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Subjective Value Theory and Government Intervention in the Labor Market

by Don Bellante

Whatever the costs to society associated with the massive federal government deficits of the 1980s, they have brought a minor benefit. It is probably true that the presence of those deficits has slightly moderated the tendency of public office holders and seekers to propose massive new spending programs. In the recent federal election, both major parties proposed a variety of new spending programs, but their approach was more incremental than grand. We should have no illusion that the share of government spending will as a result shrink or even remain stable as a percentage of total G.N.P. At best, we may for the time being return to the "creeping socialism" of earlier decades, rather than a rebirth of massive social engineering projects of the "Great Society" type. Of course, the basic incentives of office seekers have not changed: spending programs buy votes, explicit tax increases cost votes. Before indexation of tax brackets economic growth, and even more so inflation, brought enormous revenue growth to the federal government without Congress having to explicitly raise tax rates. Even with indexation, recent economic growth has increased tax revenues by substantial amounts: about \$60 billion annually during the 1980s and a projected \$74 billion annually over the next five years.¹ Given the tendency of the Federal Government to spend an additional \$1.58 for every \$1 it receives in additional taxes,² the best that can be hoped for is moderation in the tendencies of Congress and the Administration toward social engineering with tax dollars.

We should therefore expect the unchanged incentives of politicians to manifest themselves in an increased tendency to seek votes through additional regulations and the mandating of benefits to voting blocks where the costs of these programs are borne directly by the private sector. The "taxes" to pay for these programs are very real, but are largely in the form of higher costs of production passed on to consumers, losses of job opportunities to the working public, and reduced economic growth. We have already seen some of this redirection of governmental effort in proposed or passed legislation in the form of plant closing laws, compulsory provision for maternal leave and for



Professor Don Bellante

child care, etc. In short, we may experience the death and reversal of the deregulation movement, tentative as it was. Yet the reasoning behind the mandating of benefits is badly flawed. Such reasoning is most basically flawed in its failure to recognize the subjective nature of value and its implications for the functioning of labor markets in a free society. Free market economists of all schools can recognize some of the fallacy in the welfare state mentality, but the subjective value theory of Austrian economics best highlights the broadest consequences of such misconceptions.

The Austrian approach is most distinct from mainstream economics in its thorough emphasis on the individual decision maker as the focus of scientific

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analysis. Yet with the values and motives of individuals being entirely subjective it is impossible for an analyst to pass judgment on the optimality of the individual's chosen actions. Nonetheless, it is possible to evaluate social institutions, including labor market policies, in terms of whether they facilitate or impede the process of economic coordination of the actions of economic agents, and the process of discovery. Austrian economists view competition as a process that brings forth the discovery of potential gains from trade. The alertness of the entrepreneur (the catalyst in the discovery process) to previously unexploited opportunities to achieve pure economic profits is the essence of the process of value creation. It is the entrepreneur who in a free enterprise system provides, through his actions, the coordination of individual plans. In no society can individual plans be perfectly coordinated, but the entrepreneur's role is to move markets, including labor markets, in the direction of perfect coordination. Criticism of labor market intervention should be based on a conceptual framework of labor markets that recognizes the heterogeneity of worker tastes, propensities and circumstances. That conceptual framework should also recognize that the labor market does not generate a single price of labor consisting of a monetary compensation in the form of wages and fringe benefit package but rather, a vector of prices in which each element in that vector is a market generated price for a job-associated characteristic. These characteristics include not only effort supplied but also such things as income variability, physical risk exposure, advancement opportunity (including the provision of on-the-job training), status, etc., in short everything associated with the job that affects the worker's utility.³ The market price of each characteristic is an "adjustment" to the wage rate paid for a specific job. Each job thus presents the worker with a given combination of wage and other variables, but the quantities of these job-associated variables in any one job situation, though given, are not fixed. An employer chooses the quantities of each variable to combine with the wage rate. The law of diminishing returns applies to the provision of each of these variables. For example, the safety aspects of any job environment can be improved, but at increasing cost per percentage point reduction in the probability of incurring a serious accident, although the exact shape and position of the relevant cost curves may vary immensely across employers.

The employer is thus operating on a number of margins. Given the heterogeneity of worker tastes and propensities, the package of pay and other variables offered by the firm will over time tend to attract those employees for whom the package is most advantageous. In the context of heterogeneous worker tastes and employer cost curves, a process of sorting and matching takes place. For example, the employer who offers little or nothing in the way of health insurance but is rather liberal in the use of sick leave in the event of illness of other family members will be more attractive to some married women, for whom health insurance would be totally redundant given family coverage provided to their husbands. The optimality of the package offered by a firm cannot readily be determined by

an objective observer simply by noting its effects on the firm's costs, but the success of an entrepreneur in capturing labor market gains from trade depends on his actions over the range of margins of adjustment available to him. While the subjectivity of workers' valuations of job characteristics may prevent the scientific observer from making valid judgments about the optimality of any package, that observer must conclude that the potential for individual and thus social welfare optimization is greatest when the range of options open to workers is greatest, and when the flexibility of employers to adjust at the margin is greatest. Changes in institutional constraints (such as an increase in the

The alertness of the entrepreneur to previously unexploited opportunities is the essence of the process of value creation.

minimum wage, newly mandated employee benefits, etc.), while disturbing this package, can be adjusted along any number of available margins. But the range and diversity of options available to workers is reduced, and so then are their individual prospects for welfare maximization. In short, the labor market will provide greater welfare if employers do *not* all provide the same health care benefits, the same provisions for parental leave, the same risk of an accident, etc. Moreover, since employers have many margins on which to operate, the cost of any mandated benefit will ultimately be shifted to employees, but not necessarily or even primarily in the form of reduced wage growth. And when the shifting is complete, social welfare is not unchanged but reduced.

These considerations apply to a number of examples of labor market interventions by the government. One such example is minimum wage legislation. The mainstream literature contains a very large number of studies of the consequence of minimum wage legislation. That the resulting loss of employment is substantial and concentrated among teenagers, particularly minority teenagers, is well known. Unfortunately, employment loss is the only cost that is investigated in these studies, and other aspects of minimum wage legislation have largely been ignored. Such studies must seriously understate the costs of minimum wage legislation because they do not take into account the availability of margins of adjustment other than employment. The usual conclusion is that the gains of those who retain their jobs come at the expense of those who lose their jobs, but in reality the apparent gainers may not gain. If employers have other adjustments available, such as fringe benefits, then the job retainers will not gain. The marginal costs of job-associated non-wage variables will change, and the altered configuration of these variables may be optimized over time, but this optimization will be subject to the additional

constraint of the minimum wage and will be second best to a less constrained optimum. Moreover, it is likely that on-the-job training provision will be one of the more important margins of adjustment, so that present gains of job retainers come at the expense of their own future income.

Economists who assume away problems of information are likely to understate the costs to those who lose potential employment. A knowledge of the types of individuals who obtain minimum and near-minimum wage jobs would foster the realization that, in a sense, all of these low wage jobs provide a valuable type of on-the-job training or apprenticeship for dropouts and marginal high school graduates, even where training as it is conventionally defined is not provided. Such jobs provide an opportunity to learn, and more importantly, demonstrate the discipline and work habits that are required in advanced industrial societies. Such demonstration is necessary for advancement into the high-

Unemployment is very unevenly felt across industries, but the payroll tax to support unemployment compensation is imposed quite uniformly across all industries.

paying, high-skill blue collar jobs that are eventually available to (and almost entirely filled by) persons of little formal education. Since in the real world of imperfect information this loss of opportunity is felt disproportionately by the socioeconomic groups seen to be disadvantaged, access to middle-class status is made most difficult for the people the social engineers would presumably most like to help.

The rationales for most types of labor market interventions, not just minimum wage legislation, are based on overly simplified ideas about how labor markets function, ideas that understate the role of implicit markets for job characteristics and ignore the subjective nature of the choice process. For another example, consider the entrepreneur in a highly seasonal industry who can devise ways to provide greater employment stability to his work force. He may find that he can obtain the same quality of work force at a lower wage bill if significant numbers of individuals value that stability more than the difference in wages. Workers whose subjective evaluation of stability and wage income are such that they do not find the tradeoff attractive will, in a world of diversity and free choice, gravitate to other employment situations. The employer who on the other hand provides jobs, such as in high rise construction, where the cost of providing an average level of job safety is very high, will find that he must offer a significant wage premium. Again, the attractiveness of the total wage is a matter of subjective evaluation, and it is through experimentation and discovery that this premium evolves, with workers effecting their evaluations through their choices of

occupation, industry and employer. Thus unemployment insurance and the regulation of job safety become two readily apparent policies in need of examination.

The incidence of unemployment is very uneven across industries, but the payroll tax to support the unemployment compensation is imposed much more uniformly across industries. Such insurance reduces the size of the premium that must be paid to attract workers into jobs that are seasonal in nature or particularly sensitive to the business cycle. The tax affects not only the overall level of wages and employment, but also the structure of relative wages across occupations and industries and does so in a way that distorts the processes that maximize individual well being through subjectively based choices. This observation is ironic, as government interference is often justified as a cure for a supposed market failure. But the cross-employer subsidization induced by the unemployment compensation program reduces the relative prices of goods produced in industries with unstable and seasonal demand, providing a clear example of how government intervention creates a market failure where none would have existed.

The federal government has in recent years tried to affect the safety of the work place through direct regulation, most particularly with the Occupational Safety and Health Act of 1970. The Act imposes about 4000 uniform rules or standards. The rationale for such legislation ignores the fact that profit motives of employers, in light of their heavy investment in their workers, provide substantial incentive to search for socially optimal safety conditions, and the fact that market processes produce compensating wage differentials across work environments to account for differences in the costs of providing safety.

Empirical work in the years following passage of the Act fails to show any increase in work place safety. For economists not inclined to view the entrepreneur as in the best position to recognize the opportunities for and costs of job safety peculiar to his own circumstances, there is a ready explanation (in terms of administrative and adjustment lags) for the lack of improvement in safety in the several years following passage. But a fuller recognition of the role of the entrepreneur as the agent of change in the discovery process should lead us to expect that the Act's effect on work place safety will in the long run be not neutral but detrimental. The phenomenon of work place safety, like all other aspects of production, is subject to a process of technological change and improvement that can be frustrated by the bureaucratic imposition of rules that tend to freeze the technology of safety and reduce the incentive for entrepreneurial alertness to and discovery of new safety possibilities. The Act specifies many rules that take into account the best technologies available at the time, but which were obsolete by the time the Act took effect. While the rules can be and have been revised, the motives for their change are less related to the incentives for safety provision and more related to the sometimes perverse incentives that are entailed in the substitution of bureaucracy for market mechanisms.

In summary, conventional economic analysis has pointed to some of the failings of welfare state interventions into the labor market. However, the perspective on market processes that is characteristic of the Austrian approach provides a great deal more insights about the consequences and basic fallacies of labor market regulations of the sort examined here. Minimum wage legislation, unemployment compensation, and safety regulation are but examples of policies that are based on a faulty conception of how labor markets work. Other examples are available, but none of these is so much in conflict with subjective value theory as the bureaucratic imposition of "comparable worth."⁴ In general, the negative impact of federally mandated fringe benefits and other welfare state policies will always be less than fully appreciated in the absence of a recognition of the subjective nature of the heterogeneous preferences of workers, and of the ability of a free labor market to generate a range of job opportunities that allows workers to sort themselves out in such a way as to maximize individual welfare.

Notes

1. Daniel J. Mitchell, *Tax Increases or Spending Restraint: A Citizen's Guide to Deficit Reduction* (Washington, D.C.: Citizens for a Sound Economy Foundation, 1989).

2. Richard Vedder, Lowell Gallaway, and Christopher Frenze, "Federal Tax Increases and the Budget Deficit, 1947-1986: Some Empirical Evidence," Report to the Republican Members of the Joint Economic Committee, 1987.

3. The "characteristics" approach suggested here is closely related to Kevin Lancaster's treatment of product demand in "A New Approach to Consumer Demand Theory," *Journal of Political Economy*, 74 (April 1966): 132-57. In the mainstream literature, one can find several partial applications to the labor market: on the employer side, Richard Thayer

and Sherwin Rosen, "The Value of Saving a Life: Evidence from the Labor Market," in N. Terleckyi, ed., *Household Production and Consumption* (N.B.E.R.: 1975) pp. 265-98, and on the employee side, Don Bellante and Albert Link, "Worker Response to a Menu of Implicit Contracts," *Industrial and Labor Relations Review*, 35 (July 1982) pp. 590-99. However, the Thayer-Rosen theoretical construct contains no elements of subjective value, and most applications of it including the one contained in the Thayer-Rosen article, have been clearly inconsistent with subjective value theory.

4. An excellent subjectivist critique of comparable worth is Deborah Walker, *Value and Opportunity: Comparable Pay for Comparable Worth* (College Station, Texas: Center for Education and Research in Free Enterprise, 1988). ■

What Does the ECU Portend?

by Leland B. Yeager

Probably not by coincidence, the acronym for the European Currency Unit is also the name (derived from Latin *scutum*, shield) of an old French dollar-sized silver coin. The modern ecu, launched in 1979, is defined as a basket of specified amounts of ten currencies (those of Germany, France, the U.K., the Netherlands, Italy, Belgium, Denmark, Greece, Ireland, and Luxembourg). The ecu serves as a reference point in setting the parities of the eight of those currencies that participate in the European Monetary System's scheme of near-stabilization of exchange rates. The European Monetary Cooperation Fund (EMCF), administered by the Bank for International Settlements, keeps its books in ecus, issues ecu deposits to the member central banks in exchange for 20 percent of their gold holdings and gross dollar holdings, carries out operations connected with interest payments on official debts and claims denominated in ecus, and effects transfers of ecu balances among central banks.

In being an accounting unit defined by a basket of currencies and in being used for certain transactions among central banks, the ecu closely resembles the SDR (Special Drawing Right) issued by the International Monetary Fund, just as the EMCF resembles the IMF. The resemblance is even closer to the SDR as it was intended to function in the Bretton Woods system if that system of worldwide exchange-rate pegging had not collapsed in 1971-73. The European Monetary System is a European miniature of the Bretton Woods system. As such, it shares some of the latter's defects, including vulnerability to occasional waves of one-way-option speculation touched off by expectations of adjustments in the fixed exchange rates. The European system exhibits somewhat less instability than its defunct worldwide counterpart, thanks, probably, to less diversity among its members and their lesser reluctance to keep their monetary policies in rough conformity with the requirements of exchange-rate pegging.

Like the SDR, the ecu does not exist in banknote form and rarely serves as a medium of exchange in private transactions. However, some official and private bonds and loans have been denominated in both of those basket currencies (although payments and

Contributors to this Issue

Don Bellante is professor of economics and department head at the University of South Florida.

Samuel Bostaph is professor of economics and department head at the University of Dallas.

Roy E. Cordato is an economist at the Institute for the Research of the Economics of Taxation.

David Gordon is a senior fellow at the Mises Institute.

Peter G. Klein is a Mises Institute graduate student at the University of California, Berkeley.

Amy Marie Marshall is a Mises Institute graduate student at the University of Nevada, Las Vegas.

George Selgin is associate professor of economics at the University of Georgia.

Jeffrey A. Tucker is the managing editor of the *Free Market* and a Mises Institute graduate student at George Mason University.

Leland B. Yeager is holder of the Ludwig von Mises chair at Auburn University.

repayments take place in equivalent amounts of national currencies). The ecu has won more private market acceptance than the SDR. One apparent reason is that the ecu is a better alternative to or hedge against the U.S. dollar, since the dollar remains outside the ecu basket but is the largest component of the SDR basket. Germany dropped its ban on ecu-denominated deposits in 1987. Some private banks have formed the ECU Banking Association, whose clearing and settlement system is administered by the Bank for International Settlements. In collaboration with American Express, a group of European banks has offered ecu-denominated travelers' checks. Still, the current fashion for privately issued ecu bonds and bills could fade as the scheduled dismantling of exchange controls in Europe deprives the ecu of its appeal as a device for circumventing the controls (on this last point, see *The Economist*, 10 December 1988, p. 85).

Should readers of the *Austrian Economic Newsletter* welcome the ecu? One fact recommending scarcely more enthusiasm for it than for the SDR is its role as an instrument of price-fixing, that is, as the centerpiece of a miniature Bretton Woods system of pegging exchange rates among what are still distinct national fiat currencies. Full-fledged monetary unification is quite a different animal from exchange-rate pegging, however; and conceivably the ecu is a first step toward a single currency, issued by a single central bank, for most of Western Europe. How one views that prospect depends on what policies one expects such a central bank to pursue under the political pressures inevitably operating on it. How attractive that prospect of a new monetary bureaucracy is depends, more fundamentally, on one's assessment of fiat currency itself, whether managed by one or by several government authorities in the territories concerned. One ground for optimism is that general economic integration, including monetary integration, is probably more feasible on a laissez-faire basis than on the basis of detailed coordination of national controls.

Even short of monetary unification, the abolition of all controls on borrowing and lending, bank accounts, and payments in ecus would give private parties one more alternative to the use of their respective national currencies; and this additional alternative might help restrain governmental monetary irresponsibility. Abolition of the controls would be the main source of wider options for private parties, however; and adding a contrived unit like the ecu to the national currencies already available would not greatly expand private options.

The ecu does not, after all, represent a fundamental reform. Like the SDR, it is merely a basket of national currencies, each of which continues suffering erosion of its purchasing power for reasons amply illustrated in the entire history of fiat money. In contrast with the "eurostable" proposed by Jacques Riboud (1975, 1977), the ecu is not a stable unit.

Riboud's eurostable would also be a basket of national currencies, but—and this is the essential difference—the number of units of each national currency included in the basket would be periodically adjusted up (or down) in proportion to a price index of the



Dr. Karl Socher, from the University of Innsbruck, spoke recently to the Austrian Economics Colloquium at Auburn University on the integration of the economic community. He is pictured here with Professor Leland Yeager.

country issuing it. The eurostable would thus have a stable average purchasing power over the goods and services whose prices entered into calculating the national price indexes employed in adjusting the basket's composition. The eurostable would provide private transactors a meaningful alternative to national currencies as they exist today, and its attractiveness might induce a high degree of international monetary integration on a voluntary basis.

The idea underlying the eurostable can, however, be implemented in a simpler way. Instead of being defined by amounts of national currencies periodically adjusted in view of several national price indexes, a stable unit might be defined *directly* by a basket of goods and services of the kinds and in the physical amounts appropriate for calculating an international wholesale or cost-of-living index.

The issue of money denominated in this new stable unit would not necessarily be entrusted either to national governments or to a supranational agency. Issues of notes and deposits denominated in the new unit might be left to competing private enterprises. Taking the money issue out of the hands of governments and subjecting it to the discipline of competition would end the abuses so long associated with monopolistic control over money. F. A. Hayek (1978 and other publications) has envisaged free banking along lines like these, and the literature on such possibilities keeps growing.

The ECU as it exists today is a minor step indeed toward stable money and economic integration. It might possibly evolve along healthy lines, or it might evolve into the tool of an ambitious international bureaucracy.

What attitude should supporters of sound money and liberalized international trade and finance adopt? Should we divert our intellectual energies and whatever political influence a minority of us may have into promoting a monetary innovation as timid yet possibly ominous as the ecu? Let us work, rather, to cultivate ideas and win public attention for more fundamental reform in the direction of laissez faire.

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The Implications of Free Banking and Note Issue: Answers to Some Questions

by George A. Selgin

(This is the conclusion of an article based on a lecture given at the Mises Institute's Austrian Economics Colloquium at Auburn University.)

1. If free banking can work, why did it fail when it was actually tried?

The answer to this is in two parts. First, where it was actually tried, free banking didn't fail. One example that is well known is Scotland, which had free banking prior to 1845. Lawrence White's book, *Free Banking in Britain* (Cambridge: Cambridge University Press, 1984) shows, among other things, that the Scottish system was widely regarded by contemporaries to be a very good banking system—and much better than its next-door neighbor.

Canada's banking system in the nineteenth century was also relatively free from legal restrictions, including restrictions on note issue. Most authorities agree that it also was a very good banking system. Reformers in the United States, trying to find a cure for their monetary and banking ills in the nineteenth century, cast admiring glances across the border to Canada, hoping to discover a solution. They managed to recognize the virtues of branch banking—a crucial part of a well-working free banking system which the U.S. was unfortunately politically unable to institute. But apart from that they came away empty handed, because they could not find any of the government regulations which they assumed had to be responsible for Canada's success!

Probably the best banking system in the U.S. before the Civil War was the Suffolk System in New England. It was more free than regulated, although it was handicapped by its lack of branch banking. The Suffolk Bank made up for that defect ingeniously with its arrangement for note redemption. Historians are generally misled by this experience into thinking that what was involved here was a "free market central bank." However, the Suffolk did not possess any of the dangerous privileges and powers that all true central banks enjoy: it could not create reserves from its printing press; it could only restrain rival banks by forcing them actively to redeem their notes. At the same time other banks restrained the Suffolk, by presenting its notes to it to replenish their clearing accounts. In every crucial respect, the Suffolk system

exemplified the workings of a free-banking arrangement. It was not an example of the virtues of central banking or of monopolized currency supply.

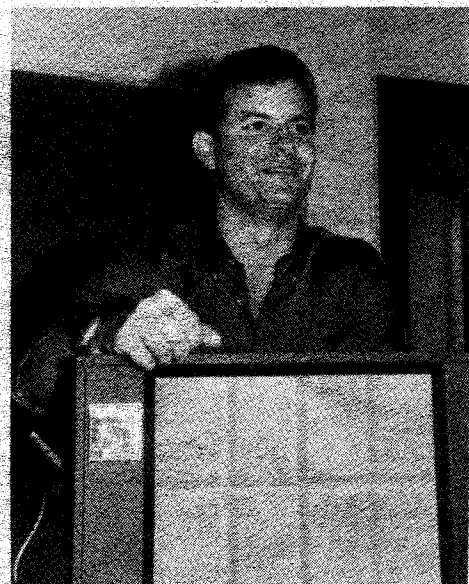
Sweden was another place where notes were issued competitively throughout the nineteenth century, and its monetary and financial system is also acknowledged to have been relatively advanced. It was not an entirely free system, as the government-run Riksbank competed against the private banks, and enjoyed special privileges compared to them.

In China free banking was the norm in many provinces throughout the late Ming and Ch'ing dynasties. I have studied one particular episode, in Fuzhou. It may have been the least regulated banking system ever. Yet its performance, according to numerous, contemporary observers, was admirable—better than anything the Chinese government managed to achieve in the way of currency reform either before or since. Other places whose free-banking experiences still need to be looked into include Switzerland and New Zealand. Italy, Chile, and Ireland had narrow brushes with free banking, and something about it can probably be learned from their experiences, also.

Second, in some places where free banking is alleged to have been tried, it was not. The outstanding example of this is the so-called "free banking era" in the U.S. between 1837 and 1864. During this time "free banking" laws were adopted in many states to do away with earlier arrangements where banks could only get started with special, limited charters from the state legislatures.

The first thing to note about true free banking is that it doesn't require any special law or legislation; it is what happens spontaneously when money and banks are allowed to evolve free of legislative interference. So when one hears about "free banking laws," one ought to be a little wary. One should not assume that the laws involve a complete stripping away of government interference. Yet that is what many people think happened in the U.S. during so-called free banking era. It accounts for the fact that the worst excesses of banking during that time—including the so-called "wildcat" banks—are blamed on inadequate regulation.

George Selgin was one of the lecturers at the Institute's "Mises University" held at Stanford University in July.



In fact the U.S. has never had true free banking, though it came close with the Suffolk system. As banking historian Bray Hammond has observed, the choice of state and territorial governments early in this country's banking history was always between monopoly and prohibition—with no thought of laissez faire. The "free banking" laws were an improvement upon that early state of affairs in so far as they allowed for free entry into the banking business. But entry was all that was free, or nearly so. The same laws encumbered the new banks with bond-collateral requirements for note issue. These requirements were responsible for all of the worst banking done during the free banking era, though failure of the courts in certain places to enforce the convertibility of bank notes was also to blame. Nor did the evil effects of bond-collateral requirements end during the Civil War, when state banks were forced out of the note issue business. For the same requirements were included in the National Bank Act, and were to be responsible for the disastrous currency shortages and financial panics of the late nineteenth century.

Modern day writers repeat the myth that the National Banking System was set up "to unify the currency." Frankly, this is a bunch of malarkey, as anyone who looks closely can discover. Had Salmon Chase, the then Secretary of the Treasury, desired only to unify the currency, he could have created a national version of the Suffolk System, which everyone at the time knew was the best banking system around. But Chase was not merely interested in "unity": his job was to raise money to pay for the war. That was why the National Banks were created, and it is why they were required (as a condition for note issue) to buy the government's debt. It is also why a law was passed to snuff-out the Suffolk System one year later, because the currency issued by banks in that system was *too* uniform and too well liked by the public, which meant that no one in New England wanted to get a National Bank charter to help the government sell its bonds.

2. If free banking can work, why have so many countries set up central banks?

This one is fairly easy. Their reasons have often been the same as Salmon Chase's reason for setting up the National Banking system: those responsible wanted to allow their governments to escape from the confines of private, competitive finance. Look at the history of monopoly banks of issue, and you will see that they were established in many countries years before Walter Bagehot or anyone else came up with any broad public service for them to perform. It was up to later generations of economists to re-interpret the founding of these monopolies as a public-spirited effort to improve monetary stability. The economists even manage to do this in cases where they know that prior experience with competitive note issue was not at all unfavorable.

George Clayton, in an article on banking in Sweden, notes that it had 28 note-issuing private banks in 1880. He then observes that "although this power to issue notes was used with such discretion that there were no instances of default, the unfortunate consequences of

excessive note issues in other countries had not been lost on the Swedish government. Consequently," he continues, "the sole right of issue was vested in the central bank [the Riksbank] and *enskilda* banks were given until 1904 to withdraw their own notes from circulation." (In R. S. Sayers, ed., *Banking in Western Europe* [Oxford: Clarendon Press, 1962], p. 60.)

Not a whisper about the fact that the Swedish government stood to gain several million kroner of interest-free loans from doing this. Nor does Clayton attempt to explain why private banks did not overissue if they were able to do so. As for the "excessive issues" of notes in other countries, Clayton does not say which other countries, although his argument implies that they must also have had competing banks of issue for its conclusion to be valid. My guess is that Clayton is thinking about the phoney "free banking" episode in the U.S. But that his argument rests upon a misinterpretation of history by other persons is no excuse: he is still in the position of someone who, having just seen a black swan, still insists that all swans are white because someone has reported a white swan.

Free banking does not require any special law or legislation; it is what happens spontaneously when money and banks are allowed to evolve free of legislative interference.

Now that economists like Clayton have gone to work reinterpreting the past, it is no longer true that central banks are established solely for reasons of government finance. Since the World War II, for example, newly independent countries set out at once to create their own central banks of issue. But by then they were influenced just as much by "expert" opinion, which held that a country could not pursue any "scientific" monetary policy without having a central bank, as by financial considerations, which led to many of the new institutions being involved in runaway inflation shortly after they were established.

3. Surely, if this is true, economists would have defended free banking. So why didn't they?

Some did. Adam Smith is routinely criticized for not having said more about the need to regulate money and banks. But why should he have said more? After all, Smith lived in Scotland, and Scotland's banking system, which was free from most of the restrictions that are now held to be essential, worked well. What is really curious, then, is not that Smith did not call for regulation of banks, but that he did call for some regulation, including the prohibition of small notes and of the option clause. Smith was wrong on both counts; but his error is understandable since he happened to write the *Wealth of Nations* just as Scotland was having its only really serious banking crisis. Perhaps if Smith had waited a few years he would have eased off a bit.

Lawrence White has shown that the famous debate between the Currency and Banking Schools actually included a third side: the Free Banking School, which argued that what England needed was to reform its banking system along Scottish lines by revoking the special privileges of the Bank of England. This school, whose members included Thomas Joplin, combined some of the best features of the Currency and Banking Schools. Like the Banking School, it recognized the essential similarity of notes and deposits, but like the Currency School it also recognized the possibility of overissue, only it viewed this possibility as due entirely to the special powers of the Bank of England. Were all banks placed on equal footing, with strict enforcement of the convertibility of their notes, none would be able, the Free Banking School argued, to overissue.

Unfortunately, the Free Bankers, including Adam Smith, also shared a theoretical fallacy with the Banking School: the Fullartonian "law of the reflux" or "real-bills doctrine." It was, of course, complete nonsense to say that the money supply would be kept in its proper bounds so long as banks only issued loans on short-term paper. If that were true, the convertibility would not have been necessary, and it would have not made a difference whether one bank or a thousand had note-issue privileges, provided the real-bills rule were strictly enforced. The kind of assets banks take on neither bear any particular relation to the size of the nominal money stock, or to the demand for money. What constrains banks in a free banking system is the fact they are continually called upon by the clearing mechanism to redeem any excess issues. The "reflux" that matters is not the reflux of notes in repayment of short-term loans, but the reflux of notes through the clearinghouse from rival note-issuing banks. Prior to the present century most of the other defenders of free banking known to me believed in the real-bills doctrine and to that extent they helped to discredit an otherwise practical position. Examples were members of the French free-banking school, including J.E. Horn, Charles Coquelin and Henri Cernuschi; Adolf Wagner in Germany and Henry Carey in the United States (before they converted to interventionism); Charles Conant (also in the United States), and Francesco Ferrara in Italy.

Nowadays, of course, plenty of people are defending free banking once again, including such illustrious economists as Friedrich Hayek and Milton Friedman. So lack of serious support for free banking is no longer a reason for assuming that it must be a bad idea.

4. Even if they were established for unsound reasons, aren't central banks needed to serve as lenders of last resort?

This depends, first of all, on what the central bank is supposed to lend. This could be one of two things: it could be currency or hand-to-hand money, or it could be base-money proper—the "ultimate money of redemption." The difference is that the public will only insist on the ultimate money of redemption if it has lost confidence in the banking system.

As far as demand for hand-to-hand money is con-

cerned, no such loss of confidence is implied. The public wants merely to hold bank promises in a form other than deposits. In so far as this is all that has to be worried about, then the only reason why central banks have to serve as lenders of "last resort" is because the "first resort" source of hand-to-hand money—free note issue—has been restricted or outlawed.

To see why this is a flimsy justification for central banking, consider the following silly story. In Ruritania the demand for snow tires typically increases relative to the demand for regular tires after the first major snow storm of the year. Years ago private, competitive firms produced and sold both kinds of tires. But then the Ruritanian government decided to restrict private production of snow tires. This led to a great increase in car accidents during the winter months, in response to which the Ruritanian government elected to monopolize the production of snow tires. Many years go by and soon Ruritaniacs take the monopoly of snow tires for granted. Whenever the first snow storm occurs, they are immensely grateful to the government for providing an essential service by supplying gas stations with sufficient quantities of snow tires to meet exceptional demands. If anyone is so bold as to suggest that the gas stations (or other private companies) could produce their own snow tires if it weren't illegal for them to do so, that person is denounced as a lunatic and accused of showing a cavalier attitude toward the public's well-being by wanting to expose it to tire shortages, defective tires, tires that are the wrong size, tires with dangerous studs that rip up the road, and so on. Never mind the fact that the same firms seem quite capable of supplying regular tires, that they actually pioneered snow-tire technology, that government snow tires still have tubes in them and require massive subsidies to produce, and that the government has been responsible for all of the worst snow-tire shortages of the past.

If you think this story is too silly, compare it to the story of the origins of the Federal Reserve System. At first, both National and State banks produced both deposits and hand-to-hand money. Then the government placed restrictions in the way of private production of hand-to-hand money. As these restrictions became tighter and tighter, the private banks were no longer able to accommodate seasonal increases in the demand for hand-to-hand money. Enter the Federal Reserve, dressed as a white knight, and charged with making emergency loans of currency to other banks in times of extraordinary demand. Things are different, of course, if the public loses confidence in the banking system and wants to withdraw money of ultimate redemption. Freedom of note issue would not be of any direct use here, because people are not merely interested in exchanging one form of bank promise for another: they want to get out of holding bank promises altogether.

But why should they want to do this? Doing so would mean forgoing the greater interest, convenience, and safety from theft they get from holding bank money, especially in the form of deposits. If the public were truly indifferent concerning these advantages of bank money, fractional reserve banking would never have arisen in the first place: like the sizes of bridges and tunnels, the size of

banks' holdings of reserves relative to liabilities reflects observed patterns of public behavior over long stretches of time. A run on the banks, leading to unexpected withdrawals of the ultimate money of redemption must therefore be something exceptional, due to extraordinary circumstances. What could such circumstances be?

One answer, of course, is that people fear that a bank will fail due to poor management. But such fear, if restricted to one or a small number of banks, should merely cause a temporary withdrawal of base money followed by its redeposit at other banks—and that is assuming the other banks also distrust the liabilities of the first bank and refuse to take them on deposit. If the distrusted bank is really poorly managed, it may be allowed to fail, and no one should regret this. If, on the other hand, it is really sound, it stands a good chance of being bailed out (for a price) by other banks, or at least of being taken over by one of them. As an aside, the frequency of bank failures due to poor management in our present banking system is largely a result of laws encouraging unit banking: few countries with well-developed branch banking systems experience anywhere near this frequency of bank failures.

What happens if people lose confidence in all banks at the same time? Here again, the hypothesis calls for an explanation. I can think of two: one is an "information externality" wherein people know, for example, that the collapse of a major railroad company is bound to cause at least one bank to fail; but they lack enough information about particular banks to know whether theirs is the one. Therefore, just to be safe, everyone tries to withdraw his or her savings from every bank. This is the only real theory of bank-run "contagion effects" I am aware of. But Gary Gorton, its author, has also observed that information externalities of the sort involved here would not arise if there were a "secondary market" for bank liabilities. For in that case, specialists in that market would make a point of knowing which banks are sound and which banks are not, and non-specialists could simply look in the newspaper to see if the specialists are trading their bank's liabilities at par or not. No one would have reason to stage a run on a bank whose liabilities were being traded at par by experts. The real problem is that bank deposits, the current form of competitively issued bank liabilities, lack a secondary market or have a secondary market that is too "thin" to be a source of information about the soundness of particular banks. But this would not be true of the market for competitively-issued bank notes. Therefore under free banking, no "information externality" problem would exist to give rise to a bank-run contagion.

The other circumstances that could cause everyone to lose confidence in all banks at once would be a national disaster, such as a military invasion. Admittedly such a disaster would constitute a challenge even for a central bank. How, then, would banks in a free banking system respond? They would probably respond the way insurance companies presently respond to great national as well as natural disasters: by having a special clause in their agreements with its customers, allowing them to refrain from meeting their obligations in the usual manner whenever a great emergency oc-

curs. In Scotland the free banks did precisely this on rare occasions, when they invoked an "option clause" on their notes. The clause allowed the banks to delay redemption of their notes for up to six months, provided that the banks paid interest to the holders of the notes for the duration of the period in which the clause was being invoked. Adam Smith was, of course, among those who objected to this practice. In part he was justified in so far as the Scottish banks may have abused the clause, by paying less than competitive rates of interest on suspended notes (which made resort to the clause more profitable than it should have been). But this was not the fault of the invisible hand: it was because usury laws were still in force which prevented the banks from rivalrously offering higher rates. I wonder, by the way, what Smith would have to say today about those "notice of withdrawal" clauses on passbook savings accounts.

5. Even if it is theoretically feasible, there is no way for free banking to be implemented today, so why talk about it?

Talking about it helps us finally understand the real consequences of monopoly in currency supply, and of other kinds of interference in banking. It is really quite amazing that a body of theory concerning money and banking could have grown in the absence of any detailed investigation of the implications of competition. Imagine how wrong-headed the results would have been had the same approach been taken in other fields. Everyone would have had no alternative but to start out by assuming a centrally planned economy; those unhappy with the consequences of central planning in particular fields would then have begun to set out to prove, for example, that free market forces could somehow produce the right quantities and styles of neck ties, etc., taking every industry for similar consideration, one at a time, while assuming all the rest to be centrally planned. Of course economics didn't develop this way, and thank goodness it didn't. But monetary theory has developed in a backwards sort of way; the result being that we really know much less about it than we think.

Free banking can be a real-world means for monetary reform. At the end of my book *The Theory of Free Banking* I show how one could be implemented in the United States with minimal disruption of existing arrangements. It combines the extreme monetarist-type proposal for a frozen monetary base with the recommendation that banks be allowed freely to issue demand notes redeemable in base dollars. Those who think there is something primitive and "wild" about banks issuing their own notes should realize that there is just a small difference between such notes and travellers' checks which everyone thinks of as a modern convenience.

It has been well over a year since I submitted it to the publisher and I now have some doubts about my plan. But I am not really worried about it. What I am worried about is that, failing an "easy" transition to free banking, people will let the present system continue or get worse until it ends, as all past government-monopoly fiat money systems have ended, in complete financial ruin.

Conclusion

Many economists are now engaged in studying the theory and implications of freedom in banking and note issue and that is encouraging. But free banking should not become a special field of study, to be exploited by a few "experts." An understanding of how unregulated market forces work in the money and banking industry should be part of the general stock of knowledge of every economist and policy maker. It should certainly be part of the stock of knowledge of all who are concerned about monetary theory and policy. ■

Austrian Economics Society Formed

by Roy E. Cordato

During the past twenty years the Austrian school has been undergoing a revival. Today the number of economists doing research, writing and teaching in the Austrian tradition is quite respectable. Much of this growth is due to the educational efforts of a number of outstanding institutions and organizations.

As a result of this revival, Austrian analysis is making some headway in influencing the economics profession at large. It is now becoming increasingly common to see discussions of, e.g., Austrian business cycle theory, Kirzner's theory of entrepreneurship, or Hayek's free banking theory in mainstream economics textbooks.

As the Austrian movement grows, it becomes more diverse. While strict adherence to methodological individualism and subjective value theory remain the cornerstones of Austrian analysis, there are unsettled questions that continue to arise and point to areas of analysis that need to be addressed.

A number of Austrians have spoken of the need for a broad organizational forum that provides an opportunity to deal with these issues while advancing Austrian analysis from within the paradigm. Taking note of this, Deborah Walker (Loyola University), Peter Boettke (Oakland University), John Egger (Towson State University), and I decided to see if there was an interest among Austrian economists in forming a membership organization—which we named the Austrian Economics Society (AES). With the aid of a mailing list provided by the Institute for Humane Studies, letters were sent to economists that we thought would be interested.

The response to our mailing has been overwhelmingly positive so we have decided to go ahead with AES. We have asked several Austrian economists if they would aid us in an advisory capacity. Our original advisory committee, which was established before we made our mailing, consisted of Dominick Armentano (University of Hartford), Roger Garrison (Auburn University), Israel Kirzner (New York University), Mario Rizzo (New York University), and Lawrence H. White (University of Georgia). Since then, Thomas DiLorenzo (University of Tennessee at Chattanooga), and Karen Vaughn (George Mason University) have agreed to join the committee.

The primary purpose of the AES is to provide a forum,

most likely through an annual meeting, for Austrian economists to share their research. Our hope is that the AES would encourage the expansion of Austrian analysis in the various sub-fields of economics and encourage constructive dialogue among Austrian economists.

We are hoping to have the first annual meeting in the Fall of 1990. Also, as a by-product of each meeting we would like to publish a volume of papers and proceedings. Of course, all these plans are tentative. Currently we are in the process of trying to establish the AES as a legal entity with non-profit status.

We have probably overlooked people in our mailing. So if you are interested in the AES and want information, please write to us. We will be happy to add you to our mailing list and keep you informed of developments. The address is: the Austrian Economics Society, Department of Economics, Loyola University, 6363 St. Charles Ave., New Orleans LA, 70118. ■

Conferences

Duke University Hosts Carl Menger Conference

by Peter G. Klein

In April, Duke University's Program in Economic Thought hosted "Carl Menger and His Legacy in Economics," a two-day conference celebrating Duke's acquisition of Menger's personal papers two years ago. Menger (1840-1921), long overshadowed by his contemporaries Jevons and Walras and known to most economists as simply the "literary" co-founder of marginal utility theory, has in the last fifteen years been the subject of a revival of sorts. With this background the conference directors Bruce Caldwell of the University of North Carolina at Greensboro and Craufurd Goodwin of Duke University gathered twenty-nine leading Mengerian scholars to assess Carl Menger and his contributions.

Duke has long been a leading research center in the history of economic thought, a tradition established there in the middle of the century by Joseph Spengler. The present faculty includes Goodwin, editor of the journal *History of Political Economy*, Neil de Marchi, Roy Weintraub, and A. W. Coats. The Menger conference is to be the first of an annual conference series on the history of economics; upcoming topics are the history of economics and national security for next year, and Oskar Morgenstern and game theory for 1991.

Among the highlights were two papers by Erich Streissler, the current holder of Menger's chair at the University of Vienna and author of the 1972 article that spearheaded the revival of interest in Menger.¹ In "The Influence of German Economics on the Work of Menger and Marshall" Streissler argued against the "myth," propagated by Joseph Schumpeter among others, that

Menger was largely uninfluenced by mid-nineteenth-century German economics. In "Carl Menger on Economic Policy: The Lectures to Crown Prince Rudolf" he revealed the contents of the unpublished notebooks of Crown Prince Rudolf of Austria, whom Menger served as Royal Tutor. Menger, it appears, was in fact a classical liberal or strict non-interventionist in most matters of economic policy.

Other noteworthy papers included "What Do We Know about Menger?" by Max Alter, whose just-completed dissertation on Menger will be published this year; "Ludwig von Mises and the Mengerian Legacy" by Barry Smith of the University of Manchester, who claimed that the methodological apriorism of Menger and later Mises is, at least implicitly, Aristotelian rather than Kantian; and "Austrian Capital Theory: The Early Controversies" by Roger Garrison of Auburn University. Also participating were Larry White of the University of Georgia, Mark Blaug of the Universities of London and Buckingham, Jeremy Shearmur of the Institute for Humane Studies, and Eve Menger, Vice Provost of the University of Virginia, the granddaughter of Carl Menger and the donor of the Menger papers. The most provocative papers were an account of the "Austrian Revival" by Karen Vaughn of George Mason University and a defense of hermeneutics by Don Lavoie, also of George Mason. Axel Leijonhufvud of UCLA gave the closing remarks.

The papers will be published in a special issue of the *History of Political Economy*, which will now include a conference volume as a fifth issue every year.

Note

1. Erich Streissler, "To What Extent was the Austrian School Marginalist?," *History of Political Economy*, 4 (Fall 1972): 426-41. Soon after Streissler's paper came a collection of essays edited by J. R. Hicks and W. Weber, *Carl Menger and the Austrian School of Economics* (Oxford: Clarendon Press, 1973); and William Jaffé's "Menger, Jevons and Walras De-Homogenized," *Economic Inquiry* (December 1976): 511-24. ■

"Keynes and Keynesianism"

by Amy Marie Marshall

The influence of John Maynard Keynes on economics and politics during this century can hardly be overstated. His heralded agenda against classical political economy destroyed trust and confidence in the free-market system for decades to come. In order to accomplish this he attacked (1) the gold standard, (2) the free market, and (3) balanced budgets.

Keynes's influence on domestic and foreign policy was also devastating. In his opening remarks at the Mises Institute's "Keynes and Keynesianism conference held April 28-29 at the Gutman Conference Center on the campus of Harvard University, Lew Rockwell, president of the Ludwig von Mises Institute, pointed to an open letter published in the *New York Times* from Keynes to President-elect Franklin Roosevelt on the eve of his inauguration. "You have made yourself the trustee for those in every country who seek to mend the

evils of our condition by reasoned experiment within the framework of the existing social system," Keynes said. "If you succeed, new and bolder methods will be tried everywhere, and we may date the first chapter of a new economic era from your accession to office." Rockwell commented, "Sadly, Keynes was right."

Today, conventional wisdom says that Keynesian economics is no longer threatening. This is only partially true intellectually and is wholly false politically. Macroeconomic policy manipulation is still the governing ideology in Washington—as in many other capitals around the world—as evidenced by the resurgence of Keynesians to prominent positions within the Bush administration and the recent Federal Reserve policies justifying an effort to expand and contract aggregate demand.

The Austrian tradition offers a radically different world view, one where the subjective valuations of individuals are definitive and where human action, economic calculation, and social cooperation create a balance easily tipped by government intervention. And if the idea that the economy is a machine to be operated and manipulated by policy planners is ever to be fully defeated, it will have to come through adopting a new economic "world view"—such as the one offered by the Austrian tradition.

For this reason the Mises Institute, in cooperation with Dr. Mark Skousen held the conference on "Keynes and Keynesianism." The conference was structured to



Keynes Conference Faculty (l to r): standing, Don Bellante, Jeffrey Herbener, Joe Salerno, Mark Skousen, David Gordon, and Murray Rothbard; seated, Hans Hoppe and Roger Garrison.

cover a wide range of topics as did Keynes's long career. Over 120 people attended. These lectures, along with several others concerning other aspects of Keynes's career will be published in book form next year.

Professor Mark Skousen of Rollins College and *Forecasts & Strategies* presented two papers: "A History of Anti-Keynesian Doctrines" and "Keynes and the Anti-Savings Mentality." Professor Roger Garrison of Auburn University delivered an irony-filled paper on "Income-Expenditure Analysis and the Chicago School: Why Milton Friedman is a Keynesian." Examining other trends in economic thought, Professor Don Bellante of the University of South Florida presented "Post-Keynesians and Neo-Keynesians." In one particularly important paper, Professor Jeffrey Herbener of Washington and Jefferson College attacked the "Modern Myths of Keynesian Economics," in a devastating critique of Keynes's "multiplier" and "accelerator" and

the Phillips Curve. Professor Joseph Salerno of Pace University connected poor monetary theories and world policy trends in "Keynesianism and World Inflation." Professor Hans-Hermann Hoppe of the University of Nevada, Las Vegas, engaged Keynesian macroeconomics in a battle with the Misesian theoretical framework in "Keynes vs. Mises." Dr. David Gordon of the Ludwig von Mises Institute presented, "The Philosophical Foundations of Keynesianism," showing that much of the Keynesian system flows from Keynes's own philosophical premises, based on the thought of his mentor G. E. Moore. The final paper was by Professor Murray Rothbard, "Keynes the Man: Hero or Villain?" Keynes's followers revered him as an almost godlike figure; Rothbard examined Keynes's life and found something quite different.

Within the academy, there still remains a multitude of Keynesian-oriented issues to discuss and myths to clarify from an Austrian perspective. The Mises Institute's conference on Keynes and Keynesianism made significant progress toward that end. ■

"Mises University" at Stanford University

by Jeffrey A. Tucker

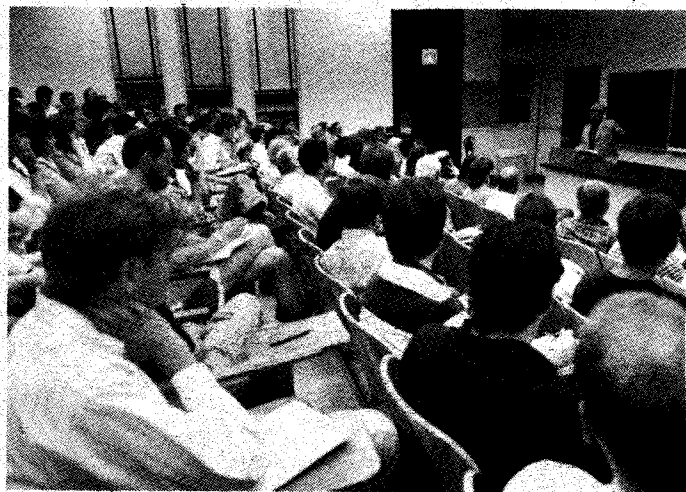
It was a milestone for Austrian instructional conferences. That was the consensus of those who took part in the "Mises University," the week-long teaching seminar on the Stanford University campus, July 8-15, 1989, sponsored by the O.P. Alford Center of the Ludwig von Mises Institute. In size, scope, and structure, it went far beyond anything ever attempted at an Austrian conference.

The 125 students had the conference faculty at their disposal for the entire week. Undergraduates, graduate students, professors of economics, and other professionals attended, coming from as far away as Europe, Central and South America, and Japan.

The structure of the conference was its most innovative feature, offering 50 separate classes in varying levels of advancement; students chose 28 classes and the staff individually tailored schedules to meet requests. This allowed students to structure their week around their own interests, whether in a particular field like philosophy, business cycle theory, industrial organization, public policy, or classes taught by particular professors.

Murray N. Rothbard of the University of Nevada, Las Vegas, and "Dean" of the "Mises University," delivered two additional lectures to the entire group. The first one elaborated on what he called the "one point" of Austrianism: praxeology, the methodological basis of Austrian economics which serves as the foundation for the rest of the system. Praxeology is essential, he said, and it is unwise to remove any particular aspect of Austrian thought from this foundation. This point became an overriding theme for the rest of the week.

Other lectures delivered by Professor Rothbard



"Mises University" students began their week of classes with Professor Rothbard's lecture on praxeology.

discussed the origins of the Federal Reserve System, the "mystery of banking," and the history of thought from Aristotle to Arrow. Before his final speech on "The Future of Austrian Economics," the students spontaneously burst into an extended round of applause.

Robert Batemarco of Marymount College is a new name within Austrian economics and his specialties include government economic statistics, financial markets, including the futures industry, and macroeconomics—subjects he spoke on during the week.

Walter Block, senior economist at the Fraser Institute and co-editor of the *Review of Austrian Economics*, is a critic of government intervention in all forms. He spoke on neoclassical economics, interventionism, regulation, and the prospects for privatization.

Williamson Evers, a Hoover Institution national fellow, spoke on the origins of classical liberalism and on the prospects for East Bloc economic reform, and he gave an advanced lecture on the philosophy of history.

Roger Garrison of Auburn University and premier Austrian business cycle theorist gave a series of lectures starting from capital and interest and building up to competing trade cycle theories within neoclassical economics. He also shared recent work on an Austrian theory of budget deficits and government financing.

David Gordon, senior fellow of the Ludwig von Mises Institute, reconstructed the philosophical foundations of Austrian thought and brought current trends in philosophical thought to bear on Austrian methodology.

Jeffrey Herbener of Washington and Jefferson College lectured on microeconomics, mathematics, and bureaucratic organization. Students appreciated his background in econometric techniques and wide knowledge of mainstream literature—and his Austrian critiques of them.

Hans-Hermann Hoppe of the University of Nevada, Las Vegas, spoke on comparative economic systems, a praxeological derivation of property rights, and his new theory of government imperialism.

Sheldon Richman, public affairs director of the Institute for Humane Studies and adjunct scholar of the Mises Institute, provided a new element to the instructional

seminar: two courses on how to write clearly. He pointed out that the written word is the primary tool for Austrians, in the same way mathematics is for neoclassicists.

Joseph Salerno of Pace University specialized in international monetary economics and trade, and he also delivered a thought-provoking lecture on economic calculation. He made a distinction between F. A. Hayek's knowledge problem and the Misesian problem of economic calculation, where the dividing line is drawn by different epistemological assumptions and diverging views of the intellectual task of the economic actor.

Lectures given by George Selgin, formerly of Hong Kong University, spanned labor economics, monetary theory, and Keynesianism and his unique theory of entrepreneurship and economic coordination.

Well-known in the investment world as editor of *Forecasts and Strategies*, Mark Skousen of Rollins College discussed the structure of production, the subject of his forthcoming book from New York University Press. He also lectured on the gold standard and the Austrian theory of economic forecasting.

Finally, Deborah Walker of Loyola University lectured on aspects of industrial organization from an Austrian perspective, including an historical treatment of Austrian monopoly theory and the theory of the firm.

Llewellyn H. Rockwell, Jr., president of the Institute said in his closing remarks that "this week showed that despite decades of socialist and Keynesian hegemony, Austrian economics is burgeoning. I am only sorry Ludwig von Mises didn't live enough to see how powerful his ideas have become." ■

Book Reviews

F. A. Hayek's

The Fatal Conceit: The Errors of Socialism

Volume 1 of the *Collected Works of F. A. Hayek*

Edited by W. W. Bartley III

Routledge, London 1988

Reviewed by Samuel Bostaph

This little book encapsulates and generalizes an argument that F. A. Hayek has been making for more than half a century. In many respects it is the core of his teaching and the culmination of a tradition beginning with Bernard de Mandeville and extending through Locke, Smith, Menger and Mises to some modern Austrian School theoreticians.

Briefly put, the argument is that the division of labor and of information in an extended moral order of human cooperation made possible the historical growth of wealth and of population that produced the contemporary world economy. (Here, by "economy" I mean the Mengerian agglomeration of individual economies, each connected to the others through exchange relations.) This vast spontaneous and consensual exchange system of information and resources—what is usually referred to by economists as "free-market capitalism"—supports modern civilization, which could not continue to exist without it.

Any disturbance or disruption of that extended order thus means disruption of the wealth-creating process that supports the current world population. Hayek argues that socialism is such a disturbing or disruptive influence in that in its attempt to "rationalize" human economic relations it assaults the very customs, traditions and institutions that both enable and sustain those relations and thus enable the division of labor and of knowledge in the extended order—customs,

Reviewed by David Gordon

Friedrich von Hayek is without question one of the most important of all Austrian economists. Not content with this eminence, he has also endeavored to contribute to social philosophy. In this field, as it seems to me, his work has both strengths and weaknesses.

It is one of the weaknesses that I propose to address here: Hayek's peculiar attempt to derive a quasi-ethics by appeal to social evolution. Hayek's views on this issue quite frankly seem to me without value. What is said here though by no means constitutes an evaluation of *The Fatal Conceit* in its totality.

To turn at once to our topic, a problem arises for Hayek owing to his ethical non-cognitivism. By this term is meant the view that denies truth or falsity to statements about what is good or bad. These statements merely express preferences. Like the Vienna Circle of the 1930s, by whose views he was greatly influenced, Hayek thinks that, e.g., if I say "Stalin was evil" I indicate an attitude of dislike toward Stalin. In contrast with the statement "Stalin was 5'2" and was rejected for the draft on medical grounds," the moral judgment makes no claim about the world.

Hayek does not discuss in *The Fatal Conceit* his reasons for adopting this position: his principal treatment of the issue, in *The Constitution of Liberty*, briefly rehearses the familiar claims of emotivism. Hayek, one suspects, hardly is aware that his view is disputable.

Hayek's skepticism about claims to truth in ethics

Bostaph . . .

traditions and institutions that evolutionary selection has proven to be nurturing.

Socialists thus suffer from a "fatal conceit"—the conceit "that man is able to shape the world around him according to his wishes" (p. 27). In this conceit, socialists are not alone and they are not merely guilty of misplaced sentiment or of poor logical development from arguably demonstrable premises. Hayek believes that they "are wrong about the facts" (p. 6) and it is the facts to which he primarily appeals in his own argument. Thus, his (1982) label of the socialist argument for economic calculation in a socialist society as "a somewhat comic fiction" finds a more extended explanation in this present work.

To those unfamiliar with the Austrian school side of the argument for the factual impossibility of a successful socialist economy, Hayek's claim may seem a fantastic, even ludicrous, one in light of the apparent historical survival of socialist economies. But, Hayek's argument does not concern mere survival; it concerns prosperity and growth. Also, the argument is too briefly put to deal with the question of the degree to which historical socialist economies have depended on non-socialist economies for their survival.

Hayek's argument proceeds by simple, yet grand, stages, and draws on original and secondary sources across the spectrum of human knowledge. It founds a theory of social structure on an human phylogeny; however, it is not determinist in the sense of either urging a philosophy of history or pretending to expose laws of social evolution. Thus, what Hayek offers is not "scientific capitalism"—an Austrian analogue to scientific socialism—but, rather, a conjectural history of modern capitalism that exposes the enabling circumstances.

The argument begins in the first chapter with the claim that cultural evolution, or the evolution of customs, traditions, institutions, morals and other rules of human conduct, supplanted the instincts of solidarity and altruism as the ordering principle for primitive social groups, and thus permitted the growth of extended social orders of cooperating strangers. These rules of property, contract, trade, competition, honesty and privacy both constrained instincts and encouraged the exercise of individual self-regarding initiative by delimiting a sphere of individual decision-making authority. They came into being spontaneously and evolved so as to nurture extended social orders in that "...they enabled those groups practising them to procreate more successfully and to include outsiders" (p. 16). And this came about because of the relative prosperity engendered by those abstract rules of conduct. At base, what cultural evolution nurtured was the information-gathering and disseminating process that cradles the wealth-creating activities of capitalist market economies.

A key element in Hayek's social history is his belief that human intelligence is contextual, and the context is provided by culture. Thus "learning how to behave is more the *source* than the *result* of insight, reason, and understanding" and "it is not our intellect that created our morals; rather, human interactions governed by our morals make possible the growth of reason and those

Gordon . . .

presents him with a problem in his development of a social theory. He has very definite opinions on economic and legal policies. But how can he reconcile his own advocacy with his views about ethics?

There is of course no contradiction in an emotivist thinking things good or bad. But why is it a reason for anyone else to adopt the measures Hayek supports that Hayek thinks them good, if all that this means is that Hayek likes them? Estimable man though he is, I cannot think that most of us will wish to accord Hayek's likes and dislikes a major role in our own thought.

The usual escape most noncognitivists adopt is to appeal to shared preferences. Once granted that we want something, reason enters the picture. When, e.g., Hayek cogently argues that a socialist economy cannot calculate, almost everyone will take this point as a reason against socialism, since few people want an inefficient economy. Whether one can completely solve the difficulty posed for noncognitivism in this fashion is a complex question that will not be dealt with here.

Instead, let us examine another solution to the noncognitivist's problem, one Hayek sets particular store by. He thinks evolution offers a way to solve the problem of the criterion for social policy.

At first, one might think Hayek's proposal an obvious non-starter. If Hayek thinks that what advances evolution is good, and what retards it bad, is not this case of just the sort of appeal to personal preference it was his endeavor to avoid? But Hayek's proposal is more subtle, and one cannot this quickly dismiss it.

He does not contend that the criterion of *ethics* is evolutionary progress. Rather, it is a fact, not a matter for evaluation, that societies develop over time. Unless we cooperate with evolutionary growth, we will cease to exist. The question is not: do we like evolution, any more than it is a matter of like or dislike that jumping from the top of a high building will probably be fatal. Our choice then is a simple one: cooperate with evolution, or be crushed.

But how is one to know wherein lies the road to evolutionary advance? Here Hayek's criterion of population growth enters the scene. In biological evolution, animals whose traits give them a selective advantage over other members of their species will outbreed them. Gradually, the advantageous genes will spread until they encompass the entire population.

Among human beings biological evolution has largely if not entirely been replaced by social evolution. Here too certain traits lead those societies that have them to evolutionary success. We can tell which these are by attention to population growth. Just as "good" genes drive out "bad" genes, so will customs that confer an edge in social evolution promote population growth. Hence the increase of population in a society offers a rough gauge of progress.

Whatever one thinks of this, it avails Hayek little toward devising a social policy that does not rest upon arbitrary preference. Suppose that Hayek's analysis of social evolution were in all particulars correct. A society that adopted the "wrong" policies would eventually fall

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capabilities associated with it" (p. 21). This is what makes the view that reason can construct social orders a "fatal conceit" as "...custom and tradition stand *between* instinct and reason—logically, psychologically, temporally" (p. 23).

Socialists, and others desirous of a purely "rational" order, who would discard traditions painfully distilled through the centuries thus risk discarding the very props of the rationality sustaining the extended order of four billion people. The alternative they offer to free market capitalism may well be mass extinction and impoverishment of those surviving.

Chapter one thus contains the gist of Hayek's argument, leaving the rest of the book for a slight extension of each of its major aspects.

Chapter two is a brief argument for the importance of private property rights (which Hayek labels "several property") and contractual property transfer for the growth of trading activities, and identifies their origin and evolution in morals and tradition.

Chapter three argues that trade expansion was enabled by the evolution of customs and rules and this encouraged division of labor, population increase, more division of labor, etc.—the whole process supported by trade in commodities and information.

In chapter four, Aristotle and Descartes are identified as the progenitors of the belief that pure reason can derive a successful morality and law that will supplant tradition. Rousseau adds the conception of liberty as the freedom to be guided by animal instinct (fictionalized as "the will of the people") to the assault on tradition, and thus rationalism and "the general will" unite "...to lead us back to a paradise wherein our natural instincts rather than learnt restraints upon them will enable us to subdue the world..." (p. 99). Private property becomes suspect as divisive under such a conception, although it was property rights that made possible the extended order.

In chapter five, Hayek argues that neither traditional morals nor any conceivable rationalist morality are rationally justifiable; however, traditional morality can be "rationally" reconstructed through the kind of conjectural history he has provided in previous chapters. Traditional morality is thus justifiable by its fruits (functionalism) "modern civilization—and by no other criterion. It sustains the extended order of human cooperation as no "rationally" constructed morality could because it is consensual and successful, whereas the morality demanded by rationalist scientism suffers from "a naive anthropomorphism" in its desire to impose a "just" and simple order on mankind. As Hayek puts it, "such demands for justice are simply inappropriate to a naturalist evolutionary process" (p. 74), where the unintended consequences of human action require a trial-and-error process of individual adaptation through markets.

Hayek argued, in chapter four, that intellectuals are seduced by rationalism to be socialists because rationalism (and socialism) overvalues intelligence and reason. Their demand for freedom in the rationalist/Rousseauian sense is really a demand to destroy the traditions that create

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before a more populous society, e.g., China or India, whose large population manifested their pursuit of the correct Hayekian line.

But why should this *now* interest us? Hayek purports to deal with the long-term trend of evolution. Except in special cases, e.g., the sudden adoption of "war communism," he does not contend that the members of society which fail to adopt Hayekian policies will at once suffer bad consequences. Unless, then, one values the long-term survival of one's society, one can ignore Hayek's view to one's heart's content. Someone might well reply to Hayek, "In the long run we are all dead." Hayek's supposed short circuiting of ethics fails of its purpose.

Regardless of its bearing on ethics, Hayek's view of social evolution possesses considerable interest in its own right. The problems confronting it have been addressed in a comprehensive way by David Steele in a recent article in the *Journal of Libertarian Studies*, but I venture to add to Steele's masterly treatment a few points from a slightly different angle.

Let us consider for a moment the analogy on which Hayek's view of social evolution rests, the process of biological change through Darwinian natural selection. The extent to which this ingenious mechanism operates cannot be settled *a priori*: we must just look and see. And just because one can conjure up an analogous process for "social evolution" does not suffice to show that social evolution actually operates. Hayek simply postulates but nowhere shows that social change proceeds in a similar manner to biological change.

Further, growth of population in absolute numbers is not the essence of biological evolution. Differential reproduction is the key to the theory: animals whose traits enable them to pass on proportionately more of their genes than other members of their species are by definition successful from the evolutionary point of view. The total number of a given population in the absence of comparison with rates of growth among evolutionary competitors tells us nothing.

Further, the Darwinist view does not contend that selective advantage is the only reason for population growth. It is one factor among others: given sufficient time, evolutionists believe its effect will have major importance. There is nothing in the evolutionary analogy that warrants one in identifying large populations among human beings as harbingers of evolutionary advance.

Hayek also wrongly takes for granted that if a society replaces another group, the "winner" did so because it was more socially advanced. No doubt superior technology often does prove the decisive factor in social conflict; but this by no means is always the case. In the fashion of the Assyrian that came down like the wolf on the fold, one society may overcome another simply by being more ruthless. Hayek would have a difficult time peddling his theory of social evolution to the citizens of Rome in 476 A.D. or the inhabitants of Byzantium in 1453.

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and maintain civilization. In this chapter he opines that intellectuals are attracted to central planning because they resent being part of an impersonal process whose ends are several, as well as unidentifiable to them personally. They refuse to concede the impossibility of a "just society" in their fatal conceit.

He goes on to argue in chapter six that intellectuals especially disdain and suspect commercial and financial institutions in a market system because they involve physical processes and common knowledge in only minor respects. Their major contributions of increasing value and organizing dispersed knowledge are both difficult to understand and seemingly "unfair."

Chapter seven contains remarks on how inappropriate language contributes to anti-capitalism; chapter eight argues the reciprocity of extension of the market and population growth; while chapter nine provides observations on the key historical role of certain religions as "guardians of tradition" beneficial to the extension of the market order—especially the traditions of family and several property.

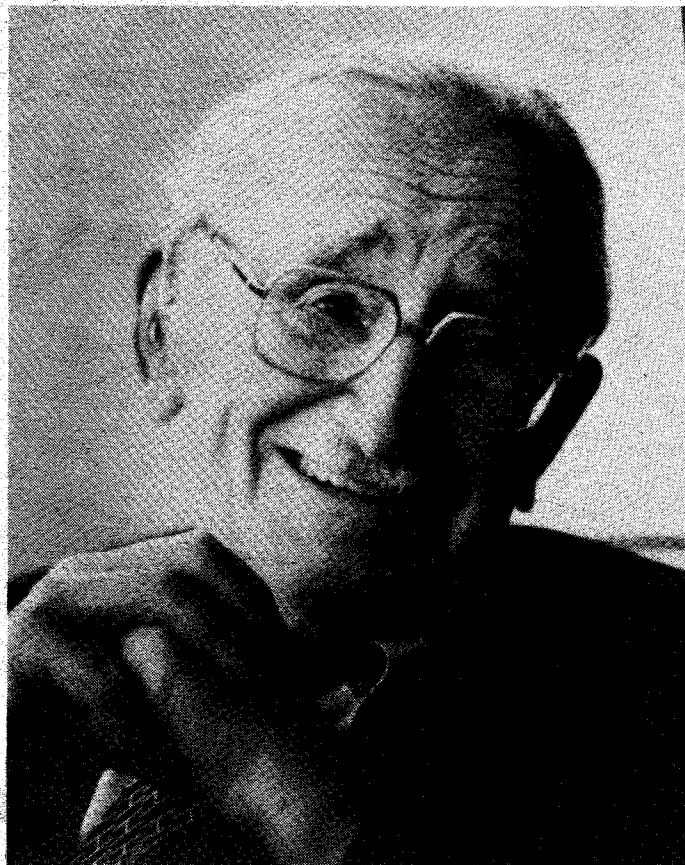
For me, the book suffers from two flaws. The first is that it is far too brief for such a grand project. The editor characterizes it as "a manifesto" and promises a glimpse of fragments of the longer work, of which this is a condensation, in volume X of the *Collected Works*. Whether this occurs or not, the manifesto itself rides on the ocean of all Hayek's lifework. Those who find the book appealing will follow the references and thereby complete the treatise it should have been.

The second flaw is less easily disposed of, but, I believe, less consequential to the main thrust of the argument. This is Hayek's view of the relation of tradition, or morality, and rationality. As Gray (1986, ch. 2) realizes, Hayek's view implies a conflict between man as a "rule-following animal" and man as purposeful in any but the most trivial sense. If man is only a rule-following animal, then traditions only change as a result of conflict produced by the incompatibility of some rules with others or with goals they set for man. Rules that survive are, presumably, rules adopted in expanding and prosperous societies that do not hinder, or, even aid that expansion. This allows Hayek to deny any claim of "goodness" for surviving rules and to say that he claims that merely poverty and death may follow the discard of particular long-followed traditions (p. 27).

For those disdaining Hayek's evolutionary epistemology and ethics, the whole argument need not be thrown out as well. Gray suggests the "economic approach to social behavior" of Gary Becker as one alternative to Hayek's particular natural selection explanation of rules evolution. There are others, e.g., that provided by rational egoism, which suggest that individual life-enhancing actions gain general acceptance for that reason, lead to alternations in the rules framework, and consequently more successfully promote

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After looking at the charivari Hayek has offered us in the guise of a theory of social evolution, one cannot help but recall Morris Cohen's remark to a student: "In the first place, you're wrong; and in the second place, even if you were right, so what?" ■



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general life enhancement—which is good. Stability of the framework is desirable for it enhances calculation, coordination, and social cooperation—which all indirectly enhance the ability of the individual to engage in life-sustaining and -promoting activities. But the life-enhancing characteristics of the rules framework are its key aspects and the key determinants of long-run change. Such a view grafted to the corpus of Hayek's manifesto allows the conclusion that the customs and traditions that promote free-market capitalism are not only necessary to support modern civilization, they are also good.

References

John Gray, *Hayek on Liberty*, 2nd ed. (Oxford: Basil Blackwell, 1986).

F. A. Hayek, "Two Pages of Fiction: The Impossibility of Socialist Calculation," *Economic Affairs* (April 1982). ■