of "abundant resources" which were put at the disposal of successful bureaus and of possibilities of advancement which were "almost never-ending" (Wintrobe, 1998, pp. 316, 324). Still, in other places he is more precise. A central argument in his theory of dictatorship is the hypothesis that dictators are usually forced to buy their supporters' loyalty by granting them rents (Wintrobe, 1990, p. 865, 1998, p. 49). Consequently, Wintrobe's theory implies that Hitler offered property rights to the bureaucratic agencies which allowed them to appropriate rents.

This is, in fact, what the resources and the chances of advancement granted to successful bureaus amounted to. Having made the assumptions contained in Wintrobe's model of bureau competition in the Third Reich more explicit, it becomes possible to deduce two conclusions:

In competition, the bureaucratic agencies discovered new ways of satisfying the dictator's demand for political support. As their support took the form of programs applying to economic policies, these programs were constantly and increasingly adapted to Hitler's wishes.

Because Hitler had a de facto monopsonistic position vis-à-vis the bureaus, he could almost arbitrarily determine the price he paid for their support. There was only one relevant restriction: the probability that a competitor to himself – that is, another dictator – would enter the market grew when he lowered the price.

Put briefly, the model predicts that over time, Hitler would choose bureaucratic agencies with increasingly lower curves of supply, that is, bureaus who were prepared to supply him with more support at a lower price paid in rents. In other words, the agencies were bound to develop programs for economic policies, which would be increasingly efficient from the dictator's point of view, that is, which would help him to maximize his power. By first looking at the competitive process of exchange and then analyzing the parallel process, the next section will show whether this prediction is correct.

3. BUREAUCRACY AND ECONOMIC POLICY

3.1. The Process of Exchange

Let's first consider the supply and demand of the bureaucratic actors. As mentioned above, the present analysis restricts itself to pre-war Germany and concentrates on the Ministries of Economic Affairs and Employment, on the German Labor Front and on the Reich Sustenance Corporation. During the first months of the Third Reich, the Ministry of Economic Affairs was led by Alfred Hugenberg,[2] from June 1933 to June 1934 by Kurt Schmitt, after that by Hjalmar Schacht and, after a brief intermezzo when Hermann Göring took over as acting minister, since February 1938 by Walther Funk (Boelcke, 1983; Herbst, 1993). Franz Seldte stayed Minister of Employment for the whole duration of the regime. The Labor Front was led by Robert Ley (Smelser, 1988; Frese, 1991), the Reich Sustenance Corporation by Walther Darré who, until 1942, held the position of Minister of Agriculture, as well (Corni, 1989). What were the aims of these actors, and what did they demand of Hitler?

At first glance, the behavior of Nazi bureaus, which shows up in the sources does not seem very closely to correspond to Wintrobe's assumptions. Rather, it agrees with hypotheses put forward by Anthony Downs (1965) in his contributions to the theory of bureaucracy. According to Downs, the utility function of bureaucrats is made up of factors like sloth, loyalty, pride in a high level of performance, and of the creation of "territories", that is, of autonomous decision-making powers defined by property rights. Territories in this sense had really prime importance, as became evident for the first time when the question arose who should control the obligatory professional associations created since 1933 (Esenwein-Rothe, 1965, p. 39ff.). In August 1934, the association of traders in imported groceries of Chemnitz, a medium-sized town in Saxony, published a circular for its members. "There is still no clarity", it said. "In Berlin, two powers are fighting with each other: the Minister of Agriculture and the Minister of Economic Affairs. Who will be the winner? Until today, nobody knows where the grocers belong" (BArch, R 3101/9043: 19).[3] Two days later, another circular asked: "What is up in Berlin? What is the game at the government's table? The fight has been swaying to and fro for weeks now: register with the Reich Sustenance Corporation, don't register, register, don't register, and so on. Now who has the right to demand that, and who has not?" (BArch, R 3101/9043: 20).

While the bureaus engaged in this squabble just tried to add one business branch to their respective territories, the argument between the Ministry of Economic Affairs and the DAF touched more fundamental questions. After assuming office, Schacht remodeled the obligatory business associations founded by his predecessor and brought them together under a new umbrella "Organization of Commerce and Industry" (*Organisation der gewerblichen Wirtschaft*) (Schweitzer, 1964, p. 254; Esenwein-Rothe, 1965, p. 65). In spite of this organization being under the Ministry of Economic Affairs, the Labor Front saw a chance to intervene (Lölhöffel, 1965, p. 175ff.). In June 1936, Schacht complained to Ley: "Lately, news multiply that functionaries of the German Labor Front [...] are claiming that the Organization of Commerce and Industry will shortly disappear and will be absorbed by the German Labor Front. [...] Such intentions of the Labor Front are already discussed by the public and by the press, too" (BArch, R 3101/10314: 61). Schacht pointed to the rumor "that these activities of your functionaries are due to recent directives of the Labor Front leadership, and that you, too, have adopted this claim" (BArch, R 3101/10314: 60). Schacht obviously feared that Ley was about to take over the competence to shape commercial and industrial policies as a whole.

The circular of the imported grocery's traders' association of Chemnitz shows that what was at stake in these quarrels was the issue who should have the right to act in certain ways and who should not. Specifically, two types of property rights were relevant here. On the one hand, the bureaus competed for rights which gave them the power to determine certain aspects of the behavior of individual concerns, business branches or whole sectors of the economy, and which thereby circumscribed the territories they tried to aggrandize. On the other hand, there were rights which allowed the bureaus to appropriate resources at the expense of some third party (the identity of this party being defined by the rights of the first type just mentioned).[4] Such rights were in demand because in order to exercise the rights which delineated the bureaus' territories, an administrative apparatus of some size was needed: beginning with local farmers' leaders of the Reich Sustenance Corporation and small Labor Front functionaries to the business branch leaders of the Organization of Commerce and Industry and finally up to Reich Commissioners or Inspectors General appointed to solve specific problems. By 1938, the RNS alone was supporting 20–30,000 functionaries, spending over 70 million Marks per year on the upkeep of its organization (Corni, 1990, p. 74). The need to acquire these funds explains the general interest in the formation and control of obligatory business associations. It becomes also evident that it was the budgetary needs of the competing bureaus which boosted their intrusion into spheres of everyday life which had hitherto been private, and which thereby contributed to the totalitarian character of the regime (cf. Mises, 1944a, p. 17). Altogether, a closer examination shows that Wintrobe's assumptions do, after all, agree with what the sources show. Appropriating rents was really of prime importance for the bureaucratic agencies.

Their rent seeking was, in fact, a variant of the budget maximizing behavior of bureaus stressed by the Niskanen-school of bureaucratic theory. Usually, this theory is focusing on the budgetary means bureaus demand of their political principals (cf. Niskanen, 1971/94). In the present case, this demand was obviously relatively unimportant because many bureaus had their own means and income, which made them independent of financial support by the government. The DAF and the RNS, for example, had taken over the property of the trade unions and of the traditional farmers' associations, respectively (Lölhöffel, 1965, p. 157; Corni, 1990, p. 73). Additionally, both organizations collected subscriptions of their members. Thus, the bureaucratic agencies of the Third Reich did not maximize their budget in the narrow sense of the word but rather the rents, which they could appropriate with the help of the property rights they demanded of Hitler. For the dictator, this was convenient: he did not have to draw on the government's budget in order to buy an economic policy program devised by one of the bureaus, but could pass on the costs to the population. Insofar, the rents granted to the bureaus equaled additional and discriminatory taxes.

Note that the aims of the bureaucratic agencies were at least in part mutually exclusive. In commercial or industrial policies, only Schacht or Ley could have the last word, and when the Reich Sustenance Corporation annexed a business branch, Darré gained competencies which the Minister of Economic Affairs could then not exert any longer. Put briefly: as the actors were trying to appropriate property rights which could not be divided, the gain of one implied, as an external effect, the loss of the other.

So much for the demand of the bureaucratic agencies. What was Hitler demanding on the opposite side of the market? In order to answer this question, it is helpful to consider what the bureaus were producing. Here, concepts and programs, which applied to economic and social policies and which at least in part widely differed from each other were really prominent. As pointed out by Wintrobe (1998, p. 319), divergence was possible because Hitler used to reveal his political demands only in a very concealed way. For example, when he demanded in February 1933 that "within four years the German farmer must be saved from impoverishment" and that "in four years, unemployment must be overcome" (Thamer, 1994, p. 470), this did not only leave much room for interpretation, but also for the development of widely different solutions and ideas. A few years later, Ley himself confessed that "it was not as if we had had a finished program which we could have pulled out and used to set up the Labor Front. Rather, the Führer ordered me to take over the trade unions, and then I had to see what to make of them" (Thamer, 1994, p. 496). What Ley set up initially was an umbrella organization for semi-autonomous corporations not only of workers, but of employers, too (Bruns, 1937, p. 20f.; Barkai, 1990, p. 123; Frese, 1991, p. 74). At the same time, the leader of the Reich Sustenance Corporation and Minister of Agriculture, Darré, advocated a program which amounted to the de-urbanization and de-industrialization of Germany (Schoenbaum, 1968/80, p. 198; Grundmann, 1979, p. 24; Corni, 1990, p. 22). As minister of economic affairs, Hugenberg was unwilling or unable to develop programs of his own (Boelcke, 1983, p. 53), but his successors supported concepts which were hardly compatible with those of Darré and Ley. Schmitt, whose way into office Göring cleared by ousting Otto Wagener – a Nazi ideologist and theoretician of the corporatist state (Barkai, 1990, p. 109; Boelcke, 1983, p. 67) – was rather more oriented toward a market economy, and Schacht proved from the start to be a friend of big business (Schweitzer, 1964, p. 255; Boelcke, 1983, p. 82f.). All these programs had, however, one thing in common: As the bureaus needed to maximize their budgets, just leaving big business, the professions, or agriculture alone would have served none of them. The funds the agencies needed could best be appropriated from obligatory social organizations subordinate to them. Hence, all their programs entailed more or less interventionist policies.

The dictator probably knew the economic programs put forward by the bureaus quite well. As they wanted to be chosen by him, it was in their interest to keep him informed and to carry the transaction costs involved here.[5] However, what determined Hitler's choice of program? If the explicit form of Wintrobe's model which is presented above is correct, he would select the scheme which helped him to maximize the support rendered to him – this, and not the expected economic consequences of the programs offered to him was the relevant factor. On the basis of this assumption, the sometimes erratic political decisions of the regime can indeed be explained quite well. Thus, it is of course possible that Hitler's refutation of concepts of the corporatist state and economy in the second half of 1933 and his swing to an economic policy which, though creating numerous interventionist instruments, did at least initially not destroy market mechanisms (Blaich, 1971, p. 9), was due to the insight that neither rearming nor reducing unemployment would be possible with the help of policies like those initially pursued by Ley (cf. Barkai, 1990, p. 110). It is, however, at least as likely that Hitler just realized that while his regime was still consolidating, he needed the support of actors like Schmitt who were on good terms with big business and had some standing abroad, too (Feldman, 2001, p. 104f.). Still, if Hitler wished to gratify or placate old comrades who advocated different economic programs, he could make concessions to them, as well. Thus, in October 1934, he signed a declaration prepared by Ley which conferred important responsibilities in economic and social policies to the DAF, among them the right to mediate between employers and employees and "to find that settlement which corresponds to national-socialist principles" (Reichsorganisationsleiter der NSDAP, 1937, p. 185ff.). This could be interpreted as if the Labor Front was from now on to determine wages. Understandably, both the Ministry of Economic Affairs and of Employment went into an uproar (Broszat, 1983, p. 152). If an agency impressed Hitler by proceeding against competitors with particular ruthlessness, thereby promising to support him with more than average energy, he could also choose this bureau's program. Such a decision could always be justified with social-Darwinist arguments which were a central component of Hitler's ideology (Weiß, 1993, p. 75). Moreover, having once chosen the more or less interventionist policies propagated by one bureau, the consequences of the implementation of this policy tended soon to require more interventions of a different sort (cf. Kirzner, 1991, p. 635), and this would justify switching to a concept devised by some other bureau. The interventionist logic itself motivated part of the regime's inconsistent and erratic economic policies.

Regardless of what determined Hitler's choice of economic policy, his decisions always constituted an implicit contract between him and the bureau he favored and to whom he either granted new property rights or confirmed old ones. So, how about Wintrobe's hypothesis that it was loyalty which prevented the violation of these contracts? In fact, if Hitler and the heads of the bureaus considered here were really linked by feelings of loyalty, the relationship must have been extremely one-sided. Clearly, loyalty did not prevent Hitler's repeated switch from one bureaucratic agency to another. His grant of new rights to Ley in October 1934, which was previously discussed neither with the Ministry of Economic Affairs nor with the Ministry of Employment, shows that the dictator was in principle prepared to exchange policies he had chosen for those offered by other bureaus when this suited him.[6] However, while the inverse case – the switch of a bureaucratic agency to a different demander of economic programs – never occurred, this need not have been due to any feelings of loyalty on the side of the heads of the bureaus. The following chapter shows that loyalty is, in fact, not a necessary argument in the explanation of the behavior of the Third Reich's bureaucratic agencies.

3.2. The Parallel Process

Above, it has been suggested that Hitler was the only demander of political support rendered to him in the form of economic programs, having, in other words, a monopsony. In fact, no leader of any bureaucratic agency examined here ever considered to offer his support to anybody but him. Even for a totalitarian dictator, such a strong position was unusual. In Italy, for example, during the whole of Mussolini's reign, the king and the fascist grand council functioned as alternative focal points for the loyalty of the subjects. What is more, they became effective as such in 1943 when Badoglio deposed the dictator and led Italy out of her alliance with Germany. Thus, the German case evidently needs explaining.

Leaving for the moment Wintrobe's loyalty-hypothesis aside, it is obvious that one problem which potential dissidents in every dictatorship face is that of collective action (cf. Olson, 1965). One need not think of a mass movement whose emergence can be prevented by any dictator with a reasonably efficient police force, but just of actors from within the regime (Tullock, 1987, p. 396), that is in the German case, of the heads of the bureaucratic agencies. Since Hitler's removal from office would have constituted a public good, the usual free-riding-problems would have arisen even if all bureaus had been equally interested in the dictator's overthrow. If, however, the head of one agency would have had a particular interest in ousting Hitler, he would have needed to offer something to the others in order to persuade them to cooperate. Here, he would have had only one option: he would have had to promise them to grant them at least as many property rights as they could obtain from Hitler. Quite apart from the problem of making such a promise credible, there were few incentives for the other bureaucratic a gencies to accept such an offer which would, moreover, have been fraught with considerable risk. Thus, the fact that collective action with the aim of deposing the dictator was difficult to bring about goes a long way in explaining why Hitler's position was so strong.

Still, the argument is no sufficient explanation. After all, it is valid for all hierarchies, which lack institutionalized procedures for filling the leading position, that is, for most dictatorships, too, which are obviously not immune to coups. However, if Hitler's strategy in the parallel process is taken into account, it becomes possible to explain his exceptionally strong position. Two aspects of his strategy were of special importance:

Hitler's propaganda-oriented view of politics made it difficult for him to admit to wrong decisions, including decisions in the area of personnel policy (Kershaw, 1998, p. 532). In consequence he tended not openly to degrade the heads of bureaus who lost his favor (Ernst Röhm, whom he had murdered in July 1934, being an obvious exception to the rule), but to allow them to continue appropriating the rents connected with the station they had reached within the regime (Weiß, 1993, p. 71). Ley, for example, whose original ambitious plans for the Labor Front were soon discarded, remained leader of the DAF and had the chance to develop other concepts for social and economic policies, which he could try to sell to his Führer.[7] The establishment of Göring's Office for the Implementation of the Four-Year-Plan in 1936 – designed to further German autarky – precipitated Schacht's fall from power, but not his dismissal. He left the Ministry of Economic Affairs on his own account. Darré lost practically all his original influence on agricultural policy when his devious permanent secretary Herbert Backe became a creature of Göring, being enticed by a high post in the Office for the Implementation of the Four-Year-Plan. Still, Darré could continue to style himself Reich Farmers' Leader and head the Reich Sustenance Corporation (Broszat, 1983, p. 301; Lehmann, 1993, p. 6; Corni, 1990, p. 247). Thus, actors who were beaten by their rivals lost only part of the property rights they had acquired at some earlier point in time in the process of exchange: they lost the rights which defined their territories, but not those which allowed them to appropriate rents at the expense of some third party. The fact that they could retain these rights reduced the incentives to invest into the establishment of an alternative demander for the political concepts they had developed.

Hitler prevented any attempt to replace the constitution of the Weimar Republic, which had de facto, if not de jure, been repealed in spring 1933, by a new national socialist constitution. During the initial years of Nazi power it was primarily the Minister of the Interior who tried to create a highly centralized state by implementing such a reform. However, by the time of the Röhm purge at the latest, Hitler seems to have realized that new political institutions would not only strengthen the traditional central bureaucratic apparatus, but would also circumscribe his own arbitrary power (Broszat, 1983, p. 119). Among the consequences of his decision to terminate a "Reich Reform" was one which he probably did not foresee. He thereby impeded the emergence and efficiency of institutions, which could have prevented the bureaus from appropriating politically relevant property rights without his explicit consent. This, too, reduced incentives to make an effort in order to oust Hitler.

Both strategies reduced the probability that an alternative demander of programs for economic policies would enter the market. Because the existence of a rival potential dictator would have been a necessary condition for the bureaus to be able to renege on the contracts they had concluded with Hitler, it is possible to explain the fact that no head of any bureaucratic agency ever considered violating a contract without assuming that the actors were linked by feelings of loyalty. Loyalty may, of course, have existed, but it is not a necessary argument.

Hitler's strategies, particularly his tacit acceptance of the non-authorized appropriation of property rights, had direct consequences for how the actors on the other side of the market behaved in the competitive parallel process, too. When the bureaus tried to gain an advantage over their rivals, this was the option they were most likely to choose. Which methods they employed in this context can be demonstrated using the activities of the Reich Sustenance Corporation as a case in kind. The RNS did not only aim at controlling agriculture, but also the trade in food. Here, it got into a dispute with the Ministry of Economic Affairs concerning control over firms which were trading in imported groceries and which were organized in the Reich Association of Retailers in Colonial Goods (Rekofei). In May 1934, Schmitt had made membership in the Rekofei obligatory, and by July of that year about 130,000 firms had joined the association (BArch, R 3101/9043: 59). On July 8, a meeting was held in Bitterfeld in present-day Sachsen-Anhalt where a local functionary of the RNS declared "he was not in the least interested in where retailers in groceries were to be organized. Since April 1, 1934, every grocer trading in the Reich Sustenance Corporation's products, including tropical fruits in their processed forms, was automatically a member of the Reich Sustenance Corporation anyway. Registration was purely a formality. He was completely unable to understand why a special association for retailers in food existed at all. The Rekofei would be dissolved just like the association of wholesale traders in food, that was dead certain" (BArch, R 3101/9043: 51). This tone was harmless as compared to the one adopted by a leading RNS-functionary on a meeting in Berlin, who declared to representatives of the Rekofei ''There are still concentration camps in Germany, and I will see that these gentlemen will spend some weeks of holiday there'' (BArch, R 3101/9043: 49). Occasionally, the Reich Sustenance Corporation was helped by the police and local authorities in forcing the members of the Rekofei into registering (BArch, R 3101/9043: 59); otherwise it relied on threats of exorbitant fines and prison sentences, which were published in the press (BArch, R 3101/9043: 188). Schmitt proved unable to put a stop to this development, having to be content with a memorandum which the Minister of Justice compiled for him and which advocated the dual membership of certain business branches in both the Reich Sustenance Corporation and the obligatory organizations of the Ministry of Economic Affairs (BArch, R 3101/9043: 174).

After the Nazis had consolidated their power, the bureaucratic agencies chose less ruthless methods but did not change their aims. The Labor Front's attempt to establish an exchange market for real estate agents which was to be controlled by its own functionaries was typical. The Reich Economy Chamber (*Reichswirtschaftskammer*), a sub-organization of the Ministry of Economic Affairs, claimed in 1936 that ''exchanging estate agents' commissions was a purely economic activity which exclusively falls into the competence of the Organization of Commerce and Industry'' (BArch, R 3101/10312: 44). The DAF, however, played the anti-Jewish card. ''In Frankfurt on the Main the struggle between Arian and non-Arian estate agents is particularly fierce'', it maintained. ''Even today large transactions are almost exclusively concluded by Jewish agents. Consequently, Arian agents have begun to wish for more joint operations among themselves. […] Naturally, only Arian estate agents were to be admitted to these joint transactions'' (BArch, R 3101/10312: 46).

As the Ministry of Economic Affairs did not choose to go against the anti-Semitism propagated by the Labor Front, it had to accept its rival's intrusions, having to be content with placing a representative of the Organization of Commerce and Industry in the controlling board of the new exchange market (BArch, R 3101/10312: 49). Simultaneous events in Saxony show that the Labor Front's care about the economic well-being of ''Arian'' estate agents was nothing but a pretext. In Dresden, the DAF obstructed the activities of the local organization of estate agents, advancing the archaic argument that they were responsible for ''turning German soil into a commodity'' (BArch, R 3101/10312: 7). Ley's organization aimed exclusively at pushing back the influence of the Ministry of Economic Affairs, that is, at extending its own territory.

The bureaus who acted in this way obviously hoped that the property rights which they appropriated would be confirmed by Hitler at some later date. As one official puts it in 1934 ''[…] one who works correctly towards the Führer along his lines and towards his aims will in future as previously have the finest reward of one day suddenly attaining the legal confirmation of his work'' (Kershaw, 1998, p. 529). For the reasons discussed above, this would enable the agencies to continue to appropriate their rents even if they lost their actual power to some rival. Because it was well known that Hitler's choice between competing bureaus depended often on who was most successful in pushing aside rivals and in usurping property rights (Mommsen, 1991, p. 408; Weiß, 1993, p. 75), the activities described above have to be seen in the context of the parallel process. In fact, they constituted the most important strategy bureaucratic agencies employed in order to defeat their competitors.

As the examination of these strategies shows, bureaus had one option, which they chose largely to ignore: They were obviously relatively uninterested in adapting their policy supply to the dictator's demand. At first, this comes as a surprise. The model introduced in Section 2 predicts, for example, that after the proclamation of the Four-Year-Plan Schacht would have nothing more urgent to do than to develop even more radical plans for autarky than Göring, thereby trying to regain Hitler's favor. Nothing like that actually happened. Darré, too, did not react to his fall from power by increasing his efforts in competition, rather immersing himself into his ever more absurd blood-and-soil ideology. Meanwhile, under Backe, the regime's agricultural policy gave increasing attention to efficiency and productivity. In the next chapter, the question is answered why bureaus whose offer Hitler spurned did not, as predicted by the model, try to adapt their policies to the dictator's demand.

4. CONCLUSION: MODEL AND REALITY

How does Wintrobe's idea of bureau competition in Nazi Germany stand up in comparison to what can be gleaned from the sources? Contrasting the model constructed along his lines in Section 2 with political processes which actually happened in the Third Reich gives a mixed impression: while the premises of the model find their counterparts in history, the conclusions which can be derived from them do not seem to agree with what the sources show. Briefly, parallels and differences between model and actual history can be summarized like this:

As assumed in the model, there was a political market in Nazi Germany on whose sides Hitler and the bureaus faced each other.

The bureaus were really exchanging political support in the form of programs and concepts for economic policies for property rights which allowed them to appropriate rents.

So far, the basic structure of the model mirrors actual history with sufficient accuracy. Still, it predicts that the bureaus would compete by investing into the search for new possibilities to satisfy Hitler's demand. In other words, it leads one to expect that the programs devised by the agencies were increasingly geared to the dictator's wishes. Instead, the sources show that in the parallel process, the acquisition of information about the demander's wishes was less important than the non-authorized appropriation of property rights, and that product competition was relatively unimportant; that is, programs for economic policies were not adapted to Hitler's demand.

Also, contrary to Wintrobe's assumptions, feelings of loyalty do not seem to have played an important role in ensuring that the actors conformed to the contracts they concluded. As a matter of fact, the hypothesis that the strategies Hitler chose in the parallel process were sufficient in order to bind the heads of the competing bureaus to their obligations leads to an explanation of why the predictions of the model differ from actual history. For example, Hitler's tendency to allow bureaus who were beaten in competition to continue appropriating rents did not only reduce incentives to plot his overthrow, but also to invest in the search for information about his wishes regarding economic policies, and to develop corresponding programs. This aspect of Hitler's strategy influenced the intensity of the bureaus' engagement in the parallel process. Even more important was the other aspect, that is, the fact that he tended to back agencies who had usurped property rights with particular ruthlessness. In this way, Hitler did not only reduce incentives to search for ways to satisfy his demand regarding economic policies, but directed the efforts of the bureaus into a completely different direction. Their competition continued to function as a discovery procedure, but what they discovered under the conditions created by Hitler's dictatorship were new ways to usurp politically relevant property rights. As shown above, these ways reached from tacitly appropriating such rights to threatening to send persons affected by the bureaus' activities into the concentration camps.

Thus, Hitler's strategy distorted bureau competition in a several ways. It did not eliminate it: in the last resort, the bureaus aimed at appropriating rents, but in order to do so, they needed at least temporarily to acquire political property rights of both types discussed above, that is, not only rights which allowed them to appropriate resources at the expense of some third party, but also rights which defined their territory. While the third party might be simultaneously exploited by several bureaus, the rights which defined the territory could be exercised only by one agency at a time. Therefore, the bureaus were still competing with each other. However, through his choice of strategy Hitler caused the competitive conflicts between the bureaucratic agencies to be resolved not at the expense of each other, but at the expense of the population who was the victim of the rent seeking – disguised as interventionist economic policies – of an increasing number of bureaus. Through his choice of strategy, he also destroyed the incentives which otherwise would have induced the bureaus to adapt the schemes they put forward to his wishes. Thus, ironically, it was Hitler himself who prevented bureau competition from having the outcome he desired.

Wintrobe's hypothesis is thus only partly tenable: there was competition, but it had other effects than he assumed. The main effect, and the one that had the strongest impact on the shape of the Third Reich's economic system, was the rampant interventionism propagated by the competing bureaus. This interventionism was a necessary consequence of their spread: each new agency, every newly appointed "Reich-Commissioner" or "Special-Plenipotentiary" was in need of funds, and in order to acquire these, he had to carve out a territory for himself whose inhabitants he could exploit. The exploitation took the form of interventionist programs, which in turn gave rise to problems that called for more interventionist agencies. Thus, the hypothesis which this paper started out to test is confirmed by what can be gleaned from the sources: At least an important part of Nazi interventionism was indeed a consequence rather of competition between the regime's bureaucratic agencies than of the ideological bias of its proponents. It followed logically from the political structure of the Nazi state.

NOTES

1. Among the economic-policy bureaus which are not treated here are the Ministry of Finance, the Office of the Reich Commissioner for Price Control, the Reich Labor Service, the Office of the Inspector General for German Roads and Streets and the "Organization Todt", which was linked to it, the Office for the Implementation of the Four-Year-Plan, the Office for the Economics of Defense, the Ministry of Armament, Albert Speer's Central Planning Office, and the Office of the Inspector General for the Allocation of Labor.

2. Until his resignation in June 1933, Hugenberg was also Minister of Agriculture.

3. Shelf-marks of sources from the *Bundesarchiv* (Federal Archive) in Berlin-Lichterfelde are cited ‘‘BArch’’. R 3101 designates files from the former Ministry of Economic Affairs.

4. While initially both types of rights were closely linked, they might become separated over time. This was important for the behavior of the bureaus in the process of exchange.

5. Creating multiple and overlapping zones of responsibility allows political principals to reduce informational asymmetries between them and their bureaucratic agents. This strengthens the principals' relative power (Wintrobe, 1997, p. 436).

6. Other examples are Hitler's switch from Schacht to Göring in 1936/1937 and his switch from Göring to Speer in 1941/1942.

7. The Labor Front developed into a mega-organization engaged in spreading Nazi propaganda among workers, brightening up workrooms, organizing professional contests among firms, and providing vacation trips and homes for employees (Frese, 1991). It also developed more directly economic interests, using the property of the trade unions which it had expropriated to establish the Volkswagen-works in Wolfsburg (Mommsen & Grieger, 1996, p. 33).

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LAW AND POLITICS: REFLECTIONS UPON THE CONCEPT OF A SPONTANEOUS ORDER AND THE EU[☆]

Jan-Erik Lane

1. INTRODUCTION

The idea of spontaneous orders dating back to Mandeville and elaborated at length by the Austrian School of Economics (Menger, Hayek) is no doubt a major contribution to the understanding of society (Hamowy, 1987). It offers great insights into how human beings solve coordination problems by unintentionally creating mechanisms for social interaction such as the market, money, language, science and law (Hamowy, 1987; Petsoulas, 2000). Such a successful concept must have its limits somewhere, as a concept which explains everything covers nothing. I wish to explore this question by relating the evolution of European integration after the Second World War to the Hayek theory of a spontaneous order. Perhaps Hayek contributed most to the elaboration of Adam Smith's vision of a self-correcting social order that needs little direction and control (Boettke, 1998). Hayek

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underlined time and again the importance of spontaneous processes with the entailed claim that government must adopt an attitude of humility towards conventions that are not the result of intelligent design, the justification of which in the particular instant may not be recognizable, and that may appear unintelligible and irrational (Hayek, 1960, 1982).

The growth of EU law calls for an analysis in order to understand how such a major institutional development could take place within such a limited period of time. The process of European integration is different from all comparable processes of integration in the emphasis given to law as an instrument of achieving the goals of integration. Whether one deals with economic integration or policy harmonization in Europe, it is EU law that is the core. Thus, real economic integration has gone far partly due to the institutional integration of Western Europe, as manifested in the emergence of EU law (Lane, 2005).

Thus, the purpose of this article is to discuss the nature of EU law from the Hayekian perspective. What needs a better understanding is that such a development of public law according to the *Civil Law framework* could prove beneficial for real life outcomes. One may put the success of the Civil Law approach used in EU law in contrast with the teachings of the school of *Law and Economics* (Posner, 1993, 1998). The highly influential approach *Law and Economics* emphasizes that the Common Law framework, with its core in contract law and tort law, is the legal tradition or family most suitable for enhancing economic efficiency. Yet, the emergence of EU law forces us to reconsider public law, especially in its Civil Law approach, and its relevance for promoting economic efficiency (Lovisi, 2003).

2. EU: REGIONAL COORDINATION

The emergence of EU law as a major legal framework in Europe would naturally lead one to the conclusion that EU displays stateness. After all, law and state are intimately connected, as legal scholars of a positivist bend would suggest. However, the basic Kelsen equation Law = State, does not apply in relation to the Union (Kelsen, 1999). Governments can create a legal order in the form of a union without setting up a federation. The EU lacks several of the most important state attributes, but it is none the less a legal order. Of its three pillars it is the Economic Community (EC), which constitutes a legal order. It is the EC, which is the model for future integration as it displays the firmness of law at the same time as it offers flexibility. As a matter of fact, the EC offers a solution to a classical problem in political science: How can states cooperate without abandoning what is the characteristic feature of a state, viz its sovereignty? The European answer to this question has not been to erect a new federation but to maintain the nation-states in Europe while at the same time delegating enough power to the Union so that it can function as a legal order. The nation-states of Europe have kept (part of their) sovereignty but they have also given part of it away, as European law trumps national law according to the jurisdiction of The Court of Justice of the European Communities. A member state can always leave the Union if it is not willing to accept EU law any longer.

Economic integration can take place in two different ways. Either the integration process is unintentionally working itself out through the invisible hand and resulting in a spontaneous order. Much of globalization is of this kind of integration today creating one global market economy (Bhagwati, 2004). Economic dependencies, resulting from trade and foreign direct investments, tend to result in economic integration, either in the real economy (production, capital) or the financial economy (financial assets). Or integration is done through a process of design, i.e. explicit institutional policy-making where explicit rules are enacted comprising various integration measures, such as e.g. the Internal Market of the Union. European integration has been of both these types. Here, I focus upon how government can enhance integration through the creation of institutions and the making of policy, resulting in public law (confirmed in explicit agreements or treaties between states), although I would not doubt a moment that most of the economic integration that actually takes places within these institutions is driven by the Austrian mechanisms of individual economic players' incentives (Kirzner, 1992; Oakley, 1999; Keizer, 1997).

When the integration process is analyzed from the design perspective, meaning as a set of policy choices or as an intended political process of change, then it may be looked upon from the means–end perspective. And one may evaluate the extent to which the policy expectations have actually been materialized. Integration in Europe has, of course, occurred both unintentionally, especially economically, and intentionally. When governments decide to integrate their countries, then how could they proceed? Governments promoting regional economic integration would have to ask themselves the following questions: How to integrate? Create the same rules for economic life – how and what scope? Harmonization or one single community standard? Solving these problems requires a mixture of law and politics, which process needs to be better theorized in the social sciences.

The explicit and intentional process of integrating countries must rely upon the states. Governments may initiate a policy of integration by amalgamating the countries in a Union. Integration may be achieved by the erection of a new state, but European integration has not gone this far. European integration is *sui generis*, accomplishing both strong integration by fiat while retaining the sovereign nation-states of Western Europe. How was this possible – an institutional innovation in the history of mankind? The reply would be: through the explicit development of public law as the foundation for regional state coordination.

3. SPONTANEOUS ORDER

Although there are many differences between the Austrian School and the school of *Law and Economics*, one may still argue that these two schools end up sharing much of the same view upon the market as well as upon economic regulation. It is worth emphasizing that the theoretical arguments that lead to the scepticism of governmental intervention and state planning differ between the classical Austrians and the modern adherents of *Law and Economics*. Here, I concentrate upon what unites the two schools, which is their preference for voluntary coordination, as it is conducive towards the emergence of spontaneous orders such as the competitive market and Common Law institutions such as tort law.

For *Law and Economics* as well as for Austrians, explicit public economic regulation may be destructive of prosperity, because it misallocates resources and is extremely destructive of small business and entrepreneurship. Thus, environmental policy can only do what it does at the cost of lowering standards of living. And antitrust policy, in contrast to its stated policy, does not generate higher consumer welfare. Any firm that attempts to sell below the costs of production will suffer losses. The moment it attempts to raise prices, it invites competitors back into the market. Civil rights legislation represents intrusive regulatory interventions into labour markets. When employers are not able to hire, fire and promote based merely on the criteria of merit and market value, dislocations are bound to occur within both the firm and in labour markets at large. Moreover, civil rights legislation could create legal preferences for some groups, which in turn could undermine the public sense of fairness that is the market's hallmark. Moreover, economic regulation by fiat may impede the entrepreneurial discovery process. This process is based on having a wide array of alternatives open to the use of capital. Yet government regulation may limit the options of entrepreneurs, and might erect barriers to the exercise of entrepreneurial talent. Safety, health, and labour regulations, for example, could not only inhibit existing production, but they might impede the development of better production methods.

Finally, *Law and Economics* as well as Austrians tend to be critical of redistribution as it takes from property owners and producers and gives, by definition, to non-owners and non-producers. This diminishes the value of the property that has been redistributed. Far from increasing total welfare, redistribution might diminish it, especially if there is rent-seeking. By making property and its value less secure, income transfers lessen the benefits of ownership and production, and thus lower the incentives to both. Austrians tend to reject the use of redistribution to stimulate the economy or otherwise manipulate the structure of economic activity. Increasing taxes, for example, can do nothing but harm due to the risk of wealth destruction by forcibly confiscating property that could otherwise be saved or invested, thus lowering the number of consumer options available. Moreover, there is no such thing as a strict consumer tax, because all taxes decrease production. This is not the place to discuss these claims, which I happen to share to a considerable extent.

Now, what is an interesting and relevant question is to relate this general governmental and state scepticism of the classical Austrians and the modern school of *Law and Economics* to the implementation of the European project. The European Union cannot be described as a spontaneous order, as it has almost achieved the "miracle" of integrating Western Europe in less than 50 years through institutional design, at least partly. And now the process of integrating Eastern Europe unfolds with great amplitude. Two forces have driven West European integration in close collaboration. On the one hand, there is the institutional integration of countries with separate legal systems and national traditions. On the other hand, there is far-reaching economic integration creating one real market economy with closely interlinked financial markets. Here, I focus upon the institutional integration of Western Europe, which has been accomplished by fiat, i.e. by a series of key policy decisions implemented through a political process.

The European project forces us to reconsider the negative view of public law and regulation that is pervasive in Austrian Economics as well as in *Law and Economics*. Public law may be employed as a tool for intentional change through law and politics, building upon a series of policy decisions implemented through a public law mechanism. Public law results to a considerable degree from political decision-making, where political authorities other than judges play a key role. The European Union is a major achievement partly due to the existence of European Law. And EU law is the outcome of the *Civil Law* approach, meaning the codification of general principles such as mutual recognition as well as the predominance of legislation over case law.

What makes the EU unique is the solidness of its basic framework, which is law and not merely recommendations or expressions of intentions. Other continents may wish to imitate the European project as they set up regional coordination mechanisms as the proper response to globalization. Let us explain how public law can enhance economic efficiency in the process of regional integration when it is employed in a cautious and flexible manner.

4. PUBLIC LAW AS THE TOOL OF REGIONAL COORDINATION

One cannot deny that the basic idea of a spontaneous order with Hayek bypasses the possibility of an explicit use of statute law for the purpose of intentional economic integration creating a whole new market for a huge area – institutional policy-making, or law and politics. The emphasis in *Law and Economics* is upon the capacity of law to promote unintended outcomes, especially economic efficiency. This is the positive theory of *Common Law*, where judges make reasonable judgements, which tend to promote economic output (Posner, 2002, 2004). However, the use of law as an explicit instrument for governments to build European integration is a different matter. Here, it is the activities of governments creating treaty law, which is essential. Thus, it is not the unintentional developments in law, which is the crux of the matter, but the explicit use of law-making through codification and the further making of statute law in order to further develop treaty law.

In *Law and Economics,* economic legislation is treated as open to the invasion of by rent-seeking activities (Posner, 2003). Thus, case law is given the driver's seat in enhancing positive outcomes. However, European integration has not been primarily driven by case law, although the rulings of the ECJ have been very important for the emergence of EU law. EU law results from a balanced combination of treaty law, secondary legislation (statute law) and case law. It is a triumph for the *Civil Law* approach, focussing upon the codification of abstract principles.

In law and economics, it is the aspects of law that the *Common Law* stands for which are emphasized. However, the success of EU law is based upon the aspects, which the *Civil Law* approach expresses. EU law is based upon codification, the derivation of general principles of law as well as abstract legal reasoning. Although case law plays a prominent role, it supports statute law and treaty law. Thus, EU law is an intentional process of legal development where the making of law plays a major role. It is public law writ large, establishing economic regulation of tremendous import. The *Common Law* approach singled out for praise in law and economics is basically tort law or private law, where case law is relied upon to correct for or supplement statute law, which judges use to arrive at general principles of jurisprudence enshrined in key decisions. EU law is the opposite of the *Common Law* framework and it has changed Western Europe in a relatively short period of time.

Public law as an instrument of change needs to be reassessed (Loughlin, 2000, 2003). Its possibilities have not been correctly evaluated in *Law and Economics*. Public law may be employed for governance purposes, as it displays both inertia and flexibility, the first deriving from constitutional law and the second from administrative law. EU law displays these two properties, inertia and flexibility, combining treaty law with secondary legislation. Public law regulation can be established in a permanent fashion without the traditional framework: constitutional law and administrative law. Let me shortly pin down the advantages

4.1. Public Law as Inertia

The key features of EU law are laid down in treaty law. And the major treaties build upon each other and have not been revised too often. This enhances stability. The revision of the treaties proceeds in an incremental manner whereby old rules are simply given a new number. EU law is placed in a wider context of conventions called Acquis Communitaire, which entails that major changes in the treaties can only be done through unanimity among the member states.

The bulk of EU law has thus changed slowly, only four major treaty revisions occurring after the Rome Treaty during 50 years. However, the treaties – one on the Union and another on the Community – only contain the essentials. Besides there is secondary legislation: regulation, directives and decisions. It has been claimed that the EU lacks a basic constitutional document. However, a EU constitution can only be written down until such time that the participants know what structure they wish the Union to have. Forcing a choice between federalism and intergovernmentalism would not make for more of stability. Public law comes in the form of constitutional law and administrative law. EU law is so far mainly administrative law. And it has proven enough to bring about economic integration in terms of a common and enforceable set of rules.

4.2. Public Law as Flexibility

EU secondary legislation offers a complement to the treaties. Here rapid changes are possible as a response to new circumstances or changing needs. It is difficult to estimate the true size of secondary legislation in the Union, but most estimates count the number of separate laws and regulations in thousands. EU legislation is the outcome of a transparent process of decision-making that is highly institutionalized and checked. Although new policies require considerable preparation in the complicated system of advice and review that predates a proposal from the Commission, it remains true that there is some scope for initiative and change. One may interpret the Union policy-making process as a rational trial and error process through which policies are sorted and refined.

The combination of treaty legislation and secondary legislation is conducive to flexibility in policy-making. Besides, there is case law, which offers a real opportunity to check policy mistakes.

4.3. Stature and Case Law

It is true that EU case law is a most vital part of EU law. However, case law in the Union is not *the* law. Public law may benefit from case law, as the alternatives are not either public law or case law. EU law consists to a large part of case law, i.e. the rulings of the EJC. However, case and statute law go hand in hand in the evolution of EU law, one conditioning the other. EU case law does not replace treaty law or secondary legislation. Instead it operates to support policy-making by clarifying the general principles underlying the EU project, especially the meaning of the Four Freedoms.

EU case law belongs to the Civil Law tradition, meaning that it is orientated towards the derivation of a small compact set of principles. These high-powered rules would preferably be recognized in treaties and secondary legislation. This amounts to codification of universal norms. Again, I underline the possibility of explicit decision-making by state officials – politicians, bureaucrats and judges, attempting to create a legal framework that may help steer the evolution of economic events.

5. CONCLUSION

Public law results from policy-making and policy implementation. It is regarded by one dominant school (Austrian economics) as inferior to private law arrangements. And another influential school claims that it will be captured by special interests (*Law & Economics*). The success of the European project accomplishing far-reaching integration both legally and in reality forces us to reconsider this negative evaluation of public law and public regulation, despite the strong theoretical accomplishments with both the Austrians and the *Law and Economics* School.

Explicit policy-making and implementation steering may accomplish much. What is crucial is the use of administrative law meaning that the rules take on an institutional status with sanctions against misbehaviour or negligence. States may employ public law in a regional coordination mechanism, although the coordinating bodies lack own implementation means. The EU is law in the strong sense of the word, but the EU is not a new federal state.

EU law is not merely the collection of a large number of cases, it displays the characteristic features of the *Civil Law* approach to legislation: codification, abstractness and generality. In a sense, EU law and the EU project is the come back of the public law approach to human coordination, showing that there may occur economic efficiency outside a spontaneous order or the *Common Law* approach.

It seems to me that we need a new research paradigm – *Law and Politics*, which helps us better understand how public law may be employed for the purpose of enhancing economic development, for instance regional economic integration. It must of course steer free of any excesses inherent in the conception of state planning, as correctly criticized by the Austrians and within *Law and Economics*.

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PART II: THE AUSTRIAN BUSINESS CYCLE DEBATE

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PROFESSOR TULLOCK ON AUSTRIAN BUSINESS CYCLE THEORY

William Barnett, II and Walter Block

1. INTRODUCTION

In "Why the Austrians Are Wrong About Depressions," Professor Tullock (1987, p. 73) makes some statements that are incorrect and others which, properly interpreted, refute or at least, fail egregiously to support, his thesis that the Austrian theory of the trade cycle is incorrect. We begin by considering one of Tullock's minor points in Section 2 and then consider his major point in Section 3. In Section 4 we take to task Tullock (1989), also on this same topic, and conclude in Section 5.

2. TULLOCK'S MINOR POINTS

His: "… second nit has to do with Rothbard's apparent belief that business people never learn. One would think that business people might be misled in the first couple of runs of the Rothbard cycle and not anticipate that the low interest rate will be raised later. That they would continue unable to figure this out, however, seems unlikely. Normally, Rothbard and the other Austrians argue that entrepreneurs are well informed and make correct judgments. At

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the very least, one would assume that a well-informed business person interested in important matters concerned with the business would read Mises and Rothbard and, hence, anticipate the government's action'' (Tullock, 1987, p. 73).

There are several problems with this line of reasoning. The first, which is typical of much non-Austrian analysis, is implied by Tullock when he refers to ''business people'' as though they are a homogeneous group. In reality, however, businessmen are a diverse lot, many, if not most of whom have little in common, save for the very fact of their *being* businessmen. Further, the composition of the group is changing continuously.

Second, given the fact that professional economists are unable to agree about the nature and cause(s) of business cycles, it is unreasonable to argue that the failure of businessmen to adopt a particular theory thereof is proof that any given theory is incorrect.

Third, Tullock seems to have adopted some form of (weak?) rational expectations theory (Salerno, 1989, p. 144). Of course, if expectations really were rational, there would be no way to explain many other economic phenomenon apart from business cycles, e.g., asset price bubbles.

Fourth, monetary-policy-induced fluctuations in interest rates are unpredictable, at least in details specific enough to be useful for many business decisions. Therefore, even when some businessmen do anticipate that an artificially low interest rate will eventually rise, they cannot *possibly* know when and by how much.

Fifth, even if a ''well-informed'' businessman ''interested in important matters concerned with the business'' who had ''read Mises and Rothbard'' could predict the Fed's policy actions in advance, and the effects thereof on future short-term interest rates, he would have no reliable way of predicting the effects thereof on long-term interest rates, or of the effects of interest rate changes on those variables relevant to his decisions. How can we expect businessmen to predict the Fed's actions better than professional ''Fed watchers,'' when even they are not all of the same mind. And, how can we expect businessmen to understand the economy better than professional economists, given that the latter certainly do not agree on such matters.

Sixth, even the Fed's policy makers can not explain in detail: (1) how they make their decisions; and, (2) what effects they expect their policies to have. Moreover, because of that, they speak in jargon, metaphors, etc. Anything but plain English; and for good reason – they avoid specificity in order to evade accountability.

Seventh, even apart from the foregoing, there is the fact that according to Austrian Business Cycle Theory (ABCT) not only is the business community in effect *fooled* into making investments, which only later are shown to be mistaken, they are also *subsidized* into undertaking these profoundly misallocative activities.[1] When expansive monetary policy lowers interest rates below the levels that would otherwise have obtained, investments at the higher order stages of production come about not only as a result of the lack of information mentioned in the six points above, but *also* as a matter of pure self-interest.

Suppose, arguendo, despite the completely valid six objections above, that the entire business community was well versed in the niceties of ABCT. Suppose, further, again arguendo, that none of the six objections mentioned above had any validity; that is, that all businessmen knew, full well, that they were engaging in malinvestments; and, suppose, even more heroically, that they could predict, without the possibility of failure, the exact timing of the downturn. Under these maniacally unlikely assumptions, would the Austrian Business Cycle (ABC) still take place? Yes. For as long as the extant entrepreneurs relied upon the fact that a "sucker is born every minute," they could get in while the "getting was good" and then, also, get out right before the recession began, provided, only, that there were at least some new investors who were not fully cognizant of ABCT. But this scenario is still consistent with the assumption that *all* businessmen, every last one of them, completely understood ABCT at the time of the initial monetary interference, and, despite this fact, rationally decided upon investing in the higher orders of production, even in the face of perfect knowledge that these investments were unsustainable.

Consider the following analogy in this regard. Suppose that the optimal ratio of spoons and socks is one-to-one; that is, on average, a marginal dollars' worth of these two items yields identical utility when consumed in the ratio of one spoon for every pair of socks. Now, along comes dirigiste government with a tax on the former, and a subsidy for the latter. Arguendo, all extant businessmen know with absolute certainty that this weird policy will create misallocations, and the political realities will force government to rescind it in exactly 5 years. Will profit considerations, nevertheless, dictate fewer investments in spoon production, and more for socks? Yes, provided only that in 5 years minus one day they will be able to unload their soon to be unprofitable sock factories on people who are not now members of the business community. They would, of course, invest the proceeds in the soon to be more profitable spoon factories.

3. TULLOCK'S MAJOR POINT

Tullock's (1987, p. 74) major objection, putting it quite bluntly, is that "if the process Rothbard describes did occur there would be many corporate bankruptcies and business people jumping out of the windows of office buildings, but there would be only minor transitional unemployment. In fact, measured GNP would be higher as a result."

Tullock is certainly correct about the effect of the Rothbard's process on corporate bankruptcies, though he failed to note a similar effect on personal bankruptcies. And, given the existence of a legal bankruptcy process, the more onerous it is, that is, the more protection it provides debtors at the expense of creditors, the slower the adjustment process. For a case in point, witness recent events in Indonesia.[2] (We ignore the suicides as hyperbole.)

As to the subsequent increases in interest rates having only minor, transitional effects on unemployment, several points should be made. The implication that labor markets make rapid adjustments to changes in market conditions is clearly erroneous. At best, markets for free labor are among the most slowly adjusting of free markets.[3] Moreover, labor markets are patently *not* free. Very much to the contrary, they are among the most highly regulated of markets. And, the more intervention there is, the less rapidly will the necessary wage adjustments be made, and the more severe will be the unemployment. Conversely, the less intervention, the more rapid the adjustment, and the less severe the unemployment. Further, the effects vary from historical case to case, depending upon the extant institutions and the specifics of the situation. That other markets are hampered as well means that the necessary price and interest rate adjustments in those markets also will be slow, with concomitant effects on the unemployment of other resources.

As to measured GNP being higher, does an elevated measurement for this statistical aggregate constitute accurate evidence of more valuable economic activity?[4] Obviously, the owners of the resources who, because of artificially low interest rates, unwittingly diverted them to sub-optimal uses; e.g., the construction of uneconomic and unneeded factories, must have had alternative uses for these resources. These alternative uses must have been considered to be of more value, else it would not have taken artificially low interest rates to divert them to their new, less valuable uses.

Moreover, measured GNP includes transaction costs in the form of the bankruptcy process; that is, legal, accounting, etc. costs which measure the expenses of trying to rectify the mistakes of the unsustainable boom: the misallocation of resources. However, perhaps the most important problem with measurements of GNP is caused by including the value of misallocated resources at the market price at the time of the misallocation, precisely that point in time when their value in the sub-optimal use registers most highly, because the market has not yet discovered that such use is a misallocation, and then failing to subtract the reduction in value from measured GNP when the discovery is finally made. That is, inflation distorts both the level and structure of prices that are used to measure the value of GNP in such ways as to artificially overstate it.

That is, there are three possibilities re measured GNP: (1) it would be higher, accurately reflecting an increase in the production of valuable goods; (2) it would be higher, even though valuable goods are being destroyed, and thus, if for no other reason (and there are many), because measured GNP is based, almost always, on false prices and interest rates, it is a virtually useless artifact; or (3) it would reflect, accurately, the destruction of valuable goods, in which case it would not be higher but, rather, lower. Although Tullock seems to choose the first alternative, either of the latter two would appear to be the better choice.

Let us put this into other words. Even supposing that unemployment effects will be at worst only marginal due to virtually instantaneous adjustments, still, this analysis focuses only on the tip of the iceberg of problems. For, according to ABCT, unemployment is not the only, or even, necessarily, the most important negative consequence of a monetary induced artificial-boom-bust cycle. There is also that small matter of loss of productivity because of the misallocation of scarce capital goods, including not least human capital. Suppose that as a result of Fed activity 90% of the labor force were assigned to the proverbial Keynesian task of "digging ditches and then filling them up again," but that not a single solitary man were thereby unemployed (due to stipulated instantaneous labor force adjustments). Tullock's concerns about unemployment would be assuaged in one fell swoop, but the economy as a whole would be in virtually total disarray. Now, no one is stating that the business cycle is *that* devastating. We merely content ourselves, here, pointing out that the misallocative effects of the ABCT can be very serious indeed *even if* unemployment does not thereby increase by even one iota.

Salerno (1989) made a Herculean attempt to correct Tullock's (1987) misunderstanding of ABCT in this regard. Despite Salerno's best efforts, Tullock (1989) shows no evidence of having understood those lessons. Instead, Tullock (1989, p. 147) accuses Salerno of playing fast and loose with the definition of the word 'depression.' In Tullock's (1989, p. 147) view: "The standard meaning of the word "depression" is a situation in which general conditions are very bad and, most importantly, there is very high unemployment." Tullock (1989, p. 147) is of the opinion that the misallocations created by Fed induced non-market interest rates "could not create the kind of massive unemployment we saw in 1929–1933." Tullock is undoubtedly correct that *if* we posit instantaneous wage adjustments; that is, inter alia, there are no governmental interventions in labor markets such as minimum wages, unemployment insurance, etc., then "mere" interferences with interest rates need not logically compel *any* unemployment at all, certainly not the horrendous levels of the Great Depression (they would only imply loss of capital value, as discussed above). However, the real world is not characterized by this "frictionless" system. And, despite his claims to the contrary, it is certainly conceivable that market interferences with interest rates that lead to unsustainable investments in the higher orders of the structure of production, *coupled* with interferences with downward wage adjustments, could well and actually *did* lead to massive unemployment during the Great Depression.[5]

But are Austrians guilty of utilizing a stipulative definition of the word "depression?" After all, praxeologists, but no one else, would characterize as a depression (or recession) a situation without massive or indeed any unemployment provided only (*per impossible*) that there were instantaneous adjustments in the labor market.

In our view, although the Austrian and the "man in the street" understanding of "depressions"[6] is somewhat different, the praxeologist's perspective is compatible with the essence of this phenomenon, while the alternative is not.

Suppose the government in its wisdom passed a minimum wage law pegged at $1,000 per hour. Or posit that a hurricane, more destructive than any we have before experienced, struck the US. Either of these would devastate the economy, bringing vast unemployment in its wake (assuming, realistically, no rational expectations, no full knowledge, and non-instantaneous adjustments). But would they constitute a "depression"? The Tullocks of the world, would, presumably, answer in the affirmative. But the Austrians would not. They, in contrast, reserve this word for massive disruptions of the economy, whether or not also characterized by "large scale unemployment," but only if there is an artificial cyclicity involved, which is patently absent in these two cases.

Although, the period from the collapse of the stock market in October 1929 until the war stimulated recovery of production[7] is known as "The Great Depression," this is strictly speaking, from the point of view of Austrian analysis, a misnomer.[8] Historically, depressions referred to the sharp, but short, contraction of production and employment subsequent to an unsustainable boom, during which the economy was purged of the excesses of the boom; that is, during which the array of relative prices was restructured to accord more closely with the preferences of consumers, with attendant reallocations of resources. By this definition, the Great Depression was a *depression plus*. That is, the fiat money/credit expansion of the 1920s caused an artificial and, therefore, unsustainable boom composed of a speculative bubble in asset prices and a massive misallocation of resources. Toward the end of 1928 or the beginning of 1929 the money/credit expansion of the 1920s ended, setting the stage for the collapse of the boom, or the cleansing recession. The crisis occurred in October of 1929, though the "real" economy had been sliding for some 6 months before that time. Were that the end of the story, in all likelihood the economy would have been in the recovery phase of the cycle by 1932. Instead, the economy was in the pits then, after which there was some improvement until 1937 (improvement that did not bring the economy even back to the level of 1929) despite which thereafter the economy contracted again. That is, what should have been a sharp, but short depression turned into the Great Depression. Why?

There were several factors – each and every one of which was either a governmental policy error or the consequence of such an error. First, the Smoot-Hawley tariff that raised tariff rates to the highest level in American history was enacted and took effect in mid-1930. Second, the Fed failed to prevent massive "secondary deflation" and bank failures on an unprecedented scale that ultimately led to the "bank holiday" of 1933. Third, the government induced and coerced as necessary the cartelization of industries, and of labor in unions. Fourth, leading politicians beat the drums incessantly against allowing wages to fall, threatening, browbeating and "jawboning." All of these factors combined to keep money prices and wages above market clearing levels, given the collapse of the money supply; they also militated against declines in real wage rates necessary for the reemployment of labor. Fifth, terminating the gold standard domestically along with other assaults on property rights created what Higgs (1997) refers to as "regime uncertainty" which led to a loss of business confidence that in turn resulted in a reduction of business investment. These factors combined to turn what would otherwise have been the "depression of 1929–1930" into the "Great Depression of 1929–1947."

Save for the secondary deflation, these factors may be thought of as nonmonetary-induced distortions of the structure of the economy; i.e., nonmonetary-induced misallocations of resources. Perhaps a better name for them, given Tullock's misunderstanding of the issue, would be *non-cyclical* governmental interventions.

According to Tullock (1987, p. 75) although "the interest rate" is of importance for decisions concerning expenditures on capital goods, it is "but of very little significance in deciding how much to produce in an existing factory." Certainly, however, interest rates are significant for operating decisions for those businesses that use credit to finance part of their operating expenses, e.g., payrolls, accounts receivable, and inventories. And, surely, rises in interest rates that increase such expenses tend to lead to higher prices and decreased quantities sold. The diminished volume of sales, in turn, lead to smaller orders placed by such businesses with their suppliers, including those with existing factories.

But even putting matters in this format is somewhat to do violence to economic reality. For, there is no hard and fast distinction to be made between expenditures on capital goods and on all other factors of production. The key element in determining how powerful an effect any given change in the interest rate will have on economic decision-making is length of run. Other things equal, the longer the amount of time involved, the more elastic the response will be with regard to interest rate changes. To be sure, it takes far more time to build *most* factories than to produce goods in an existing factory. But *some* factories are quickly built, and *some* products take a long time to manufacture. That is , the key is the extent and duration of the misallocation of resources of all types – human capital, capital goods, natural resources, and often overlooked, scarce entrepreneurial talent – regardless of the details.

Tullock (1987, p. 74) then states that, as regards capital goods already existing at the time when the expansionary monetary policy is initiated, there is no reason to think either that such goods "should be particularly damaged by what has happened" or "that there is too much of [them] under the current circumstances." But does not the creation of new capital goods "damage" the value of existing capital goods? And is not the problem precisely that the new capital goods are of the wrong type, and that, although there may not be "too much" capital goods in general, there is too much of the particular types created because of the monetary expansion?

What Tullock fails to reckon with is the primordial economic fact that goods and services have substitutes and complements. Even if no extant capital good is *directly* "damaged" by misallocative investments consequent on artificially lowered interest rates, this does not mean that every extant capital good will fit in as well with other aspects of the economy compared to the situation where the government had not meddled with the economy's price signals.[9] Capital goods, contrary to Tullock's vision, are not homogeneous. They are not putty-like substances, able to be fit into, without any additional cost, any given existing capital structure. Rather, if they are to be efficiently employed, they must be created in such a manner as to fit in with the remainder of the economy. Thus, new investments must be coordinated with whatever already exists, and also with the decisions of others. And this can best be done, Tullock notwithstanding, only if market signals are not perverted by unwise governmental monetary policy.[10] The capital structure of the efficient economy is, as it were, a delicate latticework, and the Fed is like the bull in this particular china shop.

Tullock (1987, p. 75) next deals with that class of capital goods that were produced for those industries which, themselves, produce consumer goods, and the production of which were undertaken and completed during the period of "the artificially depressed interest rate." He thinks that, although the investors therein will lose money, the capital goods, having been already completed and therefore, being a "sunk cost," there is no reason why they "… stop being used." That is true, provided the revenues generated therefrom cover the operating expenses with something left over to put against the overhead expenses, the capital goods will be used. However, depending on the specificity of the capital goods, there may be a struggle over the control and reallocation thereof. It is impossible that during such struggles, the optimal use is made of these resources.

Again, Tullock fails to take into account the interconnectedness of all capital. Yes, it cannot be denied, the *physical* manifestation of the already existing capital goods may remain largely undisturbed despite the advent of the new, misallocated, capital to come on stream. (However, the *uses* made of some of it will change.) Sunken costs are indeed sunk, as he so correctly informs us. However, the *value* of old capital goods will be attenuated by not being able optimally to work in tandem with other investments, and this is something not in Tullock's ken.

Tullock (1987, p. 75) also states that, as there is more of it, "… the demand for labor to work with it will be higher." But, of course, the demand for labor is derived from the demand for the goods the labor is to be used to produce, not from the supply of capital goods. He goes on to say that because there would then be increased production of the consumer goods, with sales at lower than anticipated prices, "… there should be higher living standards." To the extent that this occurs, there are indeed higher living standards, at least for many of those remaining employed. A measured rate of unemployment of say 15% would be considered by many economists evidence that the economy was bordering on, if not in, a depression; and yet, as measured, 85% of the workforce would still be employed, many of whom would benefit from the reduced prices and other conditions of the downturn.

Tullock's analysis continues along this line. His key point seems to be that malinvestments induced by monetary policy may lead to bankruptcies, but they do not cause significant unemployment. Thus, although Tullock never spells out his assumptions either as to how rapidly and accurately information is transmitted in the market process or as to how rapidly people react to the new knowledge, he seems to have made a typical neoclassical assumption that markets for goods and for labor and other resources adjust very, very rapidly, if not instantaneously.

Another problem with Tullock's analysis is his (implicit) objective value theory. Thus, he critiques Rothbard's statement that in response to artificially lowered interest rates, "… businessmen react as they would react if savings had genuinely increased" by stating that if, in response to lower interest rates, more factories are being built, "… then, in fact, savings that are available for building factories must have increased" (Tullock, 1987, p. 74). This ignores the centrality of the concept of subjective value to sound economic analysis.

Of course, if additional factories are built, resources must be diverted to such activity from some other use, including, possibly, leisure. But this does not necessarily mean that savings, as a category of purposeful human action, have increased. It is the subjective value attached to something by the valuing mind that is important for human action and a fortiori, economic analysis. Thus, the existence of the additional factories does not, ipso facto, mean that savings must have increased. Rather, it constitutes evidence of an *attempt* to increase savings. Consider the following example.

Today A has control of a volume of goods of a certain value to him. Suppose him to consume some of the goods, and not consume the rest, in an attempt to conserve and, perhaps, even increase, the value thereof for future consumption. There are various ways A could attempt to accomplish this, e.g., lending his command of resources to B. However, regardless of the method that A uses, what he is attempting to do is to shift his ability to satisfy his wants from the present into the future, by attempting to have more control of goods in the future, albeit at the cost of control at present. Should, for whatever reason, A's attempt prove unsuccessful, i.e., should he be unsuccessful in his attempt to conserve value for future consumption by preserving control of goods into the future, then his attempt to save would have *failed*.

Even without government intervention into the economy, many attempts to save would fail because of our inability to accurately foresee the future. Such failures, for the most part, are random in nature. Governmental monetary policy, however, induces, through false price signals, including false interest rates, an element of systemization in the attempts to save, and, consequently, an element of systemization in the failures of such attempts. The losses of value associated with these governmentally induced failures are referred to, at least by Austrian theorists, as "forced saving." This is an undesirable, because misleading, phrase; a more accurate but, unfortunately, more cumbersome phrase is, "forced destruction of some or all of the value of resources and/or goods because they were diverted from their most valuable use." In other words, malinvestments *is* forced saving. One manifestation of the fact that value has been destroyed in such situations is the attempt to minimize, and allocate among the different parties involved, the losses through the bankruptcy process, which Tullock mentions several times.

4. TULLOCK'S (1989) REPLY TO SALERNO

Let us consider two other criticisms of ABCT presented to us by Tullock. He (1989, p. 149) speaks of a "gold inflation" during the reign of Alexander the Great, explaining "Alexander spent the Persian emperor's gold reserve." But this is not at all "inflationary," except in the most superficial of understandings of that concept. True, if this reserve constituted a significant proportion of the gold in the hands of both the banking and non-banking public, then, when it is suddenly released, prices of goods in terms of gold would rise. But no less would apply to *any* sudden dishoarding. It is no more "inflationary" than were a bunch of misers to reach into their cookie jars and under their mattresses to abruptly spend money never before utilized in this manner. Nor, even, would the phrase "gold inflation" apply to a case where a new and significant seam of this metal found. The reason for this is that both the dishoarding and the discovery would be considered part and parcel of the market process. It would be no more "inflationary" than would be the case if one said that "burger inflation" took place after the advent of Ray Kroc.

Second, states Tullock (1989, p. 149), "It is possible to get out of an inflation without a depression." This can be understood in one of two ways,

1. "It is possible to get out of an inflation without creating unemployment." This, as we have seen, is only possible if we assume rational expectations, perfect information, instantaneous adjustment, etc. But without these heroic assumptions, it is *impossible* to get out of inflation without unemployment.
2. The statement might be interpreted to mean: "It is possible to get out of an inflation without suffering economic losses due to previous resource misallocation."

This is because the prior bout of inflation necessarily misallocates resources. It is not true, as Tullock (1989, p. 149) avers, that the costs of inflation are limited to "the reduction in efficiency of the economy while the inflation is going on." To be sure, these must indeed be counted in the total tally of the costs of inflation. But the costs *also* result from the misallocations of resources in the form of durable capital and consumers' goods, and of human capital that have been made and that do not cease to exist when the inflation ends. Because these misallocations do not take the form of homogeneous blobs, they cannot be costlessly integrated into a different sector, the structure of production, and thus constitute a very significant cost of inflation completely apart from the inefficiency correctly identified by Tullock. This economist (Tullock, 1989, p. 149) goes on to say that "the more severe the inflation, the easier" it is to end it without a depression. But this is surely wrong. For the greater the inflation, ceteris paribus, the more serious the misallocation it engenders. And the more serious the misallocation engendered by the inflation, the more damage it does to the economy.

5. CONCLUSION

In conclusion, neither has Tullock proven, nor can he prove, that Austrian business cycle theory is incorrect in this regard.

NOTES

1. For another critic of ABCT, who neglects this vitally important point, see Wagner (1999); for a rejoinder, see Block (2001).
2. See, e.g., Brietzke (2001) and Mar'ie Muhammad (1999).
3. Labor markets do not adjust rapidly to changes in market conditions: partly because layed-off employees frequently are uncertain as to the duration of the layoff, and thus often prefer to await anticipated recall over searching for new, possibly less desirable, employment; partly because they are not well organized; partly because of low opportunity costs (because, e.g., relocation of a family in order to become reemployed rapidly after a layoff may not seem to be a very valuable alternative); and, partly because the existence of various governmental income maintenance programs has increased the viability of unemployment.
4. We assume he means *real* GDP, for certainly, the process Rothbard describes is an inflationary one, which fact alone could easily account for an increase in measured nominal GNP.
5. This is not to suggest that the Smoot-Hawley tariff and faulty Fed policy that failed to prevent a massive secondary (monetary) deflation did not also play important roles in turning what should have been, if prior history were a reliable guide, a short, sharp downturn to correct the misallocations of the 1920s, themselves

the result of faulty Fed expansionary policies, into the massive, widespread prolonged depression of the 1930s. They, of course, did. See on this Rothbard (1975).

6. Admittedly, shared by neo classical economist such as Tullock.

7. Higgs (1992) makes the case that the economy did not recover until early 1947, some 18 months after the end of WWII and many years after the conventional dates (anywhere from 1939 to 1942, depending upon the commentator) for the end.

8. We full well recognize that the term "The Great Depression" is now so ensconced in the language that any attempt to change it would be either a hubristic venture or a Quixotic quest.

9. See in this regard Salerno's (1989, p. 142) very valuable explanation of "intertemporal complementarity."

10. See on this Lachmann (1956), Hayek (1941), Mises (1966), Rothbard (1983, 1993), Garrison (2001).

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THE AUSTRIAN VIEW OF DEPRESSIONS

Gordon Tullock

Perhaps I should begin with a little discussion of how I got involved with Austria to begin with. This will also include the rather bizarre way I got into economics. I was a student in the University of Chicago law school and they required all such students to take a one-quarter course in economics under Henry Simons, one of the founders of the Chicago school. He was a proponent of the view that depressions were caused by deflation. I found myself in complete agreement, and still am.

He favored the hundred percent reserve banking system. Today this is largely merely a matter of history, but I should point out that Murray Rothbard thought that fractional reserve banks were actually fraudulent. Simons wanted to make them illegal, but Rothbard, naturally, would not want to extend the power of the state. He proposed to organize anti-bank societies which would accumulate obligations of a bank and then present them all for payment on one day. The bank would not be able to pay them and hence would have to close its doors.

This was the first, and as it turned out, the last economics course I ever took. Further it was not a full quarter course. The draft board intervened and almost the entire class went into the army before the actual end of the quarter. The law school, charitably, gave us full credit and I received, I believe, the highest grade that Simons ever gave to a law student. This is not a very strong boast. The law students did very badly in that course.

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It changed my life, however. From then on I began reading the principal economic journals from cover to cover. That is something that I no longer do.

In any event I continued in law school, spent four months in a downtown Chicago law office, and then joined the Foreign Service and was sent to China where I got my first (nationalist) and second (communist) experience with runaway inflation. My third was in Korea. They were not followed by depressions, but granted the disturbed state of these countries at the time, that is not surprising. On my return to the United States from China I met Colin Campbell at a dinner and told him what I had observed. He suggested a joint article, my first publication in Economics.[1]

Colin and I also wrote an article on Korea, which is relevant.[2]

Lastly, I wrote an account of history's longest paper money inflation. Granted that the Chinese invented both paper and printing, it is not surprising that they also invented the use of the press to fund the government.[3]

This article, which was approved by Von Mises, also showed no depression, although the records aren't very good.

From the Government's standpoint printing money is far superior as a source of revenue to the debasement of a metallic currency which was depended on by the later Roman emperors. New sources of precious metal, whether new mines or improved methods of treating the ore like the cyanide process don't benefit the government revenue except insofar as they can be taxed.

The point of these, perhaps tedious, autobiographical notes is make it clear that I do have personal experience with inflation and have contributed to the literature on it. Of course, the fact that I was a diplomat gave me at least partial protection. Still I think I can say that people do adjust to even rapid inflations. It's unpleasant but not fatal. It's the flu not pneumonia. The basic problem is the failure to maintain a stable rate of inflation, which makes calculations difficult. Otherwise, people would make adjustments in their accounting system and the inflation would make bookkeeping more difficult and raise the nominal rate of interest, but cause little in the way of other problems.[4]

I stick to the Simons theory of depressions. Why a deflation would cause difficulty is obvious. Businessmen find that they have to repay their debts in dollars worth a good deal more than the dollars that they borrowed and they have to sell their product, whatever it is, for nominal prices lower than its cost because of the increase in the value of the currency. Bankruptcies and general hardship would be expected and that is what we saw in the great depression.

Inflation leads to the opposite set of effects. You can repay your debts in currency worth less than when you borrowed the money, and the sale price of your product in dollars is higher than the dollar cost was during production. That this is not particularly healthy for the economy is true, but the short-term effect is what we call a ''boom''.

During World War II, we financed the war with a quite substantial inflation. Many economists anticipated a depression after the war, but it didn't come. In fact, although the economy was rather badly handled, we began a 50-year period of general growth and prosperity. There have been ups and downs. The early years of the Carter presidency had quite a rapid inflation. He brought in a tough Secretary of the Treasury who stopped the inflation, but the resulting depression meant that Carter was not reelected. Reagan retained the policy, with the result that he lost control of Congress.[5]

With the Carter exception, our history since World War II has been one of general prosperity and growth with only minor ups and downs. A better management would have meant we had none of the downs and many more of the ups, but we have done reasonably well.

The basic problem, which I shall call the Simons-Rothbard problem, is the inherent instability of a fractional reserve banking system. Individual banks make mistakes and the system makes these contagious. This was true in the 19th-century and in countries other than United States. The Federal Reserve Board was supposed to cure the problem by providing what amounts to insurance against runs. We have not had the 19th century kind of banking problem since World War II, but we have had, of course, a far from stable economy.

The same can be said of most countries. They all have central banks with the power to prevent crisis, but all the central banks have generated an ability to create crises on their own. The 19th-century type of bank crisis does not occur today, but is not obvious that the present situation is basically better. It is certainly different but that doesn't mean that it is an improvement.

There seem to be two basic problems. The first of these is that the central banks just are not run very well. They have the power to prevent either inflation or deflation, but they don't. Further if you read the speeches of bank presidents and other high officials such as the Secretary of the Treasury you get the impression they don't fully understand what they're doing. Increasing or reducing the money stock in order to keep the value of the currency constant seems fairly easy. Further simply maintaining a stable and not too fast rate of inflation would be adequate. The people who are in charge do not ever really say that that is what they are doing and I do not think they think they are. They are trying to stabilize the whole economy and manipulating the money supply in accordance with a rather vague theory of the effects of their bank on the whole economy.

As a further problem many governments have become accustomed to financing some of their activities by printing money. They rarely admit that this causes inflation and they do not maintain a steady rate so many countries alternate between inflation and depression caused by stopping the inflation. All this is unfortunate and indicates that a lot of people with great prestige and high-paying jobs in central banks should be urged to seek other employment to which their talents are better fitted. I would suggest digging ditches.

Monetarism is a simple theory and the effects of either inflation or deflation on trade our obvious. Businessmen will be driven into bankruptcy in deflation and will expand their activities in inflation. If the inflation continues, and many countries including United States have been more or less inflationary for the last 50 years, business can be quite prosperous. Indeed it has been in the United States. England since Mrs. Thatcher has had a similar experience. The countries that had difficulties normally have their central bank managed badly enough so that the rate of growth of the currency stock is fast and irregular. A number of them have had periods of fairly rapid inflation. Altogether, we see many, many examples of mismanagement of the currency system.

When people become accustomed to inflation, which occurs whenever it is long lasting, they tend to economize on their holdings on money or on assets that are defined in money. In China and in Korea during the periods of rapid inflation I personally carried almost no money with me. During a period of very mild inflation such as we are having now I carry enough to cover current expenses for a week or so. With zero inflation I probably would carry more.

The reason that this is important for stopping inflation is that the government must, when it stops inflation, increase the money supply in order to provide hand-to-hand currency in the quantity that is required with a stable value of the currency. This is hard to calculate and I should say that so far as I know it has not been discussed in the formal literature. I think the central bankers find it hard to stop inflation and hence tend to continue printing money, not because they're trying to fill the gap but a simple inability to stop. But this is mere guess on my part and perhaps people who devoted more time to the issue of stopping inflations have a better idea of how much money should be printed in order to fill the average person's pockets with hand-to-hand currency.

Thus when it is decided to stop inflation, more often than not there is a depression. I would say the depression is caused by the clumsy ending of the inflation, but the Austrians appear to think that is the inflation itself, which causes the depression. May I present a medical analogy. Suppose I am ill of a germ disease. The doctor gives me an antibiotic, which kills the germs, but I react badly to that particular chemical. I'm put in the hospital by my reaction to the medicine, but I would not have taken the medicine had I not had the original disease. It would be possible to say that the cause of my going to hospital was my original disease, which led to my taking the antibiotic to which I reacted. That would be the equivalent to the Austrian's view of depression as being caused by inflation. I think it is possible to stop inflation without a deflation and the accompanying depression. I must admit that I cannot name an example.

My impression is that most terminations of inflation are handled badly, but since I have just confessed that I don't know how it should be done, how much money should be printed to fill the currency gap, that impression is of little authority. Perhaps one of my readers may be able to suggest an example where inflation was stopped without a depression.

I should close the theoretical part of this paper by saying it is possible to have a depression without a preceding inflation. If the currency supply is reduced, this would cause deflation even if there had not been any previous inflation. I would say that the great Depression was an example. Prices had been stable in the twenties.

Let me now turn to a non-theoretical subject. My opponents appear to think that you cannot have inflation if the money is Gold or based on gold. There is no reason that they cannot use the word "inflation" in this way, but it is not normal among economists. My example of Alexander the Great would be accepted by the average economist. In other words I am using the language in the normal way. My opponent is using a special meaning for the word "inflation". There is no reason he should not as long as he explains what he is doing. I do think, however, that he should not denounce me for using the language in its normal way.

NOTES

1. "Hyper-inflation in China," 1937–1940, *Journal of Political Economy*, 62 (June 1956) pp. 393–407.
2. "Some Little Understood Aspects of Korea's Monetary and Fiscal System," *American Economic Review*, 47 (June 1957) pp. 336–340.

3. "Paper Money, A Cycle in Cathay" *Economic History Review*, 9 (June 1956) pp. 393–407.

4. As accountable officer in the American Consulate General in Tientsin, I once borrowed a sizeable amount of Yuan on the credit of the United States at an interest rate of 2% per day.

5. Samuelson said that Greenspan caused the first President Bush to lose his reelection by not preventing a minor depression at that time. Whether he will do the same to the second President Bush is an open question at the time of writing.