



JE KINDLE-NOTITIES VOOR:

Economic Controversies (LvMI)

door Murray N. Rothbard, Gene Epstein

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Scientism is the profoundly unscientific attempt to transfer uncritically the methodology of the physical sciences to the study of human action. Both fields of inquiry must, it is true, be studied by the use of reason—the mind’s identification of reality. But then it becomes crucially important, in reason, not to neglect the critical attribute of human action: that, alone in nature, human beings possess a rational consciousness. Stones, molecules, planets cannot choose their courses; their behavior is strictly and mechanically determined for them. Only human beings possess free will and consciousness: for they are conscious, and they can, and indeed must, choose their course of action.¹ To ignore this primordial fact about the nature of man—to ignore his volition, his free will—is to misconstrue the facts of reality and therefore to be profoundly and radically unscientific.

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Rousseau and his host of modern followers, who hold that man is good, but corrupted by his institutions, must finally wither under the query: And who but men created these institutions? The tendency of many modern intellectuals to worship the primitive (also the childlike—especially the child “progressively” educated—the “natural” life of the noble savage of the South Seas, and so on) has perhaps the same roots. We are also told repeatedly that differences between largely isolated tribes and ethnic groups are “culturally determined”: tribe X being intelligent or peaceful because of its X-culture; tribe Y, dull or warlike because of Y-culture. If we fully realize that the men of each tribe created its own culture (unless we are to assume its creation by some mystic *deus ex machina*), we see that this popular “explanation” is no better than explaining the sleep-inducing properties of opium by its “dormitive power.” Indeed, it is worse, because it adds the error of social determinism.

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The key to scientism is its denial of the existence of individual consciousness and will.¹³ This takes two main forms: applying mechanical analogies from the physical sciences to individual men, and applying organismic analogies to such fictional collective wholes as “society.” The latter course attributes consciousness and will, not to individuals, but to some collective organic whole of which the individual is merely a determined cell. Both methods are aspects of the rejection of individual consciousness. THE

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Man as Servomechanism: Just as Bertrand Russell, one of the leaders of scientism, reverses reality by attributing determinism to men, and free will to physical particles, so it has recently become the fashion to say that modern machines “think,” while man is merely a complex form of machine, or “servomechanism.”¹⁴ What is overlooked here is that machines, no matter how complex, are simply devices made by man to serve man’s purposes and goals; their actions are preset by their creators, and the machines can never act in any other way or suddenly adopt new goals and act upon them. They cannot do so, finally, because the machines are not alive and are therefore certainly not conscious. If men are machines, on the other hand, then the determinists, in addition to meeting the above critique, must answer the question: Who created men and for what purpose?—a rather embarrassing question for materialists to answer.¹⁵

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Model-Building: Economics, and recently political science, have been beset by a plague of “model-building.”¹⁷ People do not construct theories any more; they “build” models of the society or economy. Yet no one seems to notice the peculiar inaptness of the concept. An engineering model is an exact replica, in miniature, that is, in exact quantitative proportion, of the relationships existing in the given structure in the real world; but the “models” of economic and political theory are simply a few equations and concepts which, at the very best, could only approximate a few of the numerous relations in the economy or society.

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Second, mathematical relations are functional; that is, variables are interdependent, and identifying the causal variable depends on which is held as given and which is changed. This methodology is appropriate in physics, where entities do not themselves provide the causes for their actions, but instead are determined by discoverable quantitative laws of their nature and the nature of the interacting entities. But in human action, the free-will choice of the human consciousness is the cause, and this cause generates certain effects. The mathematical concept of an interdetermining “function” is therefore inappropriate.

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Indeed, the very concept of “variable” used so frequently in econometrics is illegitimate, for physics is able to arrive at laws only by discovering constants. The concept of “variable” only makes sense if there are some things that are not variable, but constant. Yet in human action, free will precludes any quantitative constants (including constant units of measurement). All attempts to discover such constants (such as the strict quantity theory of money or the Keynesian “consumption function”) were inherently doomed to failure.

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The concept of “friction” is used in a similar way. Some economists, for example, have assumed that men have “perfect knowledge,” that the factors of production have “perfect mobility,” and so on, and then have airily dismissed all difficulties in applying these absurdities to the real world as simple problems of “friction,” just as the physical sciences bring in friction to add to their “perfect” framework. These assumptions in fact make omniscience the standard or ideal, and this cannot exist by the nature of man.

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The laws of human action are therefore qualitative, and, in fact, it should be clear that free will precludes quantitative laws. Thus, we may set forth the absolute economic law that an increase in the supply of a good, given the demand, will lower its price; but if we attempted to prescribe with similar generality how much the price would fall, given a definite increase in supply, we would shatter against the free-will rock of varying valuations by different individuals.

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The proper theoretical methodology in human affairs, then, is the axiomatic-deductive method. The laws deduced by this method are more, not less, firmly grounded than the laws of physics; for since the ultimate causes are known directly as true, their consequents are also true.

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It should be realized that values do not become true or legitimate because many people hold them; and their popularity does not make them self-evident. Economics abounds in instances of arbitrary values smuggled into works the authors of which would never think of engaging in ethical analysis or propounding an ethical system. The virtue of equality, as we have indicated, is simply taken for granted without justification; and it is established, not by sense perception of reality or by showing that its negation is self-contradictory—the true criteria of self-evidence—but by assuming that anyone who disagrees is a knave and a rogue. Taxation is a realm where arbitrary values flourish, and we may illustrate by analyzing the most hallowed and surely the most commonsensical of all tax ethics: some of Adam Smith's famous canons of "justice" in taxation.³¹ These canons have since been treated as self-evident gospel in practically every work on public finance. Take, for example, the canon that the costs of collection of any tax be kept to a minimum. Obvious enough to include in the most wertfrei treatise? Not at all—for we must not overlook the point of view of the tax collectors. They will favor high administrative costs of taxation, simply because high costs mean greater opportunities for bureaucratic employment. On what possible grounds can we call the bureaucrat "wrong" or "unjust"? Certainly no ethical system has been offered. Furthermore, if the tax itself is considered bad on other grounds, then the opponent of the tax may well favor high administrative costs on the ground that there will then be less chance for the tax to do damage by being fully collected.

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There is, however, unbeknownst to most present-day economists, a competing methodological tradition. This tradition, the method of most of the older classical economists, has been called "praxeology" by Ludwig von Mises, its most eminent modern theorist and practitioner. Praxeology holds that in the social sciences where human beings and human choices are involved, Step 3 is impossible, since even in the most ambitious totalitarian society, it is impossible to hold all the variables constant. There cannot be controlled experiments when we confront the real world of human activity. Let

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Here Say has set forth another important point of the praxeological method: that the paths in which the economist works out the implications of the axioms and the elaborated system which results will be decided by his own interests and by the kind of historical facts he is examining. Thus, it is theoretically possible to deduce the theory of money even in an economy of primitive barter, where no money exists; but it is doubtful whether a primitive praxeologist would have bothered to do so. Interestingly

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Other writers have discovered links between the Austrian method and various strands of the philosophia perennis. Thus, Emil Kauder finds a close relationship between this method and Aristotelian philosophy, which was still influential in Austria at the end of the nineteenth century. Kauder points out that all the Austrians were “social ontologists,” and that as such they believed in a structure of reality “both as a logical starting point and as a criterion of validity.” He notes Mises’s statement that economic laws are “ontological facts,” and he characterizes as both ontological and Aristotelian the concern of Menger and his followers to uncover the “essences” of phenomena, rather than to treat superficial and complex economic quantities. Kauder also points out that for Menger and the Austrians, economic theory deals with types and typical relations, which provide knowledge that transcends the immediate, concrete case and is valid for all times and places. Concrete historical cases are thus the Aristotelian “matter” which contains potentialities, while the laws and types are the Aristotelian “forms” which actualize the potential. For the Austrians, and especially for Böhm-Bawerk, furthermore, causality and teleology were identical. In contrast to the functional-mutual determination approach of Walras and of contemporary economists, the Austrians traced the causes of economic phenomena back to the wants and choices of consumers. Wieser especially stressed the grounding of economic theory on the inner experience of the mind.²³

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What, then, is the proper relationship between economic theory and economic history or, more precisely, history in general? The historian’s function is to try to explain the unique historical facts that are his province; to do so adequately he must employ all the relevant theories from all the various disciplines that impinge on his problem. For historical facts are complex resultants of a myriad of causes stemming from different aspects of the human condition. Thus, the historian must be prepared to use not only praxeological economic theory but also insights from physics, psychology, technology, and military strategy along with an interpretive understanding of the motives and goals of individuals. He must employ these tools in understanding both the goals of the various actions of history and the consequences of such actions. Because understanding diverse individuals and their interactions is involved, as well as the historical context, the historian using the tools of natural and social science is in the last analysis an “artist,” and hence there is no guarantee or even likelihood that any two historians will judge a situation in precisely the same way. While they may agree on an array of factors to explain the genesis and consequences of an event, they are unlikely to agree on the precise weight to be given each causal factor. In employing various scientific theories, they have to make judgments of relevance on which theories applied in any given case; to refer to an example used earlier in this paper, a historian of Robinson Crusoe would hardly employ the theory of money in a historical explanation of his actions on a desert island. To the economic historian, economic law is neither confirmed nor tested by historical facts; instead, the law, where

relevant, is applied to help explain the facts. The facts thereby illustrate the workings of the law. The relationship between praxeological economic theory and the understanding of economic history was subtly summed up by Alfred Schütz:

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More specifically, Ludwig von Mises to the contrary notwithstanding, neither praxeological economics nor Mises's utilitarian liberalism is sufficient to make the case for laissez-faire and the free-market economy. To make such a case, one must go beyond economics and utilitarianism to establish an objective ethics that affirms the overriding value of liberty and morally condemns all forms of statism, from egalitarianism to the murder of redheads, as well as such goals as the lust for power and the satisfaction of envy. To make the full case for liberty, one cannot be a methodological slave to every goal that the majority of the public might happen to cherish.

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I do not believe it an accident that Karl Marx is considered one of the great hermeneuticians. This century has seen a series of devastating setbacks to Marxism, to its pretensions to "scientific truth," and to its theoretical propositions as well as to its empirical assertions and predictions. If Marxism has been riddled both in theory and in practice, then what can Marxian cultists fall back on? It seems to me that hermeneutics fits very well into an era that we might, following a Marxian gambit about capitalism, call "late Marxism" or marxism-in-decline. Marxism is not true and is not science, but so what? The hermeneuticians tell us that nothing is objectively true, and therefore that all views and propositions are subjective, relative to the whims and feelings of each individual. So why should Marxian yearnings not be equally as valid as anyone else's? By the way of hermeneutics, these yearnings cannot be subject to refutation. And since there is no objective reality, and since reality is created by every man's subjective interpretations, then all social problems reduce to personal and nonrational tastes. If, then, hermeneutical Marxists find capitalism ugly and unlovely, and they find socialism beautiful, why should they not attempt to put their personal esthetic preferences into action? If they feel that socialism is beautiful, what can stop them, especially since there are no laws of economics or truths of political philosophy to place obstacles in their path?

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The inflationary recession of the early 1970s² was a shock for two reasons: (1) in the Keynesian model, recessions are supposed to be due to underspending, and inflation to overspending; how then could both occur at the same time? And what can fiscal (or even monetary) policy do about it? and (2) intervention and statist planning of fiscal policy and "growth economics" in the 1960s was supposed to have eliminated business cycles forevermore, to bring us, in the naive jargon of the economic Establishment of that day: full employment without inflation. Business cycle courses were purged from graduate curricula; for if business cycles had been rendered obsolete, such courses would only be antiquarian studies of economic history.

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The severe inflationary recession of 1973–74, followed by a similar and even more severe recession of 1979–82, ended the myth of the disappearance of business cycles.³ And if planning for growth was seen to be flawed and

even counter-productive, then perhaps government planning in general had severe problems; it was no coincidence, then, that the 1970s saw the resurgence of free-market economies and of free-market thinking among economists.

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After World War II, the Swedish profession, even more than their colleagues of other countries, was notoriously the home of Keynesianism and of econometrics; and the first Nobels, from 1969 through 1973, reflect that bias. It is no accident, then, that Hayek's Nobel prize in 1974, shared ironically with the leftist maverick Gunnar Myrdal, was the first one to be granted to a free-market economist.⁴ It is also significant that the first free-market Nobel went to Hayek, not for his later vaporings in "spontaneous order," "knowledge," "evolution," and so on, for which he is unfortunately revered by most current Austrians, but instead for his elaboration of the Misesian business cycle theory which had been prominent in Britain in the 1930s, only to be swept away, in the late 1930s, by its great enemy, the Keynesian Revolution. To grant the first free-market Nobel to the antipode of Keynesian macro-theory cannot be considered a coincidence: it symbolized the end of the unquestioned dominance of the Keynesian-statist paradigm in economics.⁵

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My contentions are: that the correct Austrian paradigm is and can only be the Misesian, that is, the paradigm of Misesian praxeology; that the competing Austrian paradigms, in particular the fundamentally irrational "evolved rules," "knowledge," "plans," and "spontaneous order" paradigm of Hayek and the more extreme "ultra-subjectivist" or nihilist paradigm of Lachmann, have both been fallacious and pernicious; that, as we shall see below in discussing the history of the modern Austrian revival as a movement, for various reasons the Misesian paradigm was almost totally cast aside and forgotten; but that now it is resurgent and rapidly becoming dominant and even triumphant within Austrian economics. And in the nick of time. The strong implication of Vaughn and of other anti-Misesian critics is that Misesians simply want Austrian economics to be static, to repeat endlessly Mises's words and ideas by rote. Not so; that this is untrue may be seen in numerous creative developments and advances in Misesian economics over the past thirty years: in particular my own earlier work in monopoly theory, theory of rent, welfare economics, government and the economy, and theory of property rights¹⁰ and more recently by the work of Hans-Hermann Hoppe in the praxeological method, comparative economic systems, taxation, and a praxeological theory of rights; and by the work of Joseph T. Salerno in Mises vs. Hayek on reason, free exchange, and socialist calculation; and of Salerno on the work of Hutt and market coordination of prices as against the Hayekian "coordination of plans." All this, as well as the recent work in the philosophical background of Austrian economics by Barry Smith and David Gordon, are notable and creative advances in developing, elaborating, and making more consistent and hard-edged, the original Misesian paradigm.¹¹ In addition, there are the papers delivered at this conference, as well as literally dozens of other contributions in the Review of Austrian Economics and elsewhere on numerous aspects of theory, method, history, and policy.

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Correct theory is based on the true and unrefutable axiom that human beings act, and proceeds by deducing the logical—and therefore true—implications from that formal fact.¹³

But, with the shunning and neglect of Mises and praxeology (shunned rather than consciously argued with or refuted), recent Austrian paradigms have allowed “subjectivism” to run riot: to extend from legitimate subjective value theory to a virtual denial of the objective existence of the real world, of the objective laws of cause and effect, and of the objective validity of deductive logic. In value theory, the non-Misesians, especially the Lachmannians, neglect or deny the objective fact that physical objects are being produced, exchanged, and evaluated, albeit that they are subjectively evaluated by acting individuals.¹⁴ Lachmannians and other pseudo-Austrians must be confronted with the fact that individual human beings exist, that their actions exist, and that the world of which they are a part also exists.

Intimately connected with the question of subjectivism is the problem of knowledge and uncertainty. Neoclassical economics has locked itself into the absurd view that everyone in the market—consumers, producers, and firms—have perfect knowledge: that demands, supplies, costs, prices, products, technologies, and markets are known fully to everyone, or to all relevant individuals. This absurd assumption can only begin to be defended on the positivist, or Friedmanite, view that it is all right to incorporate gross error into one’s assumptions so long as correct “predictions” can be made. In the praxeological view, however, quantitative predictions can never be made; in fact, it becomes necessary to guard against including error in the chain of axioms and propositions, which must be true at every step of the way. In recent years, the rational expectations theorists have compounded this absurdity even further by claiming that “the market”—as some reified all-knowing entity—has absolute knowledge not only of all present conditions, but also of all future demands, costs, products, and technologies: so that the market is omniscient about the future as well as the present.¹⁵ The Misesian praxeological view, in contrast, is that knowledge of the present, much less of the future, is never perfect, and that the world in general, and the market in particular, are eternally marked by uncertainty. On the other hand, man obtains knowledge, which one hopes increases over time, of natural laws, and of the laws of cause and effect, which enable him to discover more and better ways of mastering nature and of bringing about his goals ever more effectively. As for uncertainty, it is the task of the entrepreneur to meet that uncertainty by assuming risks, in search of profit and of avoiding loss.¹⁶ Hence, to the praxeologist, Misesian Man faces the world emphatically knowing some things about his world and not knowing others. He knows absolutely that he and the world, including other people and resources, exist; he knows that natural laws and the laws of cause and effect exist; and that such knowledge cumulates over time. His technological knowledge of what goods will satisfy his wants and of how to acquire them continually increases. And yet he lives in a world of uncertainty, of uncertain future demands, resources, products, prices and costs, all problems which entrepreneurs tackle. Over time, entrepreneurs who are successful in bearing risks and forecasting their particular future will earn profits and expand their operations, while poor risk-bearers and forecasters will suffer losses and necessarily shrink their field of activity. Hence, entrepreneurs will tend to be kept on their toes and be successful in most of their forecasts.

Since there are no laws of cause and effect in human action, Lachmannian Man would not be able to take the first step in figuring out what is happening, or likely to happen, with prices. Money? Prices? They can have no

relation into the future, qualitative or quantitative, which means they are not causally related at all. Once again, the Lachmannites have no real arguments in escalating from moderate to absolute uncertainty; they apparently think that repetition suffices for argument. It seems clear to me, on the contrary, that the entire Lachmannian paradigm is nonsense. Putting aside Lachmann's overweighing of the absolute unknowability of the past (Do we really know with certainty why Caesar crossed the Rubicon?), I know many things about the future with absolute certainty: I know with absolute certainty, for example, that I will never be elected president of the United States. I know, with even greater certainty, if possible, that I will never be named King of England. I submit that I am far more certain about these future events than I am of the reason that Lenin, at Finland Station, was the only Bolshevik to see that skipping several important stages could lead to a successful revolution in Russia.¹⁸ Since Lachmann denies the possibility of knowing the future at all, and therefore of any economic law, qualitative as well as quantitative, Lachmann and his followers inevitably become mere institutionalists, mere historians of the record of man's past economic activities. Mises would have called Lachmann and the Lachmannians, as he called all other institutionalists, "anti-economists," that phrase meant not merely as an epithet, but also as a deadly accurate summation of what they are about. Since the Lachmannians are opposed to even the possibility of economic theory, they must be set down as no longer economists at all. Faute de mieux, I suppose they could be called "historians" except (a) they do very little actual historical work, and (b) as Mises has made clear in his fundamental though much-neglected *Theory and History*¹⁹ to be a good historian you have to be able to use causal theories from various disciplines to help explain unique historical events, and the tools of economic law are indispensable parts of any genuine historian's armamentarium.²⁰ In a sense, Lachmannians and other institutionalists function as professional anti-economists and "meta-historians," expending their energies denouncing economics and urging other economists to act as historians.²¹

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For Hayekian Man, however, there is a way out: even though he knows virtually nothing, he can painfully learn through the processes of the free market, just as in law or constitutions, he can learn to accept the "evolved" rules. In contrast, Misesian Man can not only know and learn, he can do so by exercising his unique human power of reason; and reason—the body of praxeologically-deduced economic theory—can and does tell him that the market economy works extremely well, while government planning and socialism cannot work at all. Misesian Man knows the virtues of the free market and the devastating flaws of socialism by using his reason. In the case of general rules, Misesian Man would think it absurd to accept all rules simply because they are there, without also correcting them by use of his reason.

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The respective attitudes toward human knowledge and human capacity help account for the enormous differences in the various paradigms on the crucial role of the entrepreneur in the market. For Neoclassical Man, there is no need for an entrepreneur, since all men know everything about the market, its past and its future, perfectly; and all curves are tangent, and all things at rest, in the Never-Never Land of long-run general equilibrium. Austrians, in contrast, place great stress on the dynamic role of the entrepreneur, but their visions of that role are very different. Hayekian Man, the Hayekian entrepreneur, starts by knowing nothing, but he painfully learns about the world and the market through the "signals" of the price system. Hayek, and Professor Israel Kirzner after him, habitually speak of the market, of competition on the market, as a "discovery process." In contrast to Lachmann, who thinks there can be no knowledge of the world out there to learn, Hayek-Kirzner

see a world of knowledge out there, with the unconscious forces of the market supplying man with that knowledge, through market price and profit-and-loss signals. The Hayek-Kirzner entrepreneur, indeed, is strangely passive; he scarcely acts like an entrepreneur at all. He risks nothing, and he really knows nothing, except what the signals of the price-system teach him, as he and the market economy wend their way toward general equilibrium. In his elaboration of the Hayekian theme, Kirzner sees the only function of the entrepreneur, and his only necessary quality, to exercise “alertness”: to catch the market signals earlier than the next guy. In Kirzner’s favorite metaphor, a \$10 bill lies on the ground. Many people do not see that bill; but the entrepreneur is more alert than his fellows, and so he is the first to see, and to snatch that bill. Superior alertness, alertness to the truth out there, accounts for entrepreneurial profits.

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There are many problems with the Kirznerian schema. If superior alertness accounts for entrepreneurial profits, what in the Kirznerian world can account for entrepreneurial losses? The answer is nothing. And yet the crucial aspect of entrepreneurship is that stressed by Mises: that the entrepreneur takes risks, that he can make profits by risking resources and through superior forecasting of the future, while suffering losses from inferior forecasting. Yet, there are neither risks nor uncertainty of the future in the Kirznerian world. Kirznerian Man faces not the future but the present; he owns no capital resources and so he risks no losses; he simply sees present truth before others and alertly possesses it.

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In the Misesian world, in contrast, the entrepreneur is not passive but extremely active.²³ He takes risks, and attempts to forecast the future; he grapples with uncertainty. The most important Misesian entrepreneurs, the driving force of the economy, are the capitalist-entrepreneurs, those who own or partially own capital resources and risk them in projects hoping for future returns. And, in the area of knowledge, as professor Salerno has perceptively pointed out, Misesian Man knows a lot about his part of the market—not just prices, but all the qualitative knowledge that must also go into production and into risky ventures: the sort of customers he will have, the sort of products they will want, where to buy raw materials and how to transform them, and so on—that is, all the particular knowledge that Hayek has talked about in other contexts. The free price-system is vital to the entrepreneur but it is not, as in Hayek-Kirzner, his only source of knowledge.²⁴ The

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But in contrast to Mises, the Lachmannians, in particular, have thrown out final equilibrium altogether. They regard the entire concept as meaningless. Instead, they virtually use the phrase “market process” as a shibboleth, thereby throwing out not only equilibrium, but the baby of economic theory itself along with the neoclassical bathwater.

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It is impossible to engage in economic theorizing without employing what Mises called “imaginary constructions” or “thought experiments” (*Gedankenexperimenten*) which function as the praxeologist’s unique substitute for the laboratory experiments of the physical sciences. In the laboratory, the scientist holds all other

variables constant, while he examines the effect of changing one variable upon another. Since human beings cannot be “held constant,” the praxeologist does so in “thought experiments,” by means of the famed *ceteris paribus* clause. It is through such reasoning that the economic theorist concludes, for example, that an increase in the supply of money, the demand for money being held constant, will be bound to lower the value (purchasing power) of the monetary unit. In short, the economic theorist postulates an equilibrium, then mentally changes one variable, say the supply of money, keeps all other relevant variables constant, and examines the effect on prices in general. Refusing to employ equilibrium concepts is necessarily destructive of all economic theory or economic law.

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Once again, a crucial difference is the abandonment, by non-Misesians, of the Misesian concept of action—action that is necessarily goal or end-state directed, and that is purposive, active, and risktaking. Instead of “equilibrium,” these Lachmannians speak of “processes,” which connote impersonal motions and mechanisms rather than the conscious choices of persons engaging in goal-directed activity.^{29,30} We have seen, in contrast, that equilibrium constructions are indispensable for all *ceteris paribus* economic thinking, for analyzing actions, and for demonstrating the direction in which the economy is necessarily tending. As Mises indicated in the above quote, final equilibrium is also necessary for analyzing the emergence of profit-and-loss in an uncertain world; for such positive or negative returns would not exist in a world of certainty and changeless final equilibrium. The final equilibrium construct also enables the economist to distinguish short-run entrepreneurial profit-and-loss from returns brought about by time-preference, embodied in the “natural” rate of interest, returns which would still continue to exist in a world of certainty and equilibrium.

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Professor Salerno has performed the signal service of reviving William H. Hutt’s theory of price coordination and demonstrating that this Huttian concept is essentially the Misesian view.³² Not in the Never-Never Land of final equilibrium, but every day in markets, in day-to-day equilibrium, the price system coordinates prices, including wage rates and the prices of other productive factors, so that there is never any shortage or unsold surplus. From day-to-day, then, there may, for various reasons, be misallocations of resources, but never shortages and surpluses, so long as prices are free to move.

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Man, affirms Mises after Aristotle, is the uniquely rational animal; reason is man’s unique and essential instrument to find out what his needs and preferences are, and to discover and employ the means to achieve them. Mises’s stress on action, on acting man, therefore necessarily stresses the vital importance of human reason. Misesian Man acts, and therefore consciously selects goals, and decides how to pursue them.

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Hayek’s entire work, on the contrary, is devoted to a denigration of human reason. As David Gordon has pointed out, Hayek virtually assumes that human beings act unconsciously—of course, a contradiction in terms—and therefore that they neither know nor think nor choose. Therefore, their actions do not require understanding;

hence Hayek's emphasis that the best that can be done is rely on a blind and unconscious adherence to evolved rules.⁴⁰

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But, we might wonder: why the rush to celebrate unintended consequences? Wouldn't it have been better if these pro-consumer or pro-general standard of living consequences had been understood and intended by the actors as well? To put it another way: the butcher, baker, and so on desire and intend the consequences of their production yielding them a satisfying profit. But suppose that they are informed, by economists and others, that their actions also have the effect of helping the rest of society and the general standard of living? Wouldn't they then come to intend this general welfare as well, even conceding that their own self-interest would still be their primary goal? Wouldn't they be likely, at the very least, to feel better and happier about their own activities, knowing now that they benefit the body of consumers as well as themselves? How could such knowledge hurt?

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Hayek's scheme of private individuals or banks issuing their own currencies—a scheme which he himself, in more sober moments, would have dismissed as absurdly “constructivist”—was not so much adopted as coming to serve as inspiration or jumping-off point for other money-crank schemes, which have proliferated ever since. They range from private currencies to schemes for private banks freely inflating credit on top of gold currency reserves. As these proposals have multiplied, however, gold has inevitably dropped out or been pushed out of the picture. Later plans range from banks inflating notes or deposits on top of Federal Reserve Notes even after the Fed has been abolished; gold being a mere shadow helping to prop up the system; and finally schemes where banks clear each others' notes indefinitely with no possibility of the poor public's being able to redeem its way out of bank money. Finally, standard or “high powered” money disappears altogether, and inflationary banks merely redeem their notes and deposits in the equally phony notes and deposits of other inflating banks.”^{64,65}

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This brings me to the position of the bulk of free market economists, such as the Chicago School, who favor the free market but claim to do so not on ethical grounds, but purely on the grounds of “efficiency.” I maintain that it is impermissible to advocate the free market without bolstering one's economic analysis with an ethical framework. Indeed, in some cases it is even impossible to set forth a coherent free-market approach without taking a frankly ethical position, and a position which goes beyond the almost universally-held utilitarian viewpoint of economists.

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Furthermore, not only is it illegitimate for the economist to advocate a free market without also adumbrating a theory of justice in property titles; he cannot even define a free market without doing so. For even to define and expound upon the free-market model, the economist is describing a system in which property titles are being exchanged, and therefore he must also define and expound upon how these titles are arrived at in the first place; he must have a theory of original property and of how property comes into being.

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This problem of justice in property titles also exposes a fatal flaw in the concept of the “Unanimity Principle” as a supposedly value-free guide for the applied economist. Thus, Professor James Buchanan and others have declared that it is legitimate and presumably value-free for the economist to advocate a public policy, provided that everyone can agree on such a policy. Once again, and even more than in the case of the Pareto Optimum, this position is scarcely self-evident when subjected to analysis. For the implicit assumption of the Unanimity Principle is that all existing property titles are just. The Unanimity Principle would mean, for example, that it would be illegitimate to confiscate A’s watch even though he had stolen it from C. But if we regard A’s property title as illegitimate, then we must say that A’s watch should be confiscated and returned to C. Once again, our ethical systems intrude ineluctably into the discussion.

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Let us take a given individual. Since his own ends are clearly given and he acts to pursue them, surely at least his actions can be considered efficient. But no, they may not, for in order for him to act efficiently, he would have to possess perfect knowledge—perfect knowledge of the best technology, of future actions and reactions by other people, and of future natural events. But since no one can ever have perfect knowledge of the future, no one’s action can be called “efficient.” We live in a world of uncertainty. Efficiency is therefore a chimera.

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Put another way, action is a learning process. As the individual acts to achieve his ends, he learns and becomes more proficient about how to pursue them. But in that case, of course, his actions cannot have been efficient from the start—or even from the end—of his actions, since perfect knowledge is never achieved, and there is always more to learn.

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Moreover, the individual’s ends are not really given, for there is no reason to assume that they are set in concrete for all time. As the individual learns more about the world, about nature and about other people, his values and goals are bound to change. The individual’s ends will change as he learns from other people; they may also change out of sheer caprice. But if ends change in the course of an action, the concept of efficiency—which can only be defined as the best combination of means in pursuit of given ends—again becomes meaningless. If the concept of efficiency is worthless even for each individual, it is a fortiori in far worse straits when the economist employs it in an additive way for all of society. Rizzo is being extremely gentle with the concept when he says that it amounts “to little more than maximizing gross national product” which “immediately breaks down once externalities are introduced into the system.” The problem, however, is far deeper. For efficiency only makes sense in regard to people’s ends, and individuals’ ends differ, clash, and conflict. The central question of politics then becomes: whose ends shall rule? The blindness of economic thought to the realities of the world is systematic and is a product of the utilitarian philosophy that has dominated economics for a century and a half. For utilitarianism holds that everyone’s ends are really the same, and that therefore all social conflict is merely technical and pragmatic, and can be resolved once the appropriate means for the common ends are discovered and adopted. It is the myth of the common universal end that allows economists to believe that they can

“scientifically” and in a supposedly value-free manner prescribe what political policies should be adopted. By taking this alleged common universal end as an unquestioned given, the economist allows himself the delusion that he is not at all a moralist but only a strictly value-free and professional technician.

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As someone who has proclaimed that Léon Walras was the greatest economist who ever lived, Joseph A. Schumpeter (1883–1950) faced this very problem. As a Walrasian, Schumpeter believed that general equilibrium is an overriding reality; and yet, since change, entrepreneurship, profits, and losses clearly exist in the real world, Schumpeter set himself the problem of integrating a theoretical explanation of such change into the Walrasian system. It was a formidable problem indeed, since Schumpeter, unlike the Austrians, could not dismiss general equilibrium as a long-run tendency that is never reached in the real world. For Schumpeter, general equilibrium had to be the overriding reality: the realistic starting point as well as the end point of his attempt to explain economic change.² To set forth a theory of economic change from a Walrasian perspective, Schumpeter had to begin with the economy in a real state of general equilibrium. He then had to explain change, but that change always had to return to a state of equilibrium, for without such a return, Walrasian equilibrium would only be real at one single point of past time and would not be a recurring reality. But Walrasian equilibrium is a world of unending statics; specifically, it depicts the consequences of a fixed and unchanging set of individual tastes, techniques, and resources in the economy. Schumpeter began, then, with the economy in a Walrasian box; the only way for any change to occur is through a change in one or more of these static givens. Furthermore, Schumpeter created even more problems for himself. In the Walrasian model, profits and losses were zero, but a rate of interest continued to be earned by capitalists, in accordance with the alleged marginal productivity of capital. An interest charge became incorporated into costs. But Schumpeter was too much of a student of Böhm-Bawerk to accept a crude productivity explanation of interest. The Austrian approach was to explain interest by a social rate of time preference, of the market’s preference for present goods over future goods. But Schumpeter rejected the concept of time-preference as well, and so he concluded that in a state of general equilibrium, the rate of interest as well as profits and losses are all zero.

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Schumpeter acknowledged that time-preference, and hence interest, exist on consumption loans, but he was interested in the production structure. Here he stressed, as against the crude productivity theory of interest, the Austrian concept of imputation, in which the values of products are imputed back to productive factors, leaving, in equilibrium, no net return. Also, in the Austrian manner, Schumpeter showed that capital goods can be broken down ultimately into the two original factors of production, land and labor.³ But what Schumpeter overlooked, or rather rejected, is the crucial Böhm-Bawerkian concept of time and time-preference in the process of production. Capital goods are not only embodied land and labor; they are embodied land, labor, and time, while interest becomes a payment for “time.” In a productive loan, the creditor of course exchanges a “present good” (money that can be used now) for a “future good” (money that will only be available in the future). And the primordial fact of time-preference dictates that every one will prefer to have wants satisfied now than at some point in the future, so that a present good will always be worth more than the present prospect of the equivalent future good. Hence, at any given time, future goods are discounted on the market by the social rate of time-preference. It is clear how this process works in a loan, in an exchange between creditor and debtor. But Böhm-Bawerk’s analysis of time-preference and interest went far deeper, and far beyond the loan market for he

showed that time-preference and hence interest return exist apart from or even in the absence of any lending at all. For the capitalist who purchases or hires land and labor factors and employs them in production is buying these factors with money (present good) in the expectation that they will yield a future return of output, of either capital goods or consumer goods. In short, these original factors, land and labor, are future goods to the capitalist. Or, put another way, land and labor produce goods that will only be sold and hence yield a monetary return at some point in the future; yet they are paid wages or rents by the capitalist now, in the present.

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Therefore, in the Böhm-Bawerkian or Austrian insight, factors of production, hence workers or landowners, do not earn, as in neoclassical analysis, their marginal value product in equilibrium. They earn their marginal value product discounted by the rate of time-preference or rate of interest. And the capitalist, for his service of supplying factors with present goods and waiting for future returns, is paid the discount.⁴ Hence, time-preference and interest income exist in the state of equilibrium, and not simply as a charge on loans but as a return earned by every investing capitalist. Schumpeter can deny time-preference because he can somehow deny the role of time in production altogether. For Schumpeter, production apparently takes no time in equilibrium, because production and consumption are “synchronized.”⁵ Time is erased from the picture, even to the extent of assuming away accumulated stocks of capital goods, and therefore of any age structure of distribution of such goods.⁶ Since production is magically “synchronized,” there is then no necessity for land and labor to receive any advances from capitalists. As Schumpeter writes: There

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One sees, too, why for Schumpeter the entrepreneur is always a disturber of the peace, a disruptive force away from equilibrium, whereas in the Austrian tradition of Mises and Kirzner, the entrepreneur harmoniously adjusts the economy in the direction of equilibrium. For in the Austrian view the entrepreneur is the main bearer of uncertainty in the real world, and successful entrepreneurs reap profits by bringing resources, costs, and prices further in the direction of equilibrium. But Schumpeter starts, not in the real world, but in the never-never land of general equilibrium which he insists is the fundamental reality. But in the equilibrium world of stasis and certainty there are no entrepreneurs and no profit. The only role for entrepreneurship, by logical deduction, is to innovate, to disrupt a preexisting equilibrium. The entrepreneur cannot adjust, because everything has already been adjusted. In a world of certainty, there is no room for the entrepreneur; only inflationary bank credit and innovation enable him to exist. His only prescribed role, therefore, is to be disruptive and innovative.

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The entrepreneur, then, pays interest to the banks, interest for Schumpeter being a strictly monetary phenomenon. But where does the entrepreneur-innovator get the money to pay interest? Out of profits, profits that he will reap when the fruits of his innovation reach the market, and the new processes or products reap revenue from the consumers. Profits, therefore, are only the consequence of successful innovation, and interest is only a payment to inflationary banks out of profit. Inflationary

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Even within his own theory, indeed, there are grave flaws. In the Walrasian world of perfect certainty (an assumption which is not relaxed with the coming of the innovator), how is it that the old firms wait until the “completion” of the innovation to find suddenly that they are suffering severe losses? In a world of perfect knowledge and expectations, the old firms would know of their fate from the very beginning, and early take steps to adjust to it. In a world of perfect expectations, therefore, there would be no losses, and therefore no recession or depression phase. There would be no cycle as economists know it. Finally, Schumpeter’s constrained model can only work if innovations come in clusters, and the empirical evidence for such clusters is virtually nil.¹¹ In the real world, innovations occur all the time. Therefore, there is no reason to postulate any return to an equilibrium, even if it had ever existed in the past.

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Schumpeter’s Theory of Economic Development was a fascinating, though ill-conceived, attempt to derive a theory of the business cycle and economic growth from a Walrasian general equilibrium starting-point. According to Walras, tastes, technology, and resources were given in general equilibrium. If we begin with the economy in that equilibrium state, therefore, any change from that state must occur in at least one of these variables. To Schumpeter, as to other neoclassical economists, tastes could not be the changing element. Tastes he regarded as basically fixed; certainly they could not be the driving force of economic change. Total supply of resources didn’t change very frequently either. So Schumpeter was left with innovation in technology as the only possible motor force for any change, be it business cycles or economic development. But then Schumpeter was confronted with a problem: how would these innovations be financed? Not out of new savings, since tastes were given, and since by definition net savings are zero in equilibrium. Not out of profits, since by definition profits are zero in equilibrium. One way out might have been finance out of interest returns, since according to Austrian theory, savings, the result of positive time preference, are positive even in equilibrium. But Schumpeter had rejected the concept of time preference, so he was left with interest and profits both being zero in equilibrium. The result was that Schumpeter had trapped himself in a Walrasian box: the only conceivable way by which new investment, which had to be in innovations, could be financed was by the creation of new money. This meant that only inflationary bank credit could finance economic development.

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

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The concept of demonstrated preference is simply this: that actual choice reveals, or demonstrates, a man’s preferences; that is, that his preferences are deducible from what he has chosen in action. Thus, if a man chooses to spend an hour at a concert rather than a movie, we deduce that the former was preferred, or ranked higher on

his value scale. Similarly, if a man spends five dollars on a shirt we deduce that he preferred purchasing the shirt to any other uses he could have found for the money. This concept of preference, rooted in real choices, forms the keystone of the logical structure of economic analysis, and particularly of utility and welfare analysis.

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

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If a person is really indifferent between two alternatives, then he cannot and will not choose between them.²⁹ Indifference is therefore never relevant for action and cannot be demonstrated in action. If a man, for example, is indifferent between the use of 5.1 ounces and 5.2 ounces of butter because of the minuteness of the unit, then there will be no occasion for him to act on these alternatives. He will use butter in larger-sized units, where varying amounts are not indifferent to him.

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

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

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I owe to Dr. Yuri Maltsev the information that the much-vaunted Shatalin plan for the Soviet Union, which was supposed to bring about privatization and free markets in 500 days, was really not privatization at all. Apparently, existing government firms in each industry, instead of being actually privatized—that is, owned by

private individuals—would have been owned (or 80 percent owned) by other firms in the same industry. This would mean that giant state monopoly firms would continue to be state monopoly firms, and be self-perpetuating oligarchies rather than truly privately owned. Privatization must mean private property.²

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There can be no genuine free market or desocialization so long as government is permitted to counterfeit money, that is create new money, whether it be paper tickets or bank deposits, out of thin air. Such money creation functions as a hidden and insidious form of taxation and expropriation of the property and resources of producers. Ending counterfeiting means getting the government out of the money business, which in turn implies eliminating both government paper money and central banking. It also means denationalizing currency units, such as the ruble, forint, zloty, etc., and returning them to private market hands. Denationalizing currency can only be achieved by redefining paper currencies in terms of units of weight of a market metal, preferably gold. When the central banks are liquidated, they could disgorge their gold hoards; as their last act on earth they could redeem all their paper tickets at the redefined weight in gold coins.

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This brings us to the final, but scarcely the least important, plank of our proposed desocialization platform: privatizing government operations. Since theoretically all, or in practice most, production in socialist countries has been in the hands of the State, the most important desideratum, the crucial route for attaining a system of private property and free market, must be to privatize government operations.

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It would be far better to enshrine the venerable homesteading principle at the base of the new desocialized property system. Or, to revive the old Marxist slogan: “all land to the peasants, all factories to the workers!” This would establish the basic Lockean principle that ownership of owned property is to be acquired by “mixing one’s labor with the soil” or with other unowned resources. Desocialization is a process of depriving the government of its existing “ownership” or control, and devolving it upon private individuals. In a sense, abolishing government ownership of assets puts them immediately and implicitly into an unowned status, out of which previous homesteading can quickly convert them into private ownership. The homestead principle asserts that these assets are to devolve, not upon the general abstract public as in the handout principle, but upon those who have actually worked upon these resources: that is, their respective workers, peasants, and managers. Of course, these rights are to be genuinely private; that is, land to individual peasants, while capital goods or factories go to workers in the form of private, negotiable shares. Ownership is not to be granted to collectives or cooperatives or workers or peasants holistically, which would only bring back the ills of socialism in a decentralized and chaotic syndicalist form.

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A third commonly suggested route to privatization deserves to be rejected out of hand: that the government sell all its assets to the public at auction, to the highest bidder. One grave flaw in this approach is that since the government owns virtually all the assets, where would the public get the money to purchase them, except at a

very low price that would be tantamount to free distribution? But another, even more important flaw hasn't been sufficiently stressed: why does the government deserve to own the revenue from the sale of these assets? After all, one of the main reasons for desocialization is that the government does not deserve to own the productive assets of the country. But if it does not deserve to own the assets, why in the world does it deserve to own their monetary value? And we do not even consider the question: What is the government supposed to do with the funds after they have been received?⁸

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The dimensions of the proffered Rothbard Plan for desocialization should now be clear: (1) Enormous and drastic reductions in taxes, government employment, and government spending. (2) Complete privatization of government assets: where possible to return them to the original expropriated owners or their heirs; failing that, granting shares to productive workers and peasants who had worked on these assets. (3) Honoring complete and secure property rights for all owners of private property. Since full property rights imply the complete freedom to make exchanges and transfer property, there must be no government interference in such exchanges. (4) Depriving the government of the power to create new money, best done by a fundamental reform that at one and the same time liquidates the central bank and uses its gold to redeem its notes and deposits at a newly defined unit of gold weight of existing currencies. All this could and should be done in one day, although the monetary reform could be done in steps taking a few days. One

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For many reasons, then, there are no collective goods, and even if there were, as we have already seen, their supply would be coercive if furnished by government and taxation. But there is yet another vital point: For even if a good or service could only be supplied "collectively," why must that collection be compulsory? Why couldn't individuals pool their resources voluntarily, as in club dues, and make voluntary contributions for the supply of the service?⁴⁰ Or, as Gustave de Molinari argued, couldn't a government even contract for the supply of collective services with private, competitive, and therefore more efficient firms?⁴¹ Or, as Spencer Heath urged, on the model of real estate developments, shopping centers, and hotels, couldn't such "collective" or "public" goods as police, fire, roads, sanitation, and so on, be supplied by a large private firm with tenants paying for these services in their rents?⁴² Finally, if we look at human history, we find that every good, without exception, that economists glibly term a "collective good" has actually been successfully supplied by the free market. Not only do private guards and patrols exist, and private lighthouses in the past, but there have been societies, such as medieval Ireland, that supplied a complex network of defense service and insurance—including police, crime insurance, and competitive courts—without a State or taxation. Competing market courts serviced for centuries the vitally important fairs of Champagne in the Middle Ages. Common-law courts were marked by competitive, nongovernmentally appointed judges. Private guards and private arbitrators exist successfully even in our society where the State monopolizes most forms of defense.⁴³ It

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But this argument generates far more difficulties than it solves. It proves too much in many directions. In the first place, how much of the deficient good should be supplied? What criterion can the State have for deciding the optimal amount and for gauging by how much the market provision of the service falls short? Even if free

riders benefit from collective service X, in short, taxing them to pay for producing more will deprive them of unspecified amounts of private goods Y, Z, and so on. We know from their actions that these private consumers wish to continue to purchase private goods Y, Z, and so on, in various amounts. But where is their analogous demonstrated preference for the various collective goods? We know that a tax will deprive the free riders of various amounts of their cherished private goods, but we have no idea how much benefit they will acquire from the increased provision of the collective good; and so we have no warrant whatever for believing that the benefits will be greater than the imposed costs. The presumption should be quite the reverse. And what of those individuals who dislike the collective goods, pacifists who are morally outraged at defensive violence, environmentalists who worry over a dam destroying snail darters, and so on? In short, what of those persons who find other people's good their "bad"? Far from being free riders receiving external benefits, they are yoked to absorbing psychic harm from the supply of these goods. Taxing them to subsidize more defense, for example, will impose a further twofold injury on these hapless persons: once by taxing them, and second by supplying more of a hated service.

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Since the tax-and-subsidy, or government-operation, route abandons the process of the market, there is no way of knowing who the "negative free riders" are, and how much they will be suffering from an increased tax. We do have a pretty good idea, however, that one or more of these people exists: that there is at least one pacifist, anti-dam environmentalist, anarchist opposed to all government actions, and so on, in every society. But in that case, the free-rider as well as the "stronger" collective-good argument for the neutrality of government falls to the ground. The

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Thus the free-rider argument proves far too much. After all, civilization itself is a process of all of us "free-riding" on the achievements of others. We all free-ride, every day, on the achievements of Edison, Beethoven, or Vermeer. When capital investment increases, and technology improves, the real wages of workers and the standard of living of consumers increase, even though they have contributed nothing to these advances. By simply continuing to work and consume, laborers and consumers receive the benefits of the inventions and investments of others without paying for them. So what must we infer from this? Are we all to wear sackcloth and ashes? If our neighbors are wiser, prettier, or happier, we all benefit in countless ways. So what must we do about it? Must we all be taxed to subsidize their beauty and wisdom?

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There are also the inevitable grave inefficiencies in the political supply of goods and services and in the political process itself that need not be expounded here. At any rate, there is no reason to assume that the transaction costs of turning to government will be lower than those of private operation, and every reason to assume the opposite.

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For costs, like utilities, are subjective, and therefore nonmeasurable and noncomparable between persons. There is no such thing as social transaction costs or any social costs whatever.⁵⁰ Any government action will impose

enormous psychic cost on the anarchist; any private action will do likewise for the dedicated totalitarian. How are we to compare them? If an entity does not and cannot exist, then it is senseless to take as one's goal that it be minimized.

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And third, even if transaction costs were measurable and comparable, we must ask: What is so terrible about transaction costs? On what basis are they considered the ultimate evil, so that their minimization must override all other considerations of choice, freedom, or justice?⁵¹ After all, if minimizing these dread costs were truly the be-all and end-all, we could all pledge to obey one dictator, one Brezhnev or Idi Amin, in all things, and then everyone would have the assurance of knowing everyone else's relevant value-scales. Other problems would abound, but at least transaction costs would be forced down to a minimum.

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Friedrich Engels maintained that the emergence of the division of labor shattered the alleged classless harmony and uniformity of primitive society, and was responsible for the cleavage of society into separate and conflicting classes. Hence, for Marx and Engels, the division of labor must be eradicated in order to abolish class conflict and to usher in the ideal harmony of the "classless society," the society of total uniformity.⁸

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This absurd ideal—of the man "able to do everything"—is only viable if (a) everyone does everything very badly, or (b) there are only a very few things to do, or (c) everyone is miraculously transformed into a superman. Professor Mises aptly notes that the ideal communist man is the dilettante, the man who knows a little of everything and does nothing well. For how can he develop any of his powers and faculties if he is prevented from developing any one of them to any sustained extent?

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The "social harmony," the "sense of belonging," supplied by mercantilism, by the guilds, or by the caste system, provided such contentment that its members left the throes of the system when given an opportunity. Given the freedom to choose, the tribesmen abandon the bosom of their tribe to come to the freer, "atomistic" cities looking for jobs and opportunity. It is curious, in fact, that those Romantics who yearn to restore the mythical golden age of caste and status refuse to allow each individual the freedom to choose between market on the one hand, or caste and tribal commune on the other. Invariably, the new golden age has to be imposed by coercion.

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Is it, indeed, a coincidence that the natives of undeveloped countries, when given a chance, invariably abandon their "folk culture" on behalf of Western ways, living standards, and "Coca-Colaization?" Within a few years, for example, the people of Japan were delighted to abandon their centuries-old traditional culture and folkways, and turn to the material achievements and market economy of the West. Primitive tribes, too, given a chance, are eager to differentiate and develop a market economy, to shed their stagnant "harmony" and replace their magic

by knowledge of discovered law. The eminent anthropologist, Branislaw Malinowski, pointed out that primitives allow magic only to cover those areas of nature of which they are ignorant; in those areas where they have come to understand the natural processes at work, magic is, quite sensibly, not employed.³⁴

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A particularly striking example of the eager development of a pervasive market economy among primitive tribesmen is the largely unheralded case of West Africa.³⁵ And Bernard Siegel has pointed out that when, as among the Penajachel of Guatemala, a primitive society becomes large and technologically and societally complex, a market economy inevitably accompanies this growth, replete with specialization, competition, cash purchases, demand and supply, prices and costs, etc.³⁶ There

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Thus, only the specific equality of liberty—the older view of human equality—is compatible with the basic nature of man. Equality of condition would reduce humanity to an antheap existence. Fortunately, the individuated nature of man, allied to the geographical diversity on the earth, makes the ideal of total equality unattainable. But an enormous amount of damage—the crippling of individuality, as well as economic and social destruction—could be generated in the attempt. Let

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What, then, is the purchasing power, or the price, of a dollar? It will be a vast array of all the goods and services that can be purchased for a dollar, that is, of all the goods and services in the economy. In our example, we would say that the purchasing power of a dollar equals one dozen eggs, or two pounds of butter, or one-tenth of a hat, and so on, for the entire economy. In short, the price, or purchasing power, of the money unit will be an array of the quantities of alternative goods and services that can be purchased for a dollar. Since the array is heterogeneous and specific, it cannot be summed up in some unitary price-level figure. The

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Two types of shifts in relative prices occur as the result of this increase in money: (1) the redistribution from late receivers to early receivers that occurs during the inflation process and; (2) the permanent shifts in wealth and income that continue even after the effects of the increase in the money supply have worked themselves out. For the new equilibrium will reflect a changed pattern of wealth, income, and demand resulting from the changes during the intervening inflationary process. For example, the fixed income groups permanently lose in relative wealth and income.² If

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But Patinkin was mistaken; Mises's concept of the marginal utility of money always refers to the utility of holding money. Mises's point in the regression theorem is a different one, namely, that the marginal utility-to-hold is itself based on the prior fact that money can be exchanged for goods, that is, on the prior purchasing power of money in terms of goods. In short, money prices of goods, the purchasing power of money, has first to

exist in order for money to have a marginal utility to hold, hence the need for the regression theorem to break out of the circularity.¹²

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But if no one holds cash and the demand for cash balances falls to zero, all prices rise to infinity, and the entire general equilibrium system of the market, which implies the continuing existence of monetary exchange, falls apart. As Mises concluded:

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The very notion of a Walrasian general equilibrium is not simply totally unrealistic, it is conceptually impossible, since money and monetary exchange cannot be sustained in that kind of system. Another corollary contribution of Mises in this analysis was to demonstrate that, far from being only one of many “motives” for holding cash balances, uncertainty is crucial to the holding of any cash at all.

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At this point, the economy is regarded as suffering from a money shortage as evidenced by the outstripping of monetary expansion by the rise in prices. What is now called a liquidity crunch occurs on a broad scale, and a clamor arises for greater increases in the supply of money. As the Austrian school economist Bresciani-Turroni wrote in his definitive study of the German hyperinflation:

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Phase three of the inflation is the ultimate runaway stage: the collapse of the currency. The public takes panicky flight from the money into real values, into any commodity whatever. The public's psychology is not simply to buy now rather than later but to buy anything immediately. The public's demand for cash balances hurtles toward zero. The

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No institution is more necessary for State control and manipulation of a modern economy than the Central Bank, and no institution is more venerated. Most conservative economists believe themselves to be daring when they advocate independence of the Central Bank from the Treasury—a vain pretense that an organ of the State like the Central Bank can somehow be transformed into a wise and beneficent institution, “above politics.” The wisdom of Federal Reserve manipulation of the American economy, for example, goes virtually unchallenged. The Chamber of Commerce, for one, has no doubt: It

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The Central Bank can make sure that all banks expand together, can furnish needed reserves to banks throughout the country and lend to banks in trouble, and can thereby bring about a much greater, and centrally coordinated, expansion of the money supply.⁵

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One inflationist paper-money scheme, the Massachusetts Land Bank of 1740, has generally been regarded by historians as a plan instituted by a mass of small farmer-debtors, over the opposition of the merchant-creditors of Boston. This stereotype was first fashioned by the contemporary opponents of the plan, who dismissed the proponents of the bank as “plebeians”; it was systematized by such conservative economic historians as Andrew M. Davis, writing at a time when agrarian Populist inflationism was a threat to sound finance, and then taken over by neo-Marxist historians in the 1930s, to become established in the history textbooks. Actually, as Dr. Billias has shown in an important paper, the major proponents of the plan were as wealthy and as connected with business as its opponents; merchants were debtors too, and the chief advocates of a land bank “were all businessmen, politicians, or professional men residing in Boston”; the leading proponent of the plan was John Colman, a prominent Boston merchant and the founder of the Massachusetts Land Bank. Colman, indeed, tried to stir up support among the farmers by promising them that the inflation arising from the establishment of the bank would raise the prices of farm products. Businessmen were particularly eager for inflation after 1720, because after that date the Massachusetts government adopted a policy of granting unsettled frontier land to speculators, who then sold these lands to the actual settlers at far higher prices. Expanded bank credit was wanted to finance business speculation in government land grants as well as to raise land prices. Joined with inflation was another mercantilist feature: a subsidy to home manufacturing, through permitting repayment of bank debts in certain specified manufactured commodities.⁷ Nicholas

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One of the leading advocates of cheap money during this period was the prominent banker Jay Cooke. Cooke, a recipient of government land grants in his railroad ventures, benefited from inflation and credit expansion that drove up the price of land. Incidentally, Cooke had been a driving force behind the creation of the National Banking System during the Civil War, an innovation which brought federal control over the banking system for the first time since Jackson’s abolition of the Second Bank of the United States. Cooke was hired by the North to be the leading underwriter of government bonds, and he thereupon worked for the establishment of a national banking system whose reserves would rest on government bonds, thus forcing the banks to invest heavily in (Cooke’s) bonds.¹⁷

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Interestingly enough, Warburg also became one of the nation’s leading acceptance bankers, thus benefiting greatly from the system he helped found and whose course he helped set. He was Chairman of the Board of International Acceptance Bank of New York, the world’s largest acceptance bank, was a director of the important Westinghouse Acceptance Bank and of several other acceptance houses, and was chief founder and chairman of the Executive Committee of the American Acceptance Council, a trade association organized in 1919. To write of Warburg’s influence is not far-fetched speculation, for he himself boasted of his success in persuading the Federal Reserve to loosen eligibility rules for purchase of acceptances and to establish its policy of buying all acceptances offered at a subsidized rate.¹⁹ Furthermore, Warburg had considerable influence on Benjamin Strong, head of the Federal Reserve Bank of New York, which in these years virtually set the policy of the Federal Reserve.²⁰ In these case studies we have seen that inflationism and State control of the monetary system have, in many critical periods of American history, been proposed and established, not by “workers and

farmers” nor even by disaffected intellectuals, but by groups of merchants, manufacturers, and other businessmen eager to acquire special privilege, to use the State for their own advantage—in short, by men who were essentially modern mercantilists. This mercantilist drive has played a much greater role in the general movement toward statism and central planning than is generally recognized.

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Ludwig von Mises distinguished carefully between a credit and a claim transaction: a credit transaction is an exchange of a present good (e.g., money which can be used in exchange at any present moment) for a future good (e.g., an IOU for money that will only be available in the future). In this sense, a demand deposit, while legally designated as credit, is actually a present good—a warehouse claim to a present good that is similar to a bailment transaction, in which the warehouse pledges to redeem the ticket at any time on demand.

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In contrast to the Chicago School, the Austrian economist cannot rest content with arriving at the proper concept of the supply of money. For while the supply of money (M_1) is the vitally important supply side of the “money relation” (the supply of and demand for money) that determines the array of prices, and is therefore the relevant concept for analyzing price inflation, different parts of the money supply play very different roles in affecting the business cycle. For the Austrian theory of the trade cycle reveals that only the inflationary bank credit expansion that enters the market through new business loans (or through purchase of business bonds) generates the over-investment in higher-order capital goods that leads to the boom-bust cycle. Inflationary bank credit that enters the market through financing government deficits does not generate the business cycle; for, instead of causing overinvestment in higher-order capital goods, it simply reallocates resources from the private to the public sector, and also tends to drive up prices. Thus, Mises distinguished between “simple inflation,” in which the banks create more deposits through purchase of government bonds, and genuine “credit expansion,” which enters the business loan market and generates the business cycle.

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Mises did not deal with the relatively new post-World War II phenomenon of large-scale bank loans to consumers, but these too cannot be said to generate a business cycle. Inflationary bank loans to consumers will artificially deflect social resources to consumption rather than investment, as compared to the unhampered desires and preferences of the consumers. But they will not generate a boom-bust cycle, because they will not result in “over” investment, which must be liquidated in a recession. Not enough investments will be made, but at least there will be no flood of investments which will later have to be liquidated. Hence, the effects of diverting consumption investment proportions away from consumer time preferences will be asymmetrical, with the overinvestment-business cycle effects only resulting from inflationary bank loans to business. Indeed, the reason why bank financing of government deficits may be called simple rather than cyclical inflation is because government demands are “consumption” uses as decided by the preferences of the ruling government officials.

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This “classical gold standard” had numerous and considerable economic and social advantages. In the first place, the supply of money in the various countries was basically determined, not by government dictates, but—like

copper, wheat, and so on—by the supply and demand forces of the free and private market. Gold was and is a metal that has to be discovered, and then mined, by private firms. Its supply was determined by market forces, by the demand for gold in relation to the demand and supply of other commodities and factors; by, for example, the relative cost and productivity of factors of production in mining gold and in producing other goods and services. At its base, the money supply of the world, then, was determined by free market forces rather than by the dictates of government. While it is true that governments were able to interfere with the process by weakening the links between the currency name and the weight of gold, the base of the system was still private, and hence it was always possible to return to a purely private and free monetary system. To the extent that the various currency names were kept as strictly equivalent to weights of gold, to that extent the classical gold standard worked well and harmoniously and without severe inflation or booms and busts.

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The international gold standard had other great advantages. It meant that the entire world was on a single money, that money, with all its enormous advantages, had fully replaced the chaotic world of barter, where it is impossible to engage in economic calculation or to figure out prices, profits, or losses. Only when the world was on a single money did it enjoy the full advantage of money over barter, with its attendant economic calculation and the corollary advantages of freedom of trade, investment, and movement between the various countries and regions of the civilized world. One of the main reasons for the great growth and prosperity of the United States, it is generally acknowledged, was that it consisted of a large free-trading area within the nation: we have always been free of tariffs and trading quotas between New York and Indiana, or California and Oregon. But not only that. We have also enjoyed the advantage of having one currency: one dollar area between all the regions of the country, East, West, North, and South. There have also been no currency devaluations or exchange controls between New York and Indiana.

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But let us now contemplate instead what could happen were the Friedmanite scheme to be applied within the United States. After all, while a nation or country may be an important political unit, it is not really an economic unit. No nation could or should wish to be self-sufficient, cut off from the enormous advantages of international specialization and the division of labor. The Friedmanites would properly react in horror to the idea of high tariffs or quota walls between New York and New Jersey. But what of different currencies issued by every state? If, according to the Friedmanites, the ultimate in monetary desirability is for each nation to issue its own currency—for the Swiss to issue Swiss francs, the French their francs, and so on—then why not allow New York to issue its own “yorks,” New Jersey its own “jersies,” and then enjoy the benefits of a freely fluctuating “market” between these various currencies? But since we have one money, the dollar, within the United States, enjoying what the Friedmanites would call “fixed exchange rates” between each of the various states, we don’t have any monetary crisis within the country, and we don’t have to worry about the “balance of payments” between New York, New Jersey, and the other states. Furthermore, it should be clear that what the Friedmanites take away with one hand, so to speak, they give back with the other. For while they are staunchly opposed to tariff barriers between geographical areas, their freely fluctuating fiat currencies could and undoubtedly would operate as crypto-tariff barriers between these areas. During the fiat money Greenback period in the United States after the Civil War, the Pennsylvania iron manufacturers, who had always been the leading advocates of a protective tariff to exclude more efficient and lower cost British iron, now realized that depreciating greenbacks functioned

as a protective device: for a falling dollar makes imports more expensive and exports cheaper.¹ In the same way, during the international fiat money periods of the 1930s (and now from March 1973 on), the export interests of each country scrambled for currency devaluations, backed up by inefficient domestic firms trying to keep out foreign competitors. And similarly, a Friedmanite world within the United States would have the disastrous effect of functioning as competing and accelerating tariff barriers between the states. And if independent currencies between each of the fifty states is a good thing, why not go still one better? Why not independent currencies to be issued by each county, city, town, block, building, person? Friedmanite monetary theorist Leland B. Yeager, who is willing to push the *reductio ad absurdum* almost all the way by advocating separate moneys for each region or even locality, draws back finally at the idea of each individual or firm printing his own money. Why not? Because, Yeager concedes, “Beyond some admittedly indefinable point, the proliferation of separate currencies for ever smaller and more narrowly defined territories would begin to negate the very concept of money.”² That it would surely do, but the point is that the breakdown of the concept of money begins to occur not at some “indefinable point” but as soon as any national fiat paper enters the scene to break up the world’s money. For if Rothbard, Yeager, and Jones each printed his own “Rothbards,” “Yeagers,” and “Joneses” and these each among billions freely fluctuating on the market were the only currencies, it is clear that the world would be back in an enormously complex and chaotic form of barter and that all trade and investment would be reduced to a virtual standstill. There would in fact be no more money, for money means a general medium for all exchanges. As a result, there would be no money of account to perform the indispensable function of economic calculation in a money and price system. But the point is that while we can see this clearly in a world of “every man his own currency,” the same disastrous principle, the same breakdown of the money function, is at work in a world of fluctuating fiat currencies such as the Friedmanites are wishing upon us. The way to return to the advantages of a world money is the opposite of the Friedmanite path: it is to return to a commodity which the entire world can and does use as a money, which means in practice the commodity gold.

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There is another reason for avoiding fiat paper currency issued by all governments and for returning instead to a commodity money produced on the private market (for example, gold). For once a money is established, whatever supply of money exists does the full amount of the “monetary work” needed in the economy. Other things being equal, an increase in the supply of steel, or copper, or TV sets is a net benefit to society: it increases the production of goods and services to the consumers. But an increase in the supply of money does no such thing. Since the usefulness of money comes from exchanging it rather than consuming it or using it up in production, an increased supply will simply lower its purchasing power; it will dilute the effectiveness of any one unit of money. An increase in the supply of dollars will merely reduce the purchasing power of each dollar, that is, will cause what is now called “inflation.” If money is a scarce market commodity, such as gold, increasing its supply is a costly process and therefore the world will not be subjected to sudden inflationary additions to its supply. But fiat paper money is virtually costless: it costs nothing for the government to turn on the printing press and to add rapidly to the money supply and hence to ruinous inflation. Give government, as the Friedmanites would do, the total and absolute power over the supply of fiat paper and of bank deposits—the supply of money—and we put into the hands of government a standing and mighty temptation to use this power and inflate money and prices.

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Given the inherent tendency of government to inflate the money supply when it has the chance, the absence of a gold standard and “fixed exchange rates” also means the loss of balance-of-payments discipline, one of the few checks that governments have faced in their eternal propensity to inflate the money supply. In such a system, the outflow of gold abroad puts the monetary authorities on increased warning that they must stop inflating so as not to keep losing gold. Abandon a world money and adopt fluctuating fiat moneys, and the balance-of-payments limitation will be gone; governments will have only the depreciating of their currencies as a limit on their inflationary actions. But since export firms and inefficient domestic firms tend actually to favor depreciating currencies, this check is apt to be a flimsy one indeed.

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Money has to originate as a valuable nonmonetary commodity. In practice, precious metals such as gold or silver, metals in stable and high demand per unit weight, have won out over all other commodities as moneys. Hence, Mises’s regression theorem demonstrates that money must originate as a useful nonmonetary commodity on the free market.

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This brings up an important corollary. The United States, and other governments, have in effect nationalized gold. Even now, when private citizens are allowed to own gold, the great bulk of that metal continues to be sequestered in the vaults of the central banks.¹³ If the dollar is redefined in terms of gold, gold as well as the dollar can be jointly denationalized. But if the dollar is not defined as a weight of gold, then how can a denationalization of gold ever take place? Selling the gold stock would be unsatisfactory, since this (1) would imply that the government is entitled to the receipts from the sale and (2) would leave the dollar under the absolute fiat control of the government. It is important to realize what a definition of the dollar in terms of gold would entail. The definition must be real and effective rather than nominal. Thus, the U.S. statutes define the dollar as 1/42.22 gold ounce, but this definition is a mere formalistic accounting device. To be real, the definition of the dollar as a unit of weight of gold must imply that the dollar is interchangeable and therefore redeemable by its issuer in that weight, that the dollar is a demand claim for that weight in gold.

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The first thing to point out is that inflation is not ineluctably built into the economy, nor is it a prerequisite for a growing and thriving world. During most of the nineteenth century (apart from the years of the War of 1812 and the Civil War), prices were falling, and yet the economy was growing and industrializing. Falling prices put no damper whatsoever on business or economic prosperity. Thus,

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The favorite explanation of inflation is that greedy businessmen persist in putting up prices in order to increase their profits. But surely the quotient of business “greed” has not suddenly taken a great leap forward since World War II. Weren’t businesses equally “greedy” in the nineteenth century and up to 1941? So why was there no

inflation trend then? Moreover, if businessmen are so avaricious as to jack up prices 10 percent per year, why do they stop there? Why do they wait; why don't they raise prices by 50 percent, or double or triple them immediately? What holds them back? A similar flaw rebuts another favorite explanation of inflation: that unions insist on higher wage rates, which in turn leads businessmen to raise prices. Apart from the fact that inflation appeared as long ago as ancient Rome and long before unions arrived on the scene, and apart from the lack of evidence that union wages go up faster than nonunion or that prices of unionized products rise faster than of nonunionized, a similar question arises: Why don't businesses raise their prices anyway? What is it that permits them to raise prices by a certain amount, but not by more? If unions are that powerful, and businesses that responsive, why don't wages and prices rise by 50 percent, or 100 percent, per year? What holds them back?

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Furthermore, since the interest of a counterfeiter is to print as much money as he can get away with, so too will the State print as much money as it can get away with, just as it will employ the power to tax in the same way: to extract as much money as it can without raising too many howls of protest. Government control of money supply is inherently inflationary, then, for the same reason that any system in which a group of people obtains control over the printing of money is bound to be inflationary.

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Inflating by simply printing more money, however, is now considered old-fashioned. For one thing, it is too visible; with a lot of high-denomination bills floating around, the public might get the troublesome idea that the cause of the unwelcome inflation is the government's printing of all the bills—and the government might be stripped of that power. Instead, governments have come up with a much more complex and sophisticated, and much less visible, means of doing the same thing: of organizing increases in the money supply to give themselves more money to spend and to subsidize favored political groups. The idea was this: instead of stressing the printing of money, retain the paper dollars or marks or francs as the basic money (the "legal tender"), and then pyramid on top of that a mysterious and invisible, but no less potent, "checkbook money," or bank demand deposits. The result is an inflationary engine, controlled by government, which no one but bankers, economists, and government central bankers understands—and designedly so.

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First, it must be realized that the entire commercial banking system, in the United States or elsewhere, is under the total control of the central government—a control that the banks welcome, for it permits them to create money. The banks are under the complete control of the central bank—a government institution—a control stemming largely from the central bank's compulsory monopoly over the printing of money. In the United States, the Federal Reserve System performs this central banking function. The Federal Reserve ("the Fed") then permits the commercial banks to pyramid bank demand deposits ("checkbook money") on top of their own "reserves" (deposits at the Fed) by a multiple of approximately 6:1. In other words, if bank reserves at the Fed increase by \$1 billion, the banks can and do pyramid their deposits by \$6 billion—that is, the banks create \$6 billion worth of new money.

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amount of monetary inflation. The monetary history of this century has been one of repeated loosening of restraints on the State's propensity to inflate, the removal of one check after another until now the government is able to inflate the money supply, and therefore prices, at will. In 1913, the Federal Reserve System was created to enable this sophisticated pyramiding process to take place. The new system permitted a large expansion of the money supply, and of inflation to pay for war expenditures in World War I. In 1933, another fateful step was taken: the United States government took the country off the gold standard, that is, dollars, while still legally defined in terms of a weight of gold, were no longer redeemable in gold. In short, before 1933, there was an important shackle upon the Fed's ability to inflate and expand the money supply: Federal Reserve Notes themselves were payable in the equivalent weight of gold.

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There is, of course, a crucial difference between gold and Federal Reserve Notes. The government cannot create new gold at will. Gold has to be dug, in a costly process, out of the ground. But Federal Reserve Notes can be issued at will, at virtually zero cost in resources. In 1933, the United States government removed the gold restraint on its inflationary potential by shifting to fiat money: to making the paper dollar itself the standard of money, with government the monopoly supplier of dollars. It was going off the gold standard that paved the way for the mighty U.S. money and price inflation during and after World War II. But

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The business cycle arrived in the Western world in the latter part of the eighteenth century. It was a curious phenomenon, because there seemed to be no reason for it, and indeed it had not existed before. The business cycle consisted of a regularly recurring (though not strictly periodical) series of booms and busts, of inflationary periods marked by increased business activity, higher employment, and higher prices followed sharply by recessions or depressions marked by declining business activity, higher unemployment, and price declines; and then, after a term of such recession, recovery takes place and the boom phase begins again.

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A priori, there is no reason to expect this sort of cyclical pattern of economic activity. There will be cyclical waves in specific types of activity, of course; thus, the cycle of the seven-year locust will cause a seven-year cycle in locust-fighting activity, in the production of antilocust sprays and equipment, etc. But there is no reason to expect boom-bust cycles in the overall economy. In fact, there is reason to expect just the opposite; for usually the free market works smoothly and efficiently, and especially with no massive cluster of error such as becomes evident when boom turns suddenly to bust and severe losses are incurred. And indeed, before the late eighteenth century there were no such overall cycles. Generally, business went along smoothly and evenly until a sudden interruption occurred: a wheat famine would cause a collapse in an agricultural country; the king would seize most of the money in the hands of financiers, causing a sudden depression; a war would disrupt trading patterns. In each of these cases, there was a specific blow to trade brought about by an easily identifiable, one-shot cause, with no need to search further for explanation. So why the new phenomenon of the business cycle? It was seen that the cycle occurred in the most economically advanced areas of each country: in the port cities, in the areas

engaged in trade with the most advanced world centers of production and activity. Two different and vitally important phenomena began to emerge on a significant scale in Western Europe during this period, precisely in the most advanced centers of production and trade: industrialization and commercial banking. The commercial banking was the same sort of “fractional reserve” banking we have analyzed above, with London the site of the world’s first central bank, the Bank of England, which originated at the turn of the eighteenth century. By the nineteenth century, in the new discipline of economics and among financial writers and commentators, two types of theories began to emerge in an attempt to explain the new and unwelcome phenomenon: those focusing the blame on the existence of industry, and those centering upon the banking system. The former, in sum, saw the responsibility for the business cycle to lie deep within the free-market economy—and it was easy for such economists to call either for the abolition of the market (e.g., Karl Marx) or for its drastic control and regulation by the government in order to alleviate the cycle (e.g., Lord Keynes). On the other hand, those economists who saw the fault to lie in the fractional reserve banking system placed the blame outside the market economy and onto an area—money and banking—which even English classical liberalism had never taken away from tight government control. Even in the nineteenth century, then, blaming the banks meant essentially blaming government for the boom-bust cycle.

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The first economists to develop a cycle theory centering on the money and banking system were the early nineteenth-century English classical economist David Ricardo and his followers, who developed the “monetary theory” of the business cycle.³ The Ricardian theory went somewhat as follows: the fractional-reserve banks, spurred and controlled by the government and its central bank, expand credit. As credit is expanded and pyramided on top of paper money and gold, the money supply (in the form of bank deposits or, in that historical period, bank notes) expands. The expansion of the money supply raises prices and sets the inflationary boom into motion. As the boom continues, fueled by the pyramiding of bank notes and deposits on top of gold, domestic prices also increase. But this means that domestic prices will be higher, and still higher, than the prices of imported goods, so that imports will increase and exports to foreign lands will decline. A deficit in the balance of payments will emerge and widen, and it will have to be paid for by gold flowing out of the inflating country and into the hard-money countries. But as gold flows out, the expanding money and banking pyramid will become increasingly top-heavy, and the banks will find themselves in increasing danger of going bankrupt. Finally, the government and banks will have to stop their expansion, and, to save themselves, the banks will have to contract their bank loans and checkbook money.

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The sudden shift from bank credit expansion to contraction reverses the economic picture and bust quickly follows boom. The banks must pull in their horns, and businesses and economic activity suffer as the pressure mounts for debt repayment and contraction. The fall in the supply of money, in turn, leads to a general fall in prices (“deflation”). The recession or depression phase has arrived. However, as the money supply and prices fall, goods again become more competitive with foreign products and the balance of payments reverses itself, with a surplus replacing the deficit. Gold flows into the country, and, as bank notes and deposits contract on top of an expanding gold base, the condition of the banks becomes much sounder, and recovery gets under way.

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The Ricardian theory had several notable features: It accounted for the behavior of prices by focusing on changes in the supply of bank money (which indeed always increased in booms and declined in busts). It also accounted for the behavior of the balance of payments. And, moreover, it linked the boom and the bust, so that the bust was seen to be the consequence of the preceding boom. And not only the consequence, but the salutary means of adjusting the economy to the unwise intervention that created the inflationary boom. In short, for the first time, the bust was seen to be neither a visitation from hell nor a catastrophe generated by the inner workings of the industrialized market economy. The Ricardians realized that the major evil was the preceding inflationary boom caused by government intervention in the money and banking system, and that the recession, unwelcome though its symptoms may be, is really the necessary adjustment process by which that interventionary boom gets washed out of the economic system. The depression is the process by which the market economy adjusts, throws off the excesses and distortions of the inflationary boom, and reestablishes a sound economic condition. The depression is the unpleasant but necessary reaction to the distortions and excesses of the previous boom.

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The commercial banks live and profit by expanding credit and by creating a new money supply; so they are naturally inclined to do so, “to monetize credit,” if they can. The government also wishes to inflate, both to expand its own revenue (either by printing money or so that the banking system can finance government deficits) and to subsidize favored economic and political groups through a boom and cheap credit. So we know why the initial boom began. The government and the banks had to retreat when disaster threatened and the crisis point had arrived. But as gold flows into the country, the condition of the banks becomes sounder. And when the banks have pretty well recovered, they are then in the confident position to resume their natural tendency of inflating the supply of money and credit. And so the next boom proceeds on its way, sowing the seeds for the next inevitable bust.

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Thus, the Ricardian theory also explained the continuing recurrence of the business cycle. But two things it did not explain. First, and most important, it did not explain the massive cluster of error that businessmen are suddenly seen to have made when the crisis hits and bust follows boom. For businessmen are trained to be successful forecasters, and it is not like them to make a sudden cluster of grave error that forces them to experience widespread and severe losses. Second, another important feature of every business cycle has been the fact that both booms and busts have been much more severe in the “capital goods industries” (the industries making machines, equipment, plant or industrial raw materials) than in consumer goods industries. And the Ricardian theory had no way of explaining this feature of the cycle.

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Mises begins as did the Ricardians: government and its central bank stimulate bank credit expansion by purchasing assets and thereby increasing bank reserves. The banks proceed to expand credit and hence the nation’s money supply in the form of checking deposits (private bank notes having virtually disappeared). As with the Ricardians, Mises sees that this expansion of bank money drives up prices and causes inflation. But, as

Mises pointed out, the Ricardians understated the unfortunate consequences of bank credit inflation. For something even more sinister is at work. Bank credit expansion not only raises prices, it also artificially lowers the rate of interest, and thereby sends misleading signals to businessmen, causing them to make unsound and uneconomic investments.

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For, on the free and unhampered market, the interest rate on loans is determined solely by the “time preferences” of all the individuals that make up the market economy. For the essence of any loan is that a “present good” (money which can be used at present) is being exchanged for a “future good” (an IOU which can be used at some point in the future). Since people always prefer having money right now to the present prospect of getting the same amount of money at some point in the future, present goods always command a premium over future goods in the market. That premium, or “agio,” is the interest rate, and its height will vary according to the degree to which people prefer the present to the future, i.e., the degree of their time preferences. People’s time preferences also determine the extent to which people will save and invest for future use, as compared to how much they will consume now. If people’s time preferences should fall, i.e., if their degree of preference for present over future declines, then people will tend to consume less now and save and invest more; at the same time, and for the same reason, the rate of interest, the rate of time-discount, will also fall. Economic growth comes about largely as the result of falling rates of time preference, which bring about an increase in the proportion of saving and investment to consumption, as well as a falling rate of interest. But what happens when the rate of interest falls not because of voluntary lower time preferences and higher savings on the part of the public, but from government interference that promotes the expansion of bank credit and bank money? For the new checkbook money created in the course of bank loans to business will come onto the market as a supplier of loans, and will therefore, at least initially, lower the rate of interest. What happens, in other words, when the rate of interest falls artificially, due to intervention, rather than naturally, from changes in the valuations and preferences of the consuming public? What happens is trouble. For businessmen, seeing the rate of interest fall, will react as they always must to such a change of market signals: they will invest more in capital goods. Investments, particularly in lengthy and time-consuming projects, which previously looked unprofitable, now seem profitable because of the fall in the interest charge. In short, businessmen react as they would have if savings had genuinely increased: they move to invest those supposed savings. They expand their investment in durable equipment, in capital goods, in industrial raw material, and in construction, as compared with their direct production of consumer goods.

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Thus, businesses happily borrow the newly expanded bank money that is coming to them at cheaper rates; they use the money to invest in capital goods, and eventually this money gets paid out in higher wages to workers in the capital goods industries. The increased business demand bids up labor costs, but businesses think they will be able to pay these higher costs because they have been fooled by the government-and-bank intervention in the loan market and by its vitally important tampering with the interest-rate signal of the marketplace—the signal that determines how many resources will be devoted to the production of capital goods and how many to consumer goods.

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Problems surface when the workers begin to spend the new bank money that they have received in the form of higher wages. For the time preferences of the public have not really gotten lower; the public doesn't want to save more than it has. So the workers set about to consume most of their new income, in short, to reestablish their old consumer/saving proportions. This means that they now redirect spending in the economy back to the consumer goods industries, and that they don't save and invest enough to buy the newly produced machines, capital equipment, industrial raw materials, etc. This lack of enough saving-and-investment to buy all the new capital goods at expected and existing prices reveals itself as a sudden, sharp depression in the capital goods industries. For once the consumers reestablish their desired consumption/investment proportions, it is thus revealed that business had invested too much in capital goods (hence the term "monetary overinvestment theory"), and had also underinvested in consumer goods. Business had been seduced by the governmental tampering and artificial lowering of the rate of interest, and acted as if more savings were available to invest than were really there. As soon as the new bank money filtered through the system and the consumers reestablish their old time-preference proportions, it became clear that there were not enough savings to buy all the producers' goods, and that business had misinvested the limited savings available ("monetary malinvestment theory"). Business had overinvested in capital goods and underinvested in consumer goods.

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The inflationary boom thus leads to distortions of the pricing and production system. Prices of labor, raw materials, and machines in the capital goods industries are bid up too high during the boom to be profitable once the consumers are able to reassert their old consumption/investment preferences. The "depression" is thus seen—even more than in the Ricardian theory—as the necessary and healthy period in which the market economy sloughs off and liquidates the unsound, uneconomic investments of the boom, and reestablishes those proportions between consumption and investment that are truly desired by the consumers. The depression is the painful but necessary process by which the free market rids itself of the excesses and errors of the boom and reestablishes the market economy in its function of efficient service to the mass of consumers. Since the prices of factors of production (land, labor, machines, raw materials) have been bid too high in the capital goods industries during the boom, this means that these prices must be allowed to fall in the recession until proper market proportions of prices and production are restored.

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Put another way, the inflationary boom will not only increase prices in general, it will also distort relative prices, will distort relations of one type of price to another. In brief, inflationary credit expansion will raise all prices; but prices and wages in the capital goods industries will go up faster than the prices of consumer goods industries. In short, the boom will be more intense in the capital goods than in the consumer goods industries. On the other hand, the essence of the depression adjustment period will be to lower prices and wages in the capital goods industries relative to consumer goods, in order to induce resources to move back from the swollen capital goods to the deprived consumer goods industries. All prices will fall because of the contraction of bank credit, but prices and wages in capital goods will fall more sharply than in consumer goods. In short, both the boom and the bust will be more intense in the capital than in the consumer goods industries. Hence, we have explained the greater intensity of business cycles in the former type of industry. There

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As soon as credit expansion stops, the piper must be paid, and the inevitable readjustments must liquidate the unsound overinvestments of the boom and redirect the economy more toward consumer goods production. And, of course, the longer the boom is kept going, the greater the malinvestments that must be liquidated, and the more harrowing the readjustments that must be made.

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What of the Austrian explanation—the only preferred explanation—of stagflation? How is it that, in recent recessions, prices continue to go up? We must amend this first by pointing out that it is particularly consumer goods prices that continue to rise during recessions, and that confound the public by giving them the worst of both worlds at the same time: high unemployment and increases in the cost of living. Thus, during the most recent 1974–1976 depression, consumer goods prices rose rapidly, but wholesale prices remained level, while industrial raw material prices fell rapidly and substantially. So how is it that the cost of living continues to rise in current recessions?

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The Austrian point is that this scenario in relative prices in boom and bust is still taking place unchanged. During the booms, capital goods prices still rise and consumer goods prices still fall relative to each other, and vice versa during the recession. The difference is that a new monetary world has arrived, as we have indicated earlier in this chapter. For now that the gold standard has been eliminated, the Fed can and does increase the money supply all the time, whether it be boom or recession. There hasn't been a contraction of the money supply since the early 1930s, and there is not likely to be another in the foreseeable future. So now that the money supply always increases, prices in general are always going up, sometimes more slowly, sometimes more rapidly.

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In short, in the classic recession, consumer goods prices were always going up relative to capital goods. Thus, if consumer goods prices fell by 10 percent in a particular recession, and capital goods prices fell by 30 percent, consumer prices were rising substantially in relative terms. But, from the point of view of the consumer, the fall in the cost of living was highly welcome, and indeed was the blessed sugarcoating on the pill of recession or depression. Even in the Great Depression of the 1930s, with very high rates of unemployment, the 75–80 percent of the labor force still employed enjoyed bargain prices for their consumer goods.

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But now, with Keynesian fine-tuning at work, the sugarcoating has been removed from the pill. Now that the supply of money—and hence general prices—is never allowed to fall, the rise in relative consumer goods prices during a recession will hit the consumer as a visible rise in nominal prices as well. His cost of living now goes up in a depression, and so he reaps the worst of both worlds; in the classical business cycle, before the rule of Keynes and the Council of Economic Advisors, he at least had to suffer only one calamity at a time.

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They are the precise opposite from those of the Keynesian establishment. For, since the virus of distortion of production and prices stems from inflationary bank credit expansion, the Austrian prescription for the business cycle will be: First, if we are in a boom period, the government and its banks must cease inflating immediately. It is true that this cessation of artificial stimulant will inevitably bring the inflationary boom to an end, and will inaugurate the inevitable recession or depression. But the longer the government delays this process, the harsher the necessary readjustments will have to be. For the sooner the depression readjustment is gotten over with, the better. This also means that the government must never try to delay the depression process; the depression must be allowed to work itself out as quickly as possible, so that real recovery can begin. This means, too, that the government must particularly avoid any of the interventions so dear to Keynesian hearts. It must never try to prop up unsound business situations; it must never bail out or lend money to business firms in trouble. For doing so will simply prolong the agony and convert a sharp and quick depression phase into a lingering and chronic disease. The government must never try to prop up wage rates or prices, especially in the capital goods industries; doing so will prolong and delay indefinitely the completion of the depression adjustment process. It will also cause indefinite and prolonged depression and mass unemployment in the vital capital goods industries. The government must not try to inflate again in order to get out of the depression. For even if this reflation succeeds (which is by no means assured), it will only sow greater trouble and more prolonged and renewed depression later on. The government must do nothing to encourage consumption, and it must not increase its own expenditures, for this will further increase the social consumption/investment ratio—when the only thing that could speed up the adjustment process is to lower the consumption/savings ratio so that more of the currently unsound investments will become validated and become economic. The only way the government can aid in this process is to lower its own budget, which will increase the ratio of investment to consumption in the economy (since government spending may be regarded as consumption spending for bureaucrats and politicians).

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The traditional socialist answer held that the socialist society would transform human nature, would purge it of selfishness, and remold it to create a New Socialist Man. That new man would be devoid of any selfish, or indeed any self-determined, goals; his only wish would be to work as hard and as eagerly as possible to achieve the goals and obey the orders of the socialist State. Throughout the history of socialism, socialist ultras, such as the early Lenin and Bukharin under “War Communism,” and later Mao Tse-tung and Che Guevara, have sought to replace material by so-called “moral” incentives. This notion was properly and wittily ridiculed by Alexander Gray as “the idea that the world may find its driving force in a Birthday Honours List (giving to the King, if necessary, 165 birthdays a year).”² At any rate, the socialists soon found that voluntary methods could hardly yield them the New Socialist Man. But even the most determined and bloodthirsty methods could not avail to create this robotic New Socialist Man. And it is a testament to the spirit of freedom that cannot be extinguished in the human breast that the socialists continued to fail dismally, despite decades of systemic terror. But

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Economists were convinced of the Lange solution because they had already come under the sway of the Walrasian general equilibrium model; Schumpeter, for example, was an ardent Walrasian. In this model, the economy is always in static general equilibrium, a changeless world in which all “data”—tastes or value scales,

alternative technologies, and lists of resources—are known to everyone, and where costs are known and always equal to price. The Walrasian world is also one of “perfect” competition, where prices are given to all managers. Indeed, both Taylor and Lange make the point that the Socialist Planning Board will be better able to calculate than capitalist markets, since the socialist planners can ensure “perfect competition,” whereas the real world of capitalism is shot through with various sorts of “monopolies”! The socialist planners can act like the absurdly fictional Walrasian “auctioneer,” bringing about equilibrium rapidly by trial and error.

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Set aside the obvious absurdity of trusting a coercive governmental monopoly to act somehow as if it were in “perfect competition” with parts of itself. Another grievous flaw in the Lange model is thinking that general equilibrium, a world of certainty where there is no room for the driving force of entrepreneurship, can somehow be used to depict the real world. The actual world is one not of changeless “givens” but of incessant change and systemic uncertainty. Because of this uncertainty, the capitalist entrepreneur, who stakes assets and resources in attempting to achieve profits and avoid losses, becomes the crucial actor in the economic system, an actor who can in no way be portrayed by a world of general equilibrium. Furthermore, it is ludicrous, as Hayek pointed out, to think of general equilibrium as the only legitimate “theory,” with all other areas or problems dismissed as mere matters of practicality and degree. No economic theory worth its salt can be worthwhile if it omits the role of the entrepreneur in an uncertain world. The Pareto-Barone-Lange, etc. “equations” is not simply excellent theory that faces problems in practice; for in order to be “good,” a theory must be useful in explaining real life.⁸

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Another grave flaw in the Lange-Taylor trial-and-error approach is that it concentrates on consumer good pricing. It is true that retailers, given the stock of a certain type of good, can clear the market by adjusting the prices of that good upward or downward. But, as Mises pointed out in his original 1920 article, consumer goods are not the real problem. Consumers, these “market socialists” are postulating, are free to express their values by using money they had earned on a range of consumers’ goods. Even the labor market—at least in principle⁹—can be treated as a market with self-owning suppliers who are free to accept or reject bids for their labor and to move to different occupations. The real problem, as Mises has insisted from the beginning, is in all the intermediate markets for land and capital goods. Producers have to use land and capital resources to decide what the stocks of the various consumer goods should be. Here there are a huge number of markets where the State monopoly can only be both buyer and seller for each transaction, and these intra-monopoly, intra-state transactions permeate the most vital markets of an advanced economy—the complex lattice-work of the capital markets. And here is precisely where calculational chaos necessarily reigns, and there is no way for rationality to intrude on the immense number of decisions on the allocation of prices and factors of production in the structure of capital goods.

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Mises began his rebuttal in *Human Action* by discussing the “trial-and-error” method, and pointing out that this process only works in the capitalist market. There the entrepreneurs are strongly motivated to make greater profits and to avoid losses, and further, such a criterion does not apply to the capital goods or land market under socialism where all resources are controlled by one entity, the government. Continuing his reply, Mises pressed

on to a brilliant critique, not only of socialism, but of the entire Walrasian general equilibrium model. The major fallacy of the “market socialists,” Mises pointed out, is that they look at the economic problem from the point of view of the manager of the individual firm, who seeks to make profits or avoid losses within a rigid framework of a given, external allocation of capital to each of the various branches of industry and indeed to the firm itself. In other words, the “market socialist” manager is akin, not to the real driving force of the capitalist market, the capitalist entrepreneur, but rather to the relatively economically insignificant manager of the corporate firm under capitalism. As Mises brilliantly puts it:

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Mises goes on to remind the reader that the corporate manager performs only a “managerial function,” a subsidiary service that “can never become a substitute for the entrepreneurial function.” Who are the capitalist-entrepreneurs? They are “the speculators, promoters, investors and moneylenders, [who] in determining the structure of the stock and commodity exchanges and of the money market, circumscribe the orbit within which definite tasks can be entrusted to the manager’s discretion.” The crucial question, Mises continues, is not managerial activities, but: “In which branches should production be increased or restricted, in which branches should the objective of production be altered, what new branches should be inaugurated?” In short, the crucial decisions in the capitalist economy are the allocation of capital to firms and industries. With regard to these issues,” Mises adds,

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Mises has been cited as stating, in *Human Action*, that it is absurd for the socialist planning board to tell their managers to “play market,” to act as if they are owners of their firms in trying to maximize profits and avoid losses. But it is important to stress that Mises was focusing, not so much on the individual managers of socialist “firms,” but on the speculators and investors who decide the crucial allocations of capital throughout the structure of industry. It is at least conceivable that one can order a manager to play market and act as if he were enjoying the profits and suffering losses; but it is clearly ludicrous to ask investors and capital speculators to act as if their fortunes were at stake.

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In his negative review of Mises’s *Socialism*, Frank Knight, after hailing Lange’s “excellent” 1936 article, brusquely dismisses the socialist calculation debate as “largely sound and fury.” To Knight, it is simply “truistical” that the “technical basis of economic life” would continue as before under socialism, and that therefore “the managers of various technical units in production—farms, factories, railways, stores, etc.—would carry on in essentially the same way.” Note, there is no reference whatever to the crucial capital market, or to the allocation of capital to various branches of production. If capital is an automatically renewing homogeneous blob, all one need worry about is growth in the amount of that blob. Hence, Knight concludes that “socialism is a political problem, to be discussed in terms of social and political psychology, and economic theory has relatively little to say about it.”¹⁷ Certainly, that is true of Knight’s orthodox-Chicagoite brand of economic theory!

It did not take long for Oskar Lange to adjust to the persistence of the Stalinist Model. Indeed, it turns out that Lange, in post-war Poland, argued strongly for the historical necessity of the persistence of the Stalinist model as opposed to his own market socialism. Arguing against his own quasi-decentralized solution, Lange, in 1958, revealed that “in Poland, we had some discussions whether such a period of highly centralized planning and management was historical necessity or a great political mistake. Personally, I hold the view that it was a historical necessity.”
