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Features

Articles

Reviews

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Aims and Scope

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

Mission

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

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

— Ludwig von Mises

Unintended Consequences

The Miserly Index

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When he was economic adviser to Lyndon Johnson in the 1960s, Arthur Okun developed what today is known as the Misery Index. The concept is simple. Unemployment is bad for people, and inflation is also bad for people. If we add the two percentages together we get an index for how bad things are. In short, the higher the index the worse life must be for the average person, either because he doesn't have a job, or because inflation is shrinking his purchasing power.

In figure 1 we can see the ebbs and flows of Americans' good fortune according to this measure since 1948. Anecdotally we can see that there is a grain of truth in the index.

Some of the story the figure alludes to is consistent with how one might judge a period of time to be. The late 1970s and early 1980s were indeed a period of high unemployment and stifling inflation. The turmoil of 1974 is clearly visible. The more recent episodes of the housing crash and recession of December 2007 to June 2009 are also clearly visible.

Yet some anomalies also show up in the data. Excluding the mid-1990s, today's Misery Index shows what must be the best economic situation in the United States since the 1960s. This could

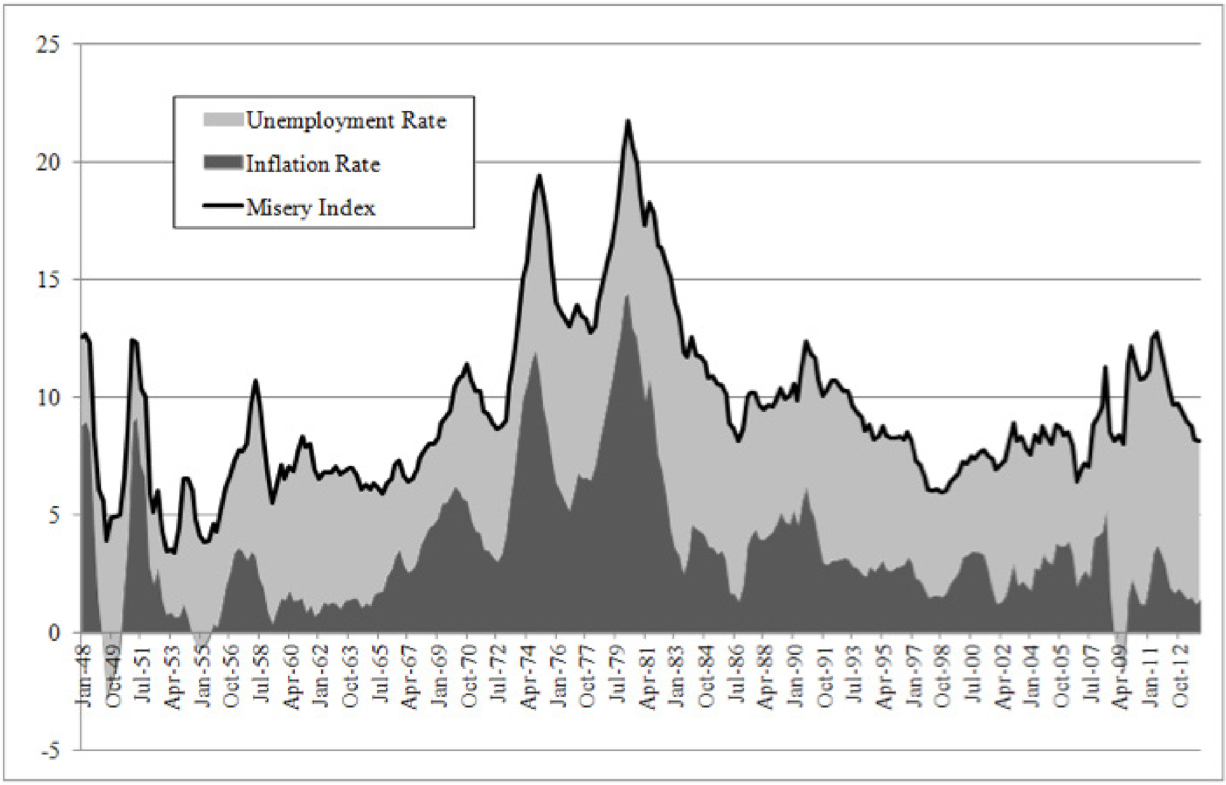

Figure 1: United States' Misery Index
Source: Federal Reserve Economic Data

well be, though I doubt Main Street USA would agree that everything is as peachy keen as the index illustrates. Indeed, according to the University of Michigan's consumer confidence survey, the American consumer is the least optimistic about the present state of affairs since the early 1980s.

One of the difficulties with such an aggregation is that the numbers being added don't have much to do with one another. It's an appealing figure, but at the end of the day it doesn't make much sense. Despite being expressed as percentages, the rate of price change in the economy is almost unrelated to the rate of employment. (I say "almost" because one could think that there is a negative relationship between people earning income and generating price pressures.) Not only are the two variables unrelated, but they are also given equal weighting in the index. Recent work charges that such an equal weighting under-weights the misery caused by unemployment relative to inflation (Di Tella *et al* 2001). The more important question is why the two variables should be associated together with any weighting?

Consider the problem created by answering "who" is affected by the Misery Index. Surely it can't be built with employed people in mind for why would such a person be harmed by a high rate of unemployment? Likewise an employed person will have the opportunity for his salary to adjust with inflation, and as such won't necessarily be worse off because of it (in fact, if his salary increases faster than inflation he could become better off).

Unemployed people will be affected by both unemployment (as it is their relevant category) and inflation, as their savings will be negatively affected by association also their well being until they can find new employment. One could say that the Misery Index is supposed to gauge the general health of the economy, but if this was the case it should be weighted according to how many unemployed people there are, or the rate of income growth for those who have jobs relative to general price inflation.[1]

has the advantage that volatility is increased. The bad times seem a little worse than otherwise because of the high unemployment that accompanies them. The corollary also holds true – the good times look a little better because they have very low rates of unemployment associated with them. Still, even the unemployment-weighted Misery Index fails to grapple with the problem

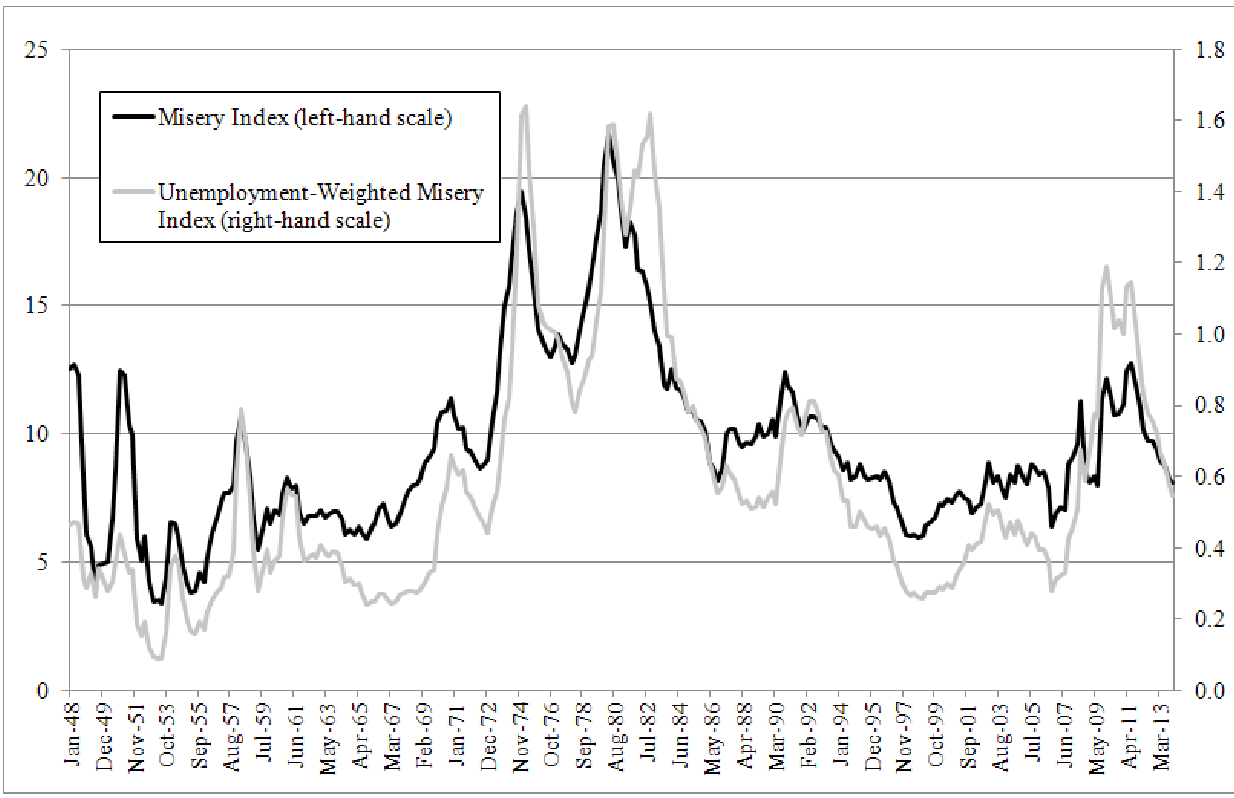

Figure 2: Misery and Unemployment-weighted Misery Index
Source: Federal Reserve Economic Data

that there is just no reason why the rates of unemployment and inflation should be summed in the first place.

Figure 2 tries to rectify the difficulties created by the Misery Index only being relevant to the unemployed class by weighting the standard index according to the unemployment rate. This weighted figure

There is an enduring appeal to the Misery Index, despite its obvious and insurmountable shortcomings. There is a desire for some general way that we can look at the well-being of the economy. Common income-related measures, such as gross income per capita, do a reasonably good job to the extent that they summarize via the average person's purchasing power what his consumption possibilities are.

1 It can also be a gauge of the general health of a country's citizens. Yang and Lester (1992) find a link between declines in the Misery Index and increases in the suicide rate from 1938-1986.

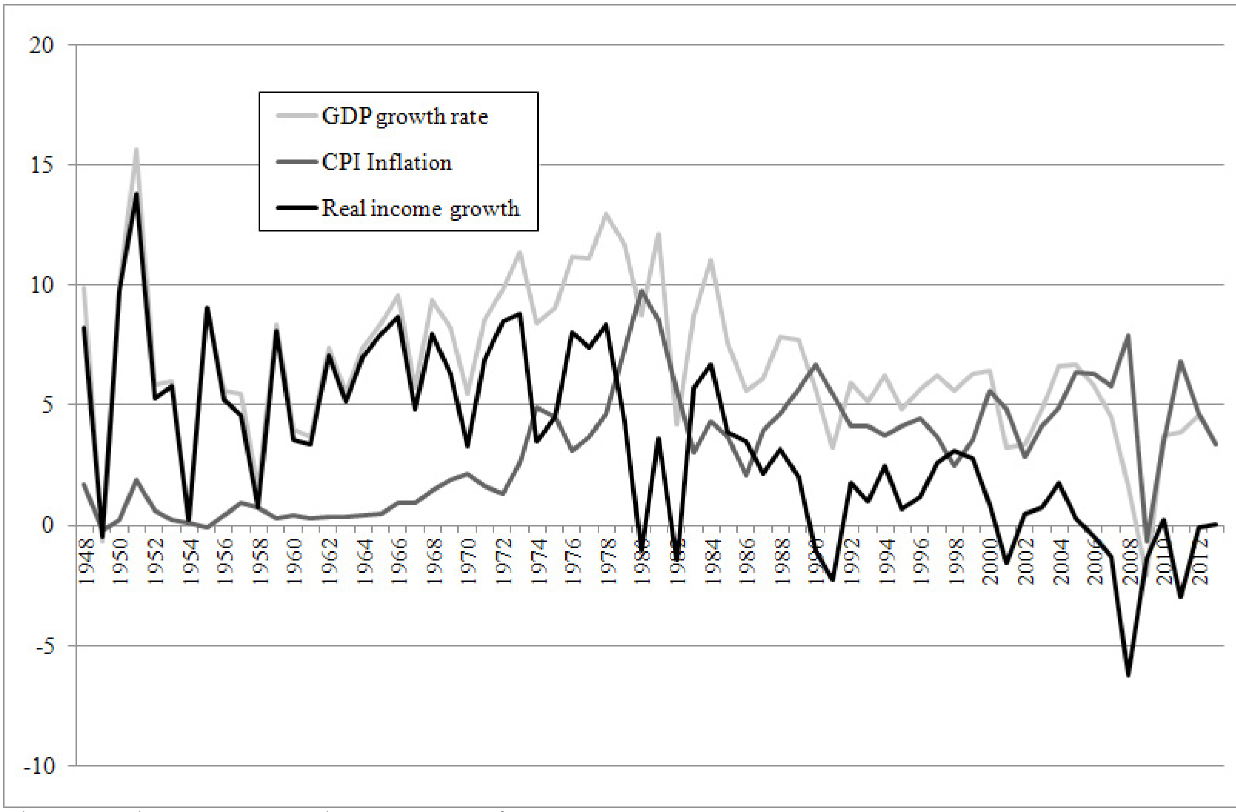

Figure 3: Real Income Growth
Source: Federal Reserve Economic Data

There are, however, two shortcomings from such measures. On the one hand, we must make certain payments, such as taxes, that reduce our purchasing power. (To the extent that wage growth doesn't adequately track the rate of inflation we may also see losses to our purchasing power, though we can use real figures to adjust for this.) The other shortcoming is that we are not only concerned with the present. To the extent that we are future-oriented, any reckoning of the present state of affairs must account for what we think the situation will be like in the future.

To account for these omissions from the Misery Index I propose the "Miserly" Index (Howden 2014). The Miserly Index shows what percentage of one's future income will remain after the effects of inflation; taxes and government debt repayment are factored for.

Inflation is harmful to the extent that wages do not keep pace with it. In other words, it is the rate of price inflation relative to the rate of income growth which is important. If income growth is stronger than inflation, purchasing power for the average person will be increased. Periods when inflation is higher than income growth are detrimental to the extent that they reduce one's purchasing power. For our purposes we will use nominal GDP growth as the proxy for income growth, and CPI inflation to express losses in purchasing power.[2]

In figure 3 we can see the real change in income since 1948. Negative figures result from rates of CPI inflation greater than nominal GDP growth, meaning a decline in purchasing power. For the most part these episodes are short-lived.

When asked what the single largest

2 Barro (1999) and Hanke (2011) have similarly modified the traditional Misery Index to account for the effects of real economic growth.

deduction from a person's pay cheque is, almost all would point to taxes. This intuition would be correct. In the United States a combination of local, state and federal taxes are deducted from one's income and act to reduce the worker's purchasing power. In figure 4 we can see the effects of the total of these taxes, as well as their evolution over time.

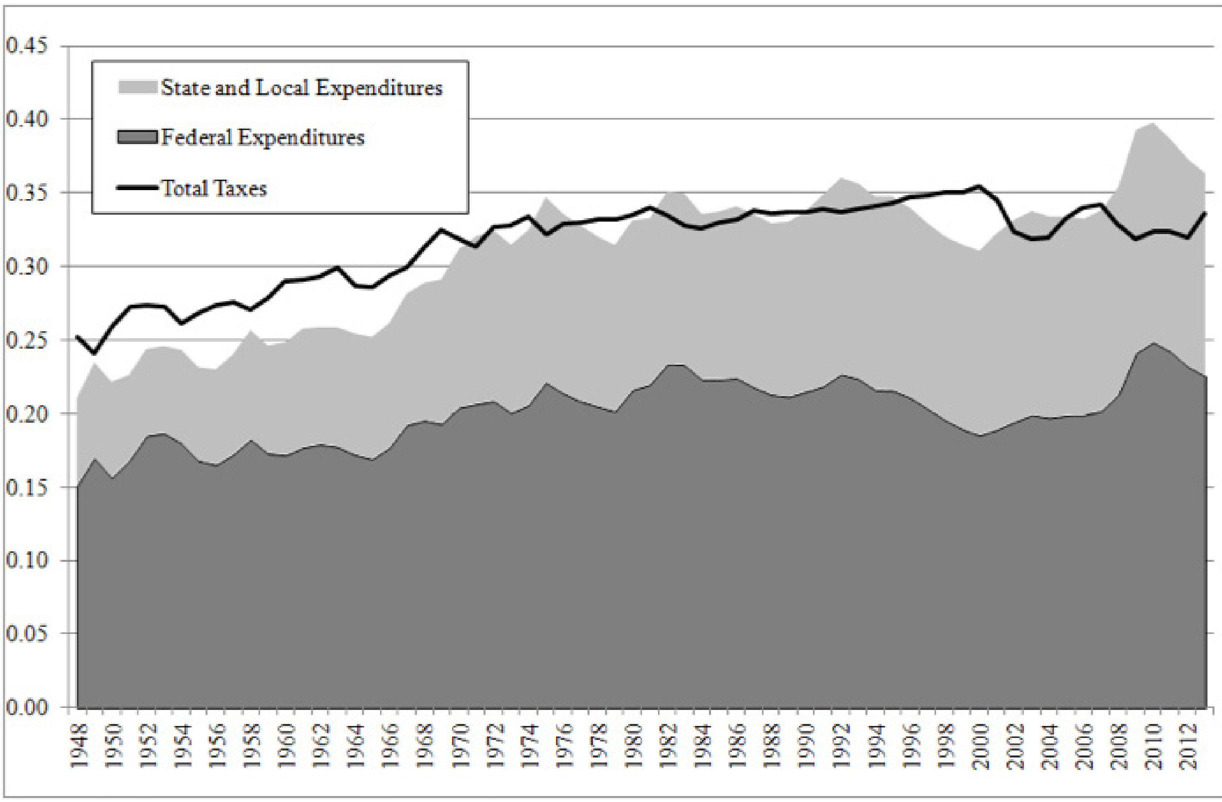

Figure 4: Government expenditures and revenues
Source: Federal Reserve Economic Data

The total tax charge for the average American has remained relatively constant over the past 30 years, meandering between 30 to 35% of his income. I have mapped the evolution of these tax charges against government revenue because this difference is what determines the total indebtedness of the government. When the total tax haul is greater than government expenditures, the aggregate government balance sheet deleverages. By this we can see that the local, state and federal governments of the United States reduced their total level of indebtedness until roughly 1970, when a period of near continual deficit spending began. The mid-1990s were the last time the combined governments of the United States ran a collective surplus, and today the deficit is around 3% of GDP.

These collective deficits and debts are significant because they contribute to the final factor that affects the Miserly Index. Today's debts will be paid at some point in the future. Outright defaults on sovereign debt, especially by developed countries like the United States, are quite rare. The debts of today will be paid in the future, either through higher taxes or through inflation. To the extent that these two factors are already covered in the Miserly Index, we can add to them by estimating what they can be reasonably expected to be in the future to pay for deficit spending of the past.

One way to estimate the future cost of the present debt is to treat it as a perpetuity that will be paid off infinitely far into the future. In effect, one can treat such debts as a perpetuity with a net present value of zero (Howden and Saona Hoffman 2014). Under such a pricing formula, the present value of the debt is given, and we can simplify the problem by assuming that it will grow at a constant rate equal to the deficit, that hat the economy will continue growing along its current growth path. The net present value of this perpetuity will be zero if the yearly payment is equal to the present value of the growing perpetuity of debts and deficits.

The payment (PMT) necessary to set the net present value of today's debt and the future stream of deficits is equal to:

$$PMT = \frac{i-g}{1+g}\,(PV_0) + d,$$

where:

i = average interest rate on outstanding debt
g = growth rate of the economy,
PV_0 = the present stock of outstanding debt, and
d = yearly deficit.

All variables are expressed as a percentage of GDP. For the average interest rate on outstanding government debt I have used the average current yield on the government's long-dated (i.e., 10-year or more) securities. The growth rate of the economy is the rate of nominal GDP growth. To avoid short-term volatilities, both of these variables have been smoothed as a five-year lagging moving average.[3] The present outstanding stock of government debt is the combination of local, state and federal levels. This figure excludes off-balance sheet items, such as pension obligations since they to not yet represent a *debt* the government is obliged to pay (and since strong economic growth could eliminate the need to finance such obligations through issuances of new debt in any case). The yearly deficit is also the sum of deficits at all three levels of government.

The resultant payment necessary to make the net present value of current and expected future debt obligations equal to zero is illustrated in figure 5, and is expressed as a percentage of current year GDP.

Years when real economic growth was strong, interest rates low, and the debt and deficit minimal resulted in a lower percentage of income necessary to pay off the then-existing debt load. At the extreme, when economic growth is higher than the interest rate on existing debt and the size of the deficit, the existing debt will pay itself off. It is in this fact that we can illustrate Mises' (1919) claim that the highly-indebted post-War European economies should focus more on generating economic growth rather than on debt reduction, per se.

More recently, the deficit spending that became prolific during the mid-1980s resulted in large growth in the stock of government debt. Coupled with still relatively high interest rates the result was that a growing percentage of income was needed to pay off these debts and deficits in the future. A similar situation is true at the moment, and it doesn't look to turn around any time soon. In fact, to the extent that interest rates are at historically low levels (constrained in many cases by the zero lower bound), there can only be room for interest rates to worsen this figure in the future.

I make no reference to Ricardian Equivalence in discussions surrounding

3 To the extent that people base their expectations on the recent past, this is not an unreasonable way to deal with these growth rates.

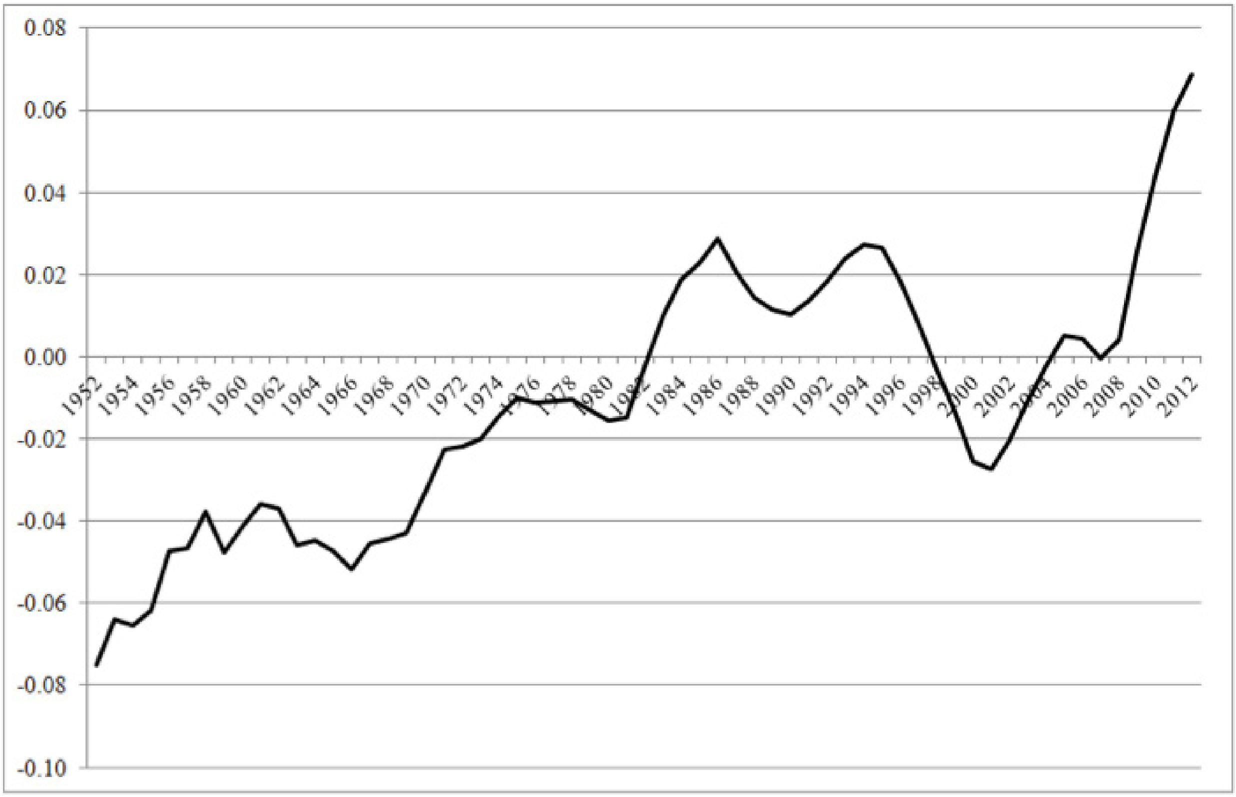

Figure 5: Income needed to repay existing debt and deficits (% GDP)
Source: Federal Reserve Economic Data, author's calculations.

figure 5. The only assumption that need be true is that the debt must not be explicitly defaulted on, and as such must be "repaid" by a combination of either higher taxes in the future or through monetization. Indeed, as a simple truism "it is fundamentally a matter of indifference whether [the government] … imposes a one-time tax on [a citizen] of half his wealth or takes from him every year as a tax the amount that corresponds to interest payments on half his wealth" (Mises 1919: 168, as quoted in Garrison 2001: 89). One way or another, the debts of today get paid.

The Miserly Index is the sum of these three components: the percent of income needed to pay taxes, payments to retire the existing debt, and adjusted for any changes to the real value of an individual's income. Figure 6 summarizes these components, and shows the evolution of the Miserly Index of the United States since 1953.

I will start by discussing the individual components affecting the Miserly Index. The total percentage of a person's income devoted to taxes has climbed somewhat over the past 60 years, though not by as much as one might think. The total figure has ebbed and flowed between 26 -35% of GDP, although there is a noticeable but gradually increasing trend. Since there has been relatively strong growth in expenditures at the state, local and federal levels, the result has been strong growth in the size of government funding deficits, as well as their frequency. This has not boded well for the amount of income expected to be needed to repay the existing stock of debt, and this figure increased from a low of -7.5% of GDP in 1953 to its current level of nearly 7%. While government debt was once overpowered by

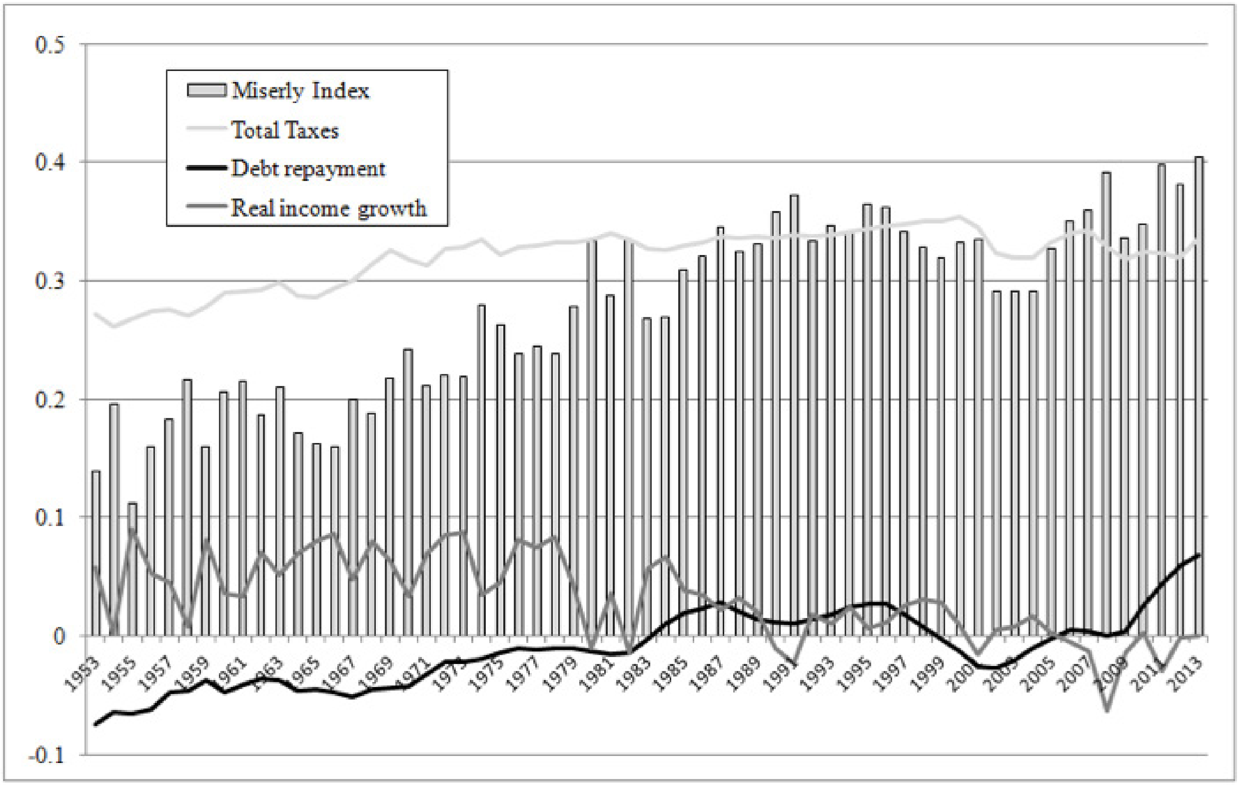

Figure 6: Miserly Index and its components

strong economic growth and low yearly deficits adding to the stock, the situation has reversed noticeably in recent decades. Debt is no longer the boon it once was, and a not insignificant amount of income is necessary to keep the country out of outright default.

These two figures have reinforced one another to make individuals today a little more "miserly" than in the past. This miserliness is in the sense that an ever-growing portion of their income must be devoted to paying taxes and retiring debt than at any time in recent history.

There is a silver lining to all this, though it has diminished gradually over the past 60 years and today is negligible. The growth rate in real income long mitigated the negative effects of a rising tax burden and the expected costs of debt repayment. However, while average real income growth was a healthy 6% from 1953 – 1978, since 2000 it has been a disappointing -1% per year. Shrinking real incomes have harmed Americans and further increased the percentage of their income which will be necessary to repay current debts in the future.

The Miserly Index reflects all three of these effects. Since 1953 it has gone through four broad phases. The period of 1953 to the early 1970s saw this measure relatively constant and low. The reason is easy to understand as the 1950s and '60s were a prosperous period of low taxes, government budget surpluses and strong real-wage growth.

The two-decade period from the early 1970s to the early 1990s saw the average American's expected future financial situation deteriorate rapidly. High deficits in the 1980s, record inflation in the late 1970s and a ballooning stock of debt all coupled to increase the amount of his future income he would need to sacrifice in the future to pay his taxes

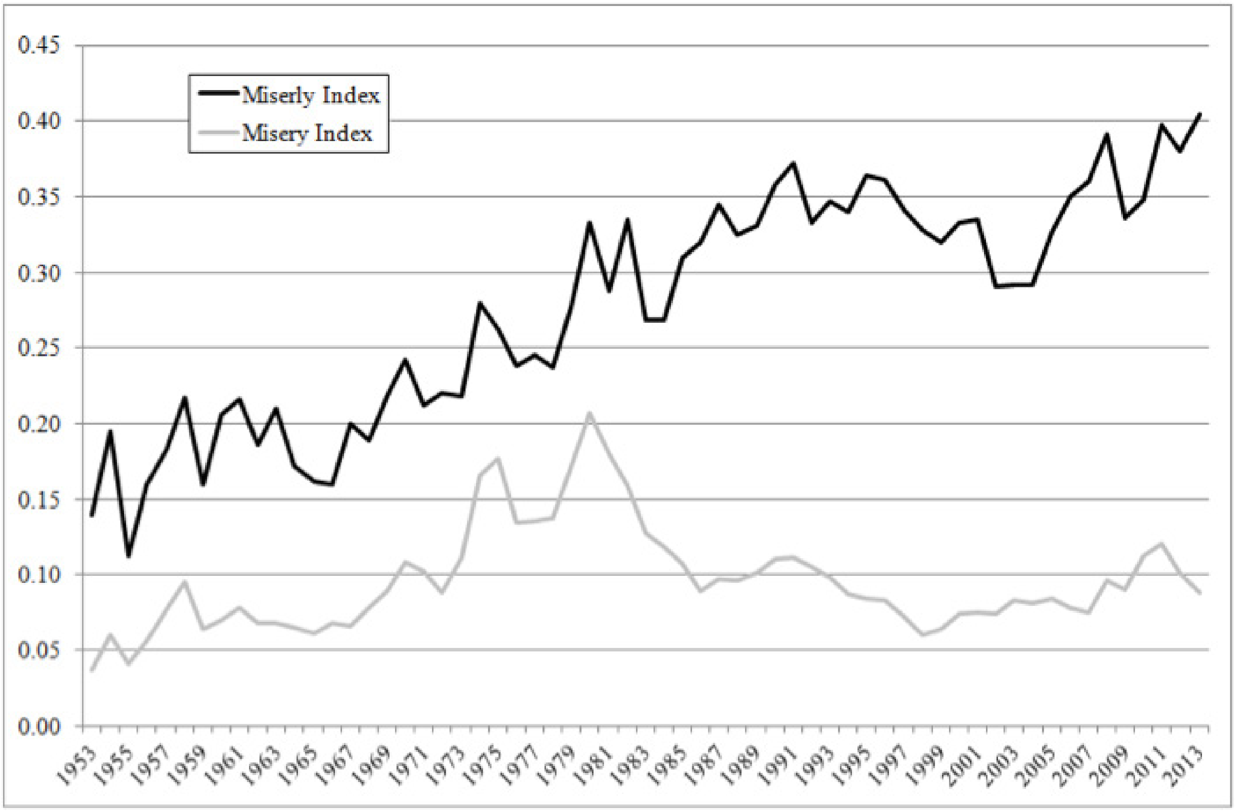

Figure 7: Misery vs. Miserly Indexes

and pare down the existing debt. The situation improved going into the early 2000s as deficits were curtailed, the debt somewhat repaid, tax growth was relatively slow and the boom of the 1990s saw decent real wage growth.

This all brings us to today. At 40%, the Miserly Index is higher than at any other moment under examination. This figure means that the average American can reasonably expect to pay 40% of his future income to a combination of taxes, debt repayment and lost purchasing power. This is in contrast to the economic situation of today, which might look reasonable with its low price inflation and unemployment back under control. The unfortunate flipside to this is that the debts and deficits that were accumulated to "foster" the current recovery will need to be repaid eventually.

I will end with a brief comparison of the Miserly and the Misery Indexes, and a final word as to why the Miserly calculation is superior. The two indexes track each other reasonably well, with the exception of the periods from 1983 – 1991 and the past five years. This former period was a generally prosperous one for the American economy. The source of this prosperity has been attributed at times to the economic policies put in place by the Reagan and Bush administrations which fell under the guise of "Reaganonomics".

Taxes were generally constant over this period, but in their place high levels of deficit spending were foisted onto the American public. The result was that there was an immediate economic improvement, which was real and can be proxyed in at least some way through the falling Misery Index during the period. The boom of the 1980s was, however, false in the sense that the increase in deficits imposed a cost onto future Americans. The

Miserly Index reflects the forward-looking element of the economic feeling of the 1980s, and shows that noticeable boom in the "here-and-now" of the 1980s was partly illusory. In this we can find much agreement with Murray Rothbard's (1987: 362) succinct comments on the myth of Reagonomics and the boom of the 1980s, "Things are not always what they seem; skim milk masquerades as cream."[4]

The same is true of the American economy today. The divergences between the two indexes after the dot-com bust and the more recent housing collapse point to the use of deficit spending to evade a more pronounced recession. While the economic situation looks promising given the mild price inflation and taming of the unemployment malaise, the Miserly Index points to the fact that the average American can expect to pay 40% of his future salary to settle today's debts.

4 With apologies to Gilbert and Sullivan.

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Bounded Rationality

The Fallacy of Government as Deus Ex Machina

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With the rise of the technocratic welfare state in the late twentieth century, economists have now carved out a ubiquitous role in government, as technical experts, advisors, and even as government ministers. This is a somewhat natural result, owing, in part, to their hegemony over the social sciences, and in part, to the ceremonial value of high economic qualifications (Markoff and Montecinos 1993). Economists, more so than other government functionaries, are able to confer an aura of legitimacy on public policies, by putting forward recommendations for government action which has been filtered through the framework of economic rationality.

Notwithstanding this fact, the actual economic approach of economists working in the government is often highly flawed. There are many reasons for this, but part of the reason is that the economist is in the position of giving advice inside the organisation, such that the appropriate role is to provide advice on *a set of actions* that will alleviate some social problem, rather than giving an examination of institutional arrangements. In view of the fact that this is internal organisational advice (or possibly advocacy of advice to government from outside), it is usually based on the presumption that the thing at issue is the optimality of a certain set of actions.

This presents a low standard for recommendations of government intervention in the economy. By providing internal advice, the government economist is able to ignore the institutional functioning and incentive mechanisms with the government apparatus and merely decide on a set of optimal actions. The standard for intervention then becomes one where intervention is recommended when the economist can identify a *set of actions* that would efficiently alleviate the social problem under consideration. Such a phenomenon plays out in many areas of public policy. In a discussion of anti-trust regulation Becker (1958) notes that:

> *"…the recommendation of government intervention does not follow from the demonstration that government intervention could improve matters. Demonstrating that a set of government decisions would improve matters is not the same as demonstrating that actual government decisions would do so. This kind of inference is logically equivalent to identifying the actual workings of the market sector with its ideal workings."*
>
> (p. 105, emphasis added)

Of course, it is well-known to government economists that their advice is not always taken, or that it may be taken, but bastardised into some unrecognisable form. This is an occupational hassle, as in any organisation, but it is not generally regarded as part of the economic problem under analysis. After all, if an economist proposes some set of actions, and the proposed actions are rejected, or altered beyond reasonable limits to some form which has some other effects, then any adverse consequence can hardly be laid at the feet of the initial advice!

In this advisory role, whether internal or external, economists are often unconcerned with the wider question of the institutional analysis of government, and unaware that they are implicitly treating the government as being outside of economics, insofar as it is treated as an entity *whose actions can be prescribed*. However, the real question to be dealt with in the analysis of government action is the economic problem of how this institution operates with its specific set of knowledge resources, incentives, and feedback mechanisms.

Incentives and feedback in firms

Economic theory analyses the behaviour of individuals and organisations whenever they act to achieve some desired goal using scarce resources. It seeks to understand how people will act in the face of a set of incentives, and what the social consequences of their actions will be. Analysing the actions of an organisation is especially challenging, because this entity is composed of multiple people who each have their own preferences and goals. The study of the behaviour of such collective entities has given rise to the 'theory of the firm', which seeks to describe why people come together into organisations to perform group tasks, rather than arranging individual transactions at arms-length using market prices.

The standard account of firm existence and behaviour is put forward in Coase (1937, 1988). Coase argued that firms exist to avoid the transaction costs involved in conducting market exchanges using the price mechanism. Exchanges on the market at prevailing market prices are substituted, within the firm, for inter-firm transactions made under the direction of a manager.[1] The fact that inter-firm transactions

1 The size and scope of firms depends on the rela-

are made under the direction of a manager, who represents the owner of the firm, does not necessarily imply that actions occurring in the firm will seamlessly reflect the goals and preferences of the owner. Indeed, it is often the case that the firm has several different part-owners, and their preferences and goals may also conflict.

Economists are well aware of these issues, and a substantial body of work within the theory of the firm is devoted to looking at the degree to which the goals of the firm's owners are perverted within the firm by the goals and preferences of the agents operating the firm (the principal-agent problem). The prevailing model of the firm that emerges in modern economics is one where the goals of the owners of the firm are mediated, and often perverted, through the influence of agents within the firm pursuing their own personal goals. Employees —including managers or subordinate employees— may wish to increase their own salary, perks, power and prestige, and might also want to minimise their labour, avoiding difficult or unpleasant work wherever possible.

Sowell (1980) has cogently analysed the knowledge problem in decision making by government and private parties, and stressed that the locus of a decision affects the incentives and feedback mechanisms of the decision maker, in ways that change the character of decision-making. In particular, he stresses that the important question of many resource decisions is not so much, *what* is to be done, but *who* is to make the decision, and subject to *what incentives and feedback*?

The double-standard — government as *deus ex machina*

In view of this complexity of incentives, economists are generally well aware that it is not legitimate to recommend socially desirable actions to a firm, and simply assume that the firm will take the suggested actions. No economist with any understanding of the theory of the firm would propose that a firm act according to some set of actions, and then blithely assume that the advice will be carried into effect, irrespective of the goals and incentives of the owners and employees. An economist who, for example, entreats a firm to avoid profit maximisation in order to pay above-market wages to its workers, would understand that this proposal might not be in accordance with the goals of the owner, and the resultant incentives of the management. To expect such a proposal to be carried into effect merely because it has been articulated as alleviating some social problem, and despite its mismatch with incentives, would be to abandon economic analysis, and treat the action as a *deus ex machina*.

In cases where the firm is connected to other firms, in the sense that other firms may influence its internal behaviour, it is also understood that this must be taken into account. The sensible economist, who gives advice to firms as to how they should operate, understands that the advice will be mediated through the goals and incentives of the principals and agents of the firm, and it may emerge in an altered form as a result of this. A recommended set of actions might be adjusted according to the goals and incentives of the principals and agents of the firm, as well as other influential outside parties.

This is all well-understood and well-appreciated except when it comes to government action. Economists who would laugh riotously at the prospect of advising private firms to sacrifice profits for some alternative social goal nonetheless earnestly advise government on actions without any regard to how that advice will be filtered through the incentives of the

tive costs of managing inter-firm transactions (including any lost efficiency compared to the use of market prices) versus the costs of conducting exchanges on the market using the price mechanism.

agents within the government apparatus, and associated lobby groups which can influence government action. In some cases they are entirely unaware of this institutional problem.

When economists undertake analysis of social problems it is frequently the case that they identify some alleged deficiency in the functioning of the free market (often relative to an idealised model of perfect competition among price-taking firms) and then prescribe a set of actions for government to intervene to correct the alleged deficiency. There is usually no analysis of whether the government can actually be expected to take the chosen actions as a result of the incentives operating on it, and how the prescribed action is likely to be altered by agents within the government, or within other firms that influence the operation of government.[2] In most cases it is regarded as sufficient to assume that, so long as the proposed set of actions yields an improvement in the social problem under consideration, then it is appropriate to advocate government intervention in the market.

This gives rise to a destructive double-standard in the way firms are analysed by many economists. For private firms there is usually appropriate scepticism of any proposals for action to alleviate social problems, since it is understood that such action may not be consistent with the incentives operating within the firm, and may be perverted by owners, managers, or subordinate employees. However, for the firm which calls itself the government, such scepticism is absent. Government is treated as an entity outside of economic analysis, giving rise to the "fallacy of government as *deus ex machina*". Such an approach is a repudiation of the very essence of economic thinking.

It is important to note how this fallacy plays itself out in destructive ways in public policy matters. When economists recommend government intervention in a market to perform some specific set of actions, designed to alleviate some social problem, the proposal has two elements. The first, and most important element, is the suggestion for intervention —i.e., the idea that it is proper for government to intervene in the market.[3] The second, and less important element, is the specific recommendation of the set of actions that the economist wishes the government to perform. When such a proposal is put forward it is common to see the recommendations of economists used publicly as support for government action, but the details of the specific actions or methods recommended are often too complex for public consideration. Once the need for government action is established, and made politically palatable to the electorate, the actions actually taken by the government are determined not by the economist, but by the process of decision-making occurring within the government, subject to all the incentives and interests of its internal agents, and any external interest groups that are able to mount pressure on these agents. In other words, the recommendation from the economist for a *specific set of actions* has the effect of helping to legitimise a certain set of *powers* of government, meaning that the government is then empowered to take a wider class of actions than those proposed. Once the proposal for government intervention in the market is made, the specific set of actions that were proposed will be mediated through the incentive operating on agents within the government. This is an unavoidable aspect of the fact that the government is itself an

2 Often it is also the case that the social problem is created or exacerbated by another set of government actions, but that is another matter.

3 Of course, in many cases, the government may already be intervening heavily in the relevant market. In such cases it is necessary to consider whether or not the suggestion for a specific kind of action by government implies endorsement of the intervention. In many (but not all) cases endorsement of government intervention in the market will be implicit in the proposal for specific actions.

economic entity which is subject to economic law.

A proper analysis of public policy issues, seeking solutions to social problems, must confront the fundamental institutional problem of how knowledge is transmitted in different kinds of firms and social institutions, and how decisions are made in those institutions. In dealing with such questions, it is crucial to consider the incentives and feedback mechanisms operating on decision-makers. When government is treated outside of this framework, as an entity *whose actions can be prescribed*, this is a recipe for intervention in the market on even the flimsiest pretexts.

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The More Things Change...

Perpetual Maladjustment

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Federal Reserve chairman Janet Yellen makes no apologies for raising the prices of stocks and bonds. It's all for the little people, she says. "We are trying help families afford things." What her employer really does is allow the bankrupt to keep operating.

Dr. Yellen claimed in a speech this spring, "Although we work through the financial markets, our goal is to help Main Street, not Wall Street." No doubt those who work at the corner of Wall and Broad, and reside in luxurious Greenwich smiled when they heard the chairman's comments. After all, the top ten percent of wealthy Americans now earn more than half the country's total income for the first time.

Securities prices soar with Fed's interest rate manipulation while the U.S. economy remains sour. Low rates haven't provided the cure. Perhaps, as Thorsten Polleit wrote on mises.org, the Fed's low interest rate cure is in fact the disease.

The new Federal Reserve didn't intervene when the economy plunged in 1920. Keynes had not yet penned *The General Theory*. Wages and wholesale price levels were left to crash.

The Fed's chairman was William P.G. Harding, a banker of all things, from Alabama of all places. He and the Board of Governors, in response to deflation, *raised* interest rates. The result, wrote Benjamin Anderson in *Economics and the Public Welfare* was: "In 1920-21, we took our losses, we readjusted our financial structure, we endured our depression, and in August 1921, we started up again. By the spring of 1923, we had reached new highs in industrial production and we had labor shortages in many lines."

Bankers don't direct the central bank anymore; it's a job for PhDs. Since Arthur Burns took the chairmanship during the Nixon administration, central banking has become macroeconomic central planning. Gone are the days of merely facilitating the banking system's seasonal liquidity needs. Ostensibly, job one is increased employment via money creation and lower interest rates. If big banks, auto companies, home builders, and government entities are saved from extinction the Fed figures its all the better.

Nobody remembers Mr. Harding and his quick solution to the 1920-21 depression. Fed chairman are now considered either the most, or second most, powerful person in the western world. Chairman Greenspan was knighted by the Queen and Ben Bernanke was Time's Person of the Year. Some are already calling Dr. Yellen the most qualified Fed Chairman ever. The more a chairman attracts fame, if not fortune, for their tinkering, the more the economy suffers.

What Dr. Yellen and her predecessors miss is the role interest rates play in providing signals to the marketplace and directing capital to its most efficient uses. With laissez faire capital flows to entrepreneurs investing in economic projects that in turn require labor. We don't know what jobs will be created, that will be dictated by consumer preferences.

The modern Fed cannot bring itself to do nothing. The Keynesians at the Fed think, as F.A. Hayek said in his Nobel acceptance speech, there "exists a simple positive correlation between total employment and the size of the aggregate demand for goods and services; it leads to the belief that we can permanently assure full employment by maintaining total money expenditure at an appropriate level." Hayek said he regarded this belief "as fundamentally false, and to act upon it, as we now experience, as very harmful."

This December it will be 40 years since Hayek told the economics profession as he accepted its highest honor, "We have indeed at the moment little cause for pride: as a profession we have made a mess of things."

The only Austrian Nobelist didn't live long enough to see a real mess of things.

These Fed-manipulated low interest rates keep the bankrupt--be it companies or governments--operating beyond their natural lives. These entities are preserved to continue wasting capital. Artificially low rates not only allow the inefficient to stay in business, but divert capital away from better operators.

Cash flow goes to service debt at the expense of making adjustments and investments to satisfy changing consumer demand. These entities will not rehabilitate, in fact, low market rates signal to them that they don't have to. Low interest rates signal lower risk and tell the borrower he or she is functioning efficiently when in fact that's not the case. Left to the market, interest rates will clearly differentiate the creditworthy from the bankrupt. When the Fed forces rates down, this distinction is blurred.

Ultimately, precious capital is squandered in the process as jobs are lost or not created in the first place. Businesses that weren't meeting consumer needs are kept in business while new entrepreneurs are excluded from managing these assets more efficiently.

Writing for the *Cato Journal* in 1986, professor Roger Garrison explained the individual elements of what he termed the Hayekian Trade Cycle Theory. Prices "convey essential information to each market participant," Garrison writes. These signals "provide the basis for economic coordination; price signals falsified by monetary manipulation create a basis for economic discoordination."

Interest rates dictate the total amount of investment and also the "pattern of investment." Lower rates encourage investment in the future. A central bank produced credit expansion "whets the appetite of producers causing them--collectively--to bite off more than they can chew," Garrison explains, taking on projects that can't be completed.

Low rates also encourage governments to expand budgets, pensions, and services to buy votes, biting off more than they could ever chew.

For instance, Greece, a country that restructured €200 billion in outstanding bonds to avert an economic meltdown two years ago, was able to issue bonds at yields below five percent in April, a fraction of the over 30 percent yields Greek bonds traded for in the crisis.

Puerto Rico, a territory that has been in recession for eight years, an unemployment rate exceeding 15 percent, with half the population living in poverty was able to float a record amount of debt earlier this year.

The country hasn't been able to make ends meet for more than a decade and owes about $87 billion including pension obligations. Yet, the municipal bond market is off to a great start according to Bloomberg, "as Puerto Rico's record $3.5 billion junk deal leaves demand for higher-yielding securities unslaked."

Less than financial powerhouses, Italy and Spain, are now borrowing ten-year money for just over three percent, not much more than the United States and Germany. The U.S. government itself is less than creditworthy, being the largest debtor in the history of the world. Last year, 71 percent of its new bond issuance was purchased by the Federal Reserve, yet, for the moment, it borrows at miniscule interest rates.

In the corporate debt world, "Investors Clamor for Risky Debt Offerings," announced the Wall Street Journal headline earlier this year. Investors put almost $3.5 billion in taxable high-yield bond funds and ETFs in the first quarter of 2014. "We're in an environment where the discerning eye of real credit investors has given in to the less discerning generic yield grab," Stuart Lippman, a portfolio manager at TIG Advisors LLC, told the WSJ.

Junk yield premiums have fallen to 5.4 percentage points, the lowest since 2007 and bond covenants are reflecting a borrower's market. "The Moody's Investors Service covenant-quality index, which rates high-yield bonds for investor protections, with 1 the highest score and 5 the lowest, fell to 4.14 in March from 4.05 in February," reports the WSJ.

Loose borrowing covenants and low yields have not dissuaded investors. According to the Bank of America Merrill Lynch Global High Yield Index the market for speculative-grade debt (junk) was near $2 trillion in April. The index began in 1997 and didn't reach $1 trillion in total value until 2009. Only five years later junk bond totals have doubled.

While speculative debt quantities explode, the quality deteriorates. "*For the first time ever*," The Elliott Wave Financial Forecast April edition pointed out, "two thirds of U.S. leveraged loans are covenant lite--loans with more liberal limits on collateral, payment terms and borrowers' income levels--

compared to just 29% reached at the height of the leveraged buyout boom in 2007."

Grant's Interest Rate Observer provided chapter and verse on the disconnect between risk and yield in its April 4th edition. Grant's mentioned the debt of casino operator Isle of Capri trading to yield just 5.50 percent, despite the company not generating enough operating income to cover interest.

Professor Garrison explained artificially low interest rates create intertemporal disruption with longer term projects financed at the expense of later stage goods. However, market participants are unaware of what effects monetary intervention has had on inputs. "Resources can be profitably misallocated in response to a distorted price so long as the resources are sold before the bust."

Investors in junk bonds must hope to sell before the inevitable crash. "After a protracted period of monetary manipulation," Garrison writes "the economy may well find itself considerably off course. The ensuing readjustments would confirm in the large--if not the small--to those that Hayek originally envisioned."

The economy on Main Street is certainly off course, while Wall Street lives in the Fed's lap of low interest luxury. Back in 1932, three years into another depression, the Nobel prize winner wrote in an essay included in *Hayek's Triangles: Two Essays On The Business Cycles*, "But, instead of furthering the inevitable liquidation of the maladjustments brought about by the boom during the last three years, all conceivable means have been used to prevent that readjustment from taking place; and one of these means, which has been repeatedly tried through without success, from the earliest to the most recent stages of depression, has been this deliberate policy of credit expansion."

The central bank forgot what it knew in 1921; to stand aside and let the market clear. Until modern central bankers heed that lesson and let maladjustments be liquidated, true recovery, and employment will have to wait.

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Adam Smith on Religion and Economics

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Abstract: Adam Smith has been studied over and over again on issues such as the invisible hand, the division of labor, specialization, free enterprise, etc. However, his contributions to the interface between economics and religion, which are also important, are less well known. Many of these contributions foreshadow such advances in economics as club goods, rational choice, and monopoly theory. The present paper is an attempt to focus on that aspect of this literature.

Keywords: Religion, economics, Adam Smith

I. Introduction

The field of Economics and Religion is starting to gain traction[1] years after its first exposure in Adam Smith's magnum opus *An Inquiry into the Nature and Cause of the Wealth of Nations* in 1776. The *Wealth of Nations* is mostly known for its theories of the division of labor and the "invisible hand" metaphor. He links the self-interest of the individual with the public interest of the entire society. However, Smith and the *Wealth of Nations* are less known for applying economic insights to the analysis of religion and its institutions.[2] Yet much has been written about this topic. This paper is an attempt to summarize this literature. How best to start this summary? It is with Smith's concept of the "invisible hand." That 18th century philosopher-economist thought that this invisible hand was God's hand.[3] There are of course other connections between Smith and religion, see on this below, but that might well be the best summary of this relationship.

Smith's views on religion are elaborated in Book V, Chapter I, Part 3, Article 3 of the *Wealth of Nations.* He considers the best method for the funding of religious institutions and states that the subsistence of teachers of these religious institutions depends "upon the voluntary contributions of their hearers, or they may derive it from some other fund to which the law of their country may entitle them; such as a land estate, a tithe or land tax, an established salary or stipend." He then considers the ideal situation for good religious institutions, the downside of the Catholic Church, and the best substitutes for this latter religious institution. These views and insights had been mostly neglected until the 20th century.

The literature surrounding religion and economics sometimes treats the former as an independent variable and sometimes as a dependent variable. According to McCleary and Barro (2006, 49) when "religion is viewed as an independent variable, a key issue is how religiosity affects individual characteristics, such as work ethic, honesty and thrift, and thereby influences economic performance." The most prominent proponent of this theory was Weber (1930), although earlier John Wesley (Maddox, 1998) held similar beliefs.

If analyzed as a dependent variable then the "central question is how economic development and political institutions affect religious participation and beliefs" (McCleary and Barro (2006, 49). Furthermore, if viewed as a dependent variable both can be broken down into supply-side and demand-side models.

Demand-side analysis includes the secularization and rational choice models. Secularization purports that the more developed a country is, the more secular it will be. The rational choice model was applied to religion by Azzi and Ehrenberg (1975).

1 It has gained so much traction that there are actually two separate scholarly endeavors in this category. One of them treats religion as an industry, and the separate types of churches, synagogues, mosques, etc., as competing businesses. The other, of which the present paper is a part, deals with the economic perspectives of leading spokesmen for these different "firms." A parallel may be found in psychology, wherein very distinct enterprises huddle under this label. For example, experiments with rats on the one hand, and the views of Freud, Jung, Ellis, etc., on the other. But then there is also educational psychology, evolutionary psychology (just to confuse matters, this is also referred to as sociobiology) and social psychology, which are all distinct from running rats through mazes and psychotherapy.

2 See on this the important work of Alvey, 2004, Oslington, 2011, 2012 and Otteson, 2011. See also Otteson 2000, 2002, 2006.

3 Mises, 1949, p. 147, fn. 3, supports this interpretation.

Because humans weigh costs against benefits, McCleary and Barro (2006, 50) state that "[Azzi and Ehrenberg's] model implies that time devoted to formal religious services and personal prayer will be high among persons with low value of time…" For example, older people may be more engaged in religious activity because their opportunity cost is low.

In this paper we follow the supply side model of Adam Smith known as the religious market model and his specific argument wherein Smith argues for competing religious organizations. According to McCleary (2008, 1) "permitting any and all religions to be practiced, the lack of state intervention (short of violence, coercion, and repression) creates an open market in which religious groups engage in rational discussion about religious beliefs."

Rosenberg (1960) was the first modern writer to address Adam Smith and religion. Since then, articles have been written by Levy (1978), Anderson (1988), and others. This work has subsequently led to much debate in the economics literature seeking to test and clarify Smith's views.

Smith was a pioneer in the field of economics and religion (McCleary, 2008) In his brief writing on this topic in the *Wealth of Nations* Smith manages to touch upon ideas and theories that would be prominent for centuries; for example, club goods theory, competition in the market place and the danger of state and religious affiliation. Sadly, this may be his most neglected contribution to economics.

This paper is divided into five sections in which we visit Smith's thought, the debate surrounding it and explain the arguments of the different sides. The two main disagreements occur between Anderson's (1998) interpretation and that of Leathers and Raines (1992). This is detailed in Section II. In Section III, we incorporate Iannaccone's (1992) theory of religion as a club good. In Section IV, we deal with Kirznerian and Rothbardian theories of entrepreneurship and monopolies respectively, explain what these have to do with the economics of religion and offer two major pitfalls in Smith's treatment of religious institutions. Section V, is our conclusion.

II. Different Interpretations

According to Rosenberg (1960) and Levy (1978), Adam Smith believed in competition in religion. However, Rosenberg reads Smith as believing that the price system's superiority "as a way of organizing economic life lay in the fact that, when it was surrounded by the appropriate institutions, it tied the dynamic and powerful motive force of self-interest to the general welfare" (p. 560). Therefore, the correct institutional structure had to be in place.

Anderson (1988) takes this idea a step further. According to him, "Smith was probably the first 'economic imperialist'" (p. 1067). This is the name given to those who apply economic principle traditionally thought to be outside the domain of economics. Examples include Buchanan and Tullocks' (1962) economic analysis of the incentives facing politicians in the political system and Becker's (1957, 1964, 1974A, 1974B, 1975, 1976, 1978, 1981, 1990) forays into an economic analysis of sex, marriage, crime, discrimination, sociology, human capital, fertility and punishment.

Anderson's statement is supported by an oft-neglected part of the *Wealth of Nations*. Smith, states Anderson, "was concerned with two basic problems: (1) the economic incentives involved in the individual's decision to practice religion and (2) the economic effects of different systems of religious belief as reflected in individual behavior" (p. 1068). Adhering to religious instruction regulates moral behavior, and also results in human capital formation and accumulation. Human capital (Becker, 1964) includes amongst myriad other things knowledge and skills gained through education, or work experience.[4] In fact Smith (1981 [1776]), states that "The institutions for the instruction of people of all ages are chiefly those for religious instruction" (p. 788)

Smith also favored many small sects rather than few large religious institutions:

> *"The teachers of each sect, seeing themselves surrounded on all sides with more adversaries than friends, would be obliged to learn that candour and moderation which is so seldom to be found among the teachers of those great sects, who [as a result of legal entry restrictions facing competing sects]… see nothing round them but followers, disciples, and humble admirers. The teachers of each little sect… would be obliged to respect those of almost every other sect, and the concessions which they would mutually find… convenient and agreeable… might in time… reduce the doctrine of the greater part of them to that pure and rational religion, free from every mixture of absurdity, imposture, or fanaticism…. This plan of ecclesiastical government, or more properly of no ecclesiastical government, [would tend to be] productive of the most philosophical good temper and moderation with regard to every sort of religious principle."* (p. 793)

Anderson says "this [passage] is probably the closest Smith comes in *Wealth* (or elsewhere) to arguing in favor of free-market anarchism" (p. 1074).

Leathers and Raines criticize Anderson's argument on the grounds of ambiguity. According to them it is ambiguous whether Smith believed in competing religious markets. Furthermore, Smith viewed established churches as inferior to free religious competition, but spoke favorably of established churches in Scotland, Switzerland, and the Netherlands. Leathers and Raines stated, "Moreover, several points raised in his discussion of established churches tend to qualify or contradict his argument for a 'supply and demand' approach to religion" (p. 504).

How can these perceived contradictions in thought be reconciled? According to Ekelund, Hebert and Tollison, (2005, 648), Smith asserted three key propositions. "Smith's maximand in religious markets was 'consumer sovereignty.'" Secondly, "Smith recognized that the good demanded (religion) was not homogeneous." And lastly, "Smith encased his views on religion within his own holist views of history and economics" (p. 648). These three propositions allow the debate surrounding what Smith really meant to be flushed out.

Laissez-faire among demanders of religion was the best choice in Ekelund, Hebert and Tollison's eye. However, when one, two, or three main religious institutions thrived he analyzed second best alternatives. In this way he was able to say, without contradiction, that "Presbyterianism was not perfect, but it was, from an economic perspective, better than most alternatives" (p. 655).[5] And Smith

4 We do not want to interpret Smith as an 18th century Chicago rational choice theorist. Placing Smith's writings in their 18th century context will tend to obviate any such interpretation. See on this Ross, 2010; Winch, 1996.

5 We can only speculate as to why he thought this. Perhaps it was because of the popularity of this

confirms this saying, "In [the clergyman's] own conduct, therefore, he is obliged to follow that system of morals which the common people respect the most" (p. 810).

The alternatives Smith considered included the Roman Catholic, Anglican, and Calvinist churches. These three were organized in a top-down, bureaucratic fashion. Presbyterianism, on the other hand, was structured in a bottom-up manner. Therefore, among the alternatives that existed in Scotland at this period, what appealed most to Smith was the internal organization of the Presbyterian clergy: "The equality which the Presbyterian form of church government establishes among the clergy, consists, first, in the equality of authority or ecclesiastical jurisdiction" (p. 809)

Ekelund, Hebert and Tollison (2005) showed that the debate was founded on inaccurate interpretations. The main question was "…how, under the constraints of establishment could preachers be relieved of indolence and greed while yet maintaining consumer choice and sovereignty?" (p. 654). The institutional mechanism of equality, freedom, etc. of Presbyterianism answered this question most satisfactorily and therefore, "It is accordingly in Presbyterian countries only that we ever find the common people converted, without persecution, completely, and almost to a man, to the established church" (Smith, p. 810).

Summarizing Smith's views, McCleary and Barro (2006, 50) state that the "literature argues that government regulation and subsidy influence competition among religion providers and thereby affects the nature of the religion product." While people may still believe in religion and things such as heaven and hell they may not "belong" or attend church. In other words they believe but don't belong.

Smith may well have preferred the bottom-up to the top-down management, but as far as compatibility with free enterprise, both are orthogonal. That is, each of these two is as fully consistent with laissez faire capitalism as the other. As long as both are voluntary, and do not engage in crony capitalist initiatives[6] that give one religious "firm" an advantage over any other, then whether they are centralized or decentralized matters not one whit. The orchestra is a very centrally planned undertaking. There is virtually no scope for initiative on the part of the musicians. The wind players are even told precisely when to *breathe!* In contrast, once the players are out there on the court, basketball and volleyball rely heavily upon individual creativity. Is the one compatible with the free market philosophy and the other not? If that is Smith's view, it is in error.

III. Club Goods

Recently, Iannaccone (1992), and Berman (2008) have analyzed religion using the club good approach. This theory views religion as an organization or institution that provides club goods. Club goods are non-rivalrous but excludable in their consumption and provide benefits such as religious instruction, and social networking and other such services. The Presbyterian Church may exclude these club goods through some sort of fee, sacrifice, or other method.

States Iannaccone (1992): "Krishnas shave their heads, wear robes, and chant in public; Jehovah's Witnesses refuse transfusions; Mormons abstain from caffeine and tobacco…" (p. 273). [7] Although the

religion at that time.

6 Sometimes called "rent seeking," but why anyone would want to sully a perfectly legitimate phase as "rent" by linking it to entry restrictions, favoritism and "crony" capitalism is beyond our ken. See on this Block, 2000, 2002.

7 The Amish, Chasidic Jews and other religious followers also adorn unique garb.

Presbyterian Church did not do such things, such as being strict Sabbatarians, it was able to gain a foothold because the competing Roman Catholic Church supported much more of these elements.[8] Furthermore, "Distinctive diet, dress, grooming, and social customs constrain and often stigmatize members, making participation in alternative activities more costly" (p. 276).

Berman addresses sacrifices in his paper stating that "our insights into rebel organizations flow from understanding *sacrifices* – acts that irreversibly destroy value such as circumcision, burnt offerings, or ritual bloodletting" (p. 1952).

It can be said that the Presbyterian church and Protestantism more generally was able to gain its foothold during the Protestant Reformation by doing away with complex rituals that raised the cost of belonging to the Roman Catholic church.

IV. Kirzner and Rothbard

Israel Kirzner has become famous for his pioneering work on the entrepreneur and the market process. He believes that "the driving force behind this systematic process (equilibration of the market) in what will be described below as entrepreneurial discovery" (1997, p. 62). For Kirzner, however, the Austrian market process depends not only on the entrepreneurial role but also on the role of discovery and rivalrous competition.

In a broad sense, Kirzner meant entrepreneurship as any human action. People act because they believe they have discovered profit opportunities. Here profit need not necessarily mean pecuniary or monetary profit, but could also mean psychic profits. In the view of Kirzner "…each entrepreneur seeks to outdo his rivals in offering goods to consumers (recognizing that because those rivals have not been offering the best possible deals to consumers, profits can be made by offering consumers better deals)" (p. 73). This meshes well with Smith's statement that:

> *"[The clergy of an established and well-endowed religion]… are apt gradually to lose the qualities, both good and bad, which gave them authority and influence with the inferior ranks of people, and which had perhaps been the original causes of the success and establishment of their religion."* (p. 789)

Whether they knew it or not, the reformers during the Protestant reformation were entrepreneurs and it is in this environment that the Protestant religion was able to gain footholds in various areas of Europe such as Switzerland, the Netherlands, and Scotland.

Leather and Raines (2008), however, argue that Smith disagreed that all competition among religious sects was beneficial. According to them, Smith believed in a regulatory role of government to ensure that religious fanaticism did not occur. Adam Smith believed the government should both leave religions alone and to make sure religions leave each other alone. In our view, this does not violate free-market competition in religion so long as there is voluntary entry and exit for religious demanders.

The Roman Catholic Church was also notable for the monopoly privileges that were often granted to it. According to Smith:

8 The Catholic Church also aligned itself throughout history with states. For example, Charlemagne ("The Christian Warrior") and the founding of The Holy Roman Empire. It also has engaged in persecutions such as the Spanish Inquisition. However, when it does this it ceases to be a club. See Block (2003), Stringham (2002). Of course, States also aligned themselves with the Roman Catholic Church (or against it). Causality runs both ways here. We owe last point to a referee of this journal.

"Such a clergy, upon such an emergency, have commonly no other resource than to call upon the civil magistrate to persecute, destroy or drive out their adversaries, as disturbers of the public peace. It was thus that the Roman Catholic clergy called upon the civil magistrates to persecute the Protestants, and the Church of England to persecute the Dissenters." (p. 789)

Kirzner's second condition was not entirely absent. However, once it did show its head, it was often violently suppressed. "This type of monopoly, stated Murray Rothbard (1962 [2001]), "can *never* arise on a free market, unhampered by state interference" (p. 591). It is safe to say that the Roman Catholic Church was a monopoly (though not in all places, nor in all regards) because it was granted "special privilege by the state" (p.591).

The Spanish Catholic church, for example, was strongly linked with the state and because of its wealth from South America was able to become stricter with commerce and religion. According to Trevor-Roper (1967):

"The Counter-Reformation State was generalized in Europe, above all, by the power of Spain. It is one of the great accidents, perhaps misfortunes, of history that it was the Castilian monarchy, that archaic "feudal" society accidentally raised to world power by American silver, which stood out, in the sixteenth century, as the champion of the Catholic Church, and thus fastened something of its own character upon both Church and State wherever their combined patronage prevailed. "This alliance between state and religious institutions Smith mentions in passing. For him, 'Times of violent religious controversy have generally been times of equally violent political faction. Upon such occasions, each political party has either found it, or imagined it for its interest to league itself with someone or other of the contending religious sects.'" (p. 791-2).

The market cannot have rivalrous competition then, and subsequently "induce dynamic entrepreneurship competition" without open entry to markets (Kirzner, p. 73). The market for religious goods is no less subject to this consideration than the one for automobiles or pens.

The Reformation found fertile soil in Scotland because religious entrepreneurs such as John Knox exploited with great effect free-entry into the religious market.[9] To wit, "In some countries, as in Scotland, where the government was weak, unpopular, and not very firmly established, the Reformation was strong enough to overturn, not only the church, but the state likewise for attempting to support the church" (Smith, p. 807). Conversely, with their assistance with the government's assistance "it was enabled, though not without great difficulty and much bloodshed, either to suppress altogether or to obstruct very much the progress of the Reformation in their dominions" (Smith, p. 806).

But Smith's views on these matters have not been without criticism. Rothbard (1995, 501) criticizes Smith on many grounds including that of entrepreneurship. According to Rothbard, Smith's "exclusive attention to

9 We have no evidence that this was easier in Scotland because of ill-feelings toward the English, and the link between the latter and the Roman Catholic and later Anglican churches. However, we regard this as highly plausible.

long-run equilibrium led [him] to toss out the entire entrepreneurship-and-uncertainty approach."[10]

Ahiakpor (1999), however, maintains that Rothbard misinterprets Smith on entrepreneurship (amongst many other issues). Ahiakpor (1999, p. 361) says "Yet Rothbard credits Smith with pointing out that 'the capitalist (the 'undertaker') *reaps profits in return for the risk*, and for interest on the investment for maintaining the workers until the product is sold- so that the capitalist earns profit for important functions.'" Smith veers from the path in that he says "There are two very easy and effectual remedies, however, by whose joint operation the state might, without violence, correct whatever was unsocial or disagreeably rigorous in the morals of all the little sect into which the country was divided" (p. 796). Immediately questions arise. Who is to decide what is unsocial? How is the state to "without violence" correct whatever it is that is unsocial, disagreeably rigorous, etc.? Smith suggests "the state might render almost universal among all middling or more than middling rank and fortune… probation… to be undergone by every person" for such and such a profession (p. 796).

V. Conclusion

We have detailed Smith's stance on religious competition and his belief in it. The debate that arose based on his remarks has made significant strides in clarifying matters. However, these issues are at best still only incompletely resolved.

The organization of the Presbyterian Church greatly appealed to Smith as a second best alternative in his theory of freely competing religious organizations and helped to demonstrate why the religious institutional structure was developed as it was.

We analyzed why the Presbyterian Church took hold in Scotland. The Roman Catholic Church had a monopoly in many places in Europe, but, Scotland was able to fight back because it was more freely open to competitive entry. This history fits nicely into a Kirznerian and Rothbardian theory of entrepreneurship and monopoly.[11]

For all his work on behalf of the free marketplace, Smith did not completely rule out a beneficial positive role for the state. He believed the government could furnish a link between the self-interest of the individual and the public interest of society as a whole. His non-state institutional mechanisms may have provided the answer to his failure to fully support free enterprise.

These non-state institutional mechanisms (competing religious organizations providing club goods, entrepreneurs seeking alternatives to those consumers didn't desire, etc.) have helped support arguments for anarchism. The state does not need to push for human welfare; it already moves in that direction better than any other institution.

Modern economic theory has further elaborated, debated and supported the economic analysis and conclusions about religion that were first formulated in Smith's *The Wealth of Nations* in 1776, so his views don't seem out of place even in the modern era. He hinted at the foundation of club-

10 Why is this section on entrepreneurship of relevance to our inquiry regarding Smith and religion? The link is that the essence, at least for us, of the connection between Smith and religion is his thought that the invisible hand is God's hand. However, in turn, the key element of the invisible hand is entrepreneurship. It is the entrepreneur, not anyone else, who is led by his self interest, his seeking after profits, to promote the public good. So, it is crucial, for our analysis, to delve into Smith's views of the entrepreneur, and critiques of it, and also defenses of it.

11 The latter two economists actually diverged with regard to their theory of monopoly. See on this Block (1977).

good theory by putting forth the view that individuals join organizations because of the goods they receive from membership and he foreshadowed treating the church or religious institution as a firm subject to the same laws of the free-market as any other. Both of these advancements would combine in the present day subfield of Economics and Religion.

These developments mentioned here should only serve to bolster Adam Smith's reputation as anticipating recent work in economic thought, including in the field of the economics of religion. (As Viner said, "It's all in Adam Smith.") Although "sophisticated" theories with highly mathematical language may have become the norm in economics, the fact remains: Adam Smith's economic analysis, and many of the greatest additions to it, is strictly qualititative, and yet very much adds to our store of economic analysis.

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Fiscal Effects of Central Bank Recapitalization

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Abstract: Monetary authorities enacted novel policies to exit the economic crisis of 2008. Fiscal backing of the monetary authority was important as central banks faced the growing threat of insolvency as unorthodox policies or political events, e.g., a potential Eurozone break up, allowed for central bank balance sheet losses. The fiscal authority has three options to support or recapitalize a central bank, with three resultant secondary effects. First, seigniorage can be foregone as notes and coins are given free of charge to the central bank for distribution (instead of the normal practice of selling them at cost). Second, the Treasury can halt profit remittances from the central bank to its own coffers. Finally, the Treasury can make a direct capital infusion to the central bank in the form of government bonds. We assess these options, and look at secondary effects on government borrowing rates and fiscal resources that result from a recapitalization of a central bank.

Keywords: monetary policy; fiscal policy; central bank independence; insolvency; joint analysis of fiscal and monetary policy

Introduction

The recent crisis of 2008 introduced novel monetary policies with some equally novel secondary fiscal effects. The threat of the zero lower bound (ZLB) for interest rates led central banks around the world to seek alternative stimulus measures. Hindered from provoking higher inflationary expectations, insufficiently low real interest rates hamper the central bank confined by the ZLB. As savers find themselves indifferent between holding low or negative yielding bonds and interest-free cash, aggregate demand is unable to be stimulated. The central bank finds itself in the midst of a liquidity trap.

The revival of deflationary fears has led economists to seek out new ways to implement monetary policy. While there is considerable agreement on how to avoid the liquidity trap, escape from its clutches once caught leaves much controversy (Svensson 2003: 149). Unorthodox monetary measures have left central banks exposed to balance sheet losses. In extreme cases some central banks have become insolvent, as in the cases of Zimbabwe and Tajikistan (Buiter 2008: 10), with others dangerously close as in the case with Iceland (Bagus and Howden 2011: 100). Speculating on the future, a breakup of the Eurozone may lead to the insolvency of the national central banks that are member of the Eurosystem. If Germany left the euro, a new Deutschmark (DM) would likely appreciate sharply. The liabilities of the Bundesbank would be constituted mainly by the monetary base of the new DM, while its assets, mainly TARGET2 credits denominated in euros, would depreciate, reducing the Bundesbank´s capital.[1]

A fiscal authority stepping in to proffer a recapitalization when cash flows are strained solves this insolvency problem. This paper assesses some secondary fiscal effects of exiting the liquidity trap through unorthodox monetary policies that threaten the central bank's solvency.[2]

Central bank independence, far from being the boon that many economists believe, actually limits monetary policy options during times of crisis. Fiscal assurances via the Treasury establish not only a broader range of policy options, but also an increased credibility that the central bank may successfully pursue them. Insolvency becomes less of a binding constraint, as an infusion of Treasury bonds can quickly and easily provide recapitalization.

Central bank insolvency has gained both exposure and importance during the present crisis. No longer confined to the developing world, the recent Icelandic example has demonstrated that economies highly indebted in foreign-denominated liabilities face the stark potentiality of going bust (Bagus and Howden 2011; Howden 2013a, b). Lacking a credible lender of last resort, central banks of countries with similar situations face impotency and eventual insolvency as they lack hard assets to enact monetary policy – countries such as Estonia, Hungary, Latvia, Lithuania and Serbia spring instantly to mind, but Britain, Luxemburg, and Switzerland could also find themselves at risk. Even well-developed central banks with reserve-currency status – the Fed and Eurosystem – face the possibility of insolvency (Bagus and Howden 2009a, b; Bagus and Howden 2014).

Existing literature on fiscal and monetary

1 We may view insolvency in two ways. Cash flow insolvency involves an inability to pay obligations as they fall due (more commonly referred to as illiquidity), while balance sheet insolvency involves holding liabilities in excess of assets. Rosa María Lastra (2007) and Buiter (2008: 5) assess the conceptual differences between these two types and implications thereof.

2 Mark Stone *et al.* (2011) provide a summary of unorthodox monetary policies, especially those that have a fiscal dimension to them in the post-2008 world

policy links has focused on four main areas of policy interaction (Svensson 2009): the effectiveness of fiscal stimulus on the real economy, the degree of Ricardian equivalence, the structure of public expenditure, and the distribution between expenditure increases and tax reductions. These areas overlook the secondary fiscal repercussions stemming from central bank insolvency or the threat thereof.

The impotence and eventual insolvency of the monetary authority implies – implicitly or explicitly depending on the country – a rescue by the fiscal authority.[3] As a monetary authority would only find itself insolvent under extreme and adverse market conditions, the fiscal authority will likely also be under pressure. We focus on three particular concerns resulting from a Treasury recapitalization of the central bank: 1) the shift of resources from conventional fiscal activity to central bank recapitalization, 2) the upward pressure placed on interest rates of Treasury debt stemming from the increased debt issued to fund the recapitalization, and 3) the effect of reduced government spending as fiscal spending is directed toward the central bank. Finally, as the inflated money supply will place upward pressure on prices prior to the Treasury recuperating the recapitalization funds, the effectiveness of Treasury spending is hampered accordingly.

Central Bank Recapitalization and Resource Shifts

As the outstanding liabilities of a central bank exceed its assets, or come dangerously close to doing so, a recapitalization by the Treasury augments its coffers with government debt. Assets would be replenished and monetary policymaking ability restored.[4]

The central bank generally acts as the fiscal agent to the Treasury. In the American system, the Treasury holds a checking account with the Fed through which federal tax deposits and outgoing payments are processed. The Fed sells and redeems government securities – Treasury bonds, notes, and coins – as part of this working relationship.[5] Specifically, the Bureau of the Mint and the Bureau of Engraving and Printing produce the United States´ money supply (notes and coins) and sell them to the Fed at cost (currently around 4 cents per note). The Fed then issues these notes through its member banks to the nation.

The Fed´s balance sheet assets are composed, historically and primarily, of U.S. Treasury bills. The Fed remits interest earned on these bills to the Treasury at year-end, net of operating expenses. For the Fed to become insolvent, it would need to suffer a loss on these assets. There are three manners which the fiscal authority can recapitalize a central bank nearing insolvency under such conditions.

First, the Bureaus of the Mint, and of Engraving and Printing, can sell coins and notes to the Fed for distribution at no cost.

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3 America's Federal Reserve System (Fed) operates with an implicit link to the Treasury. Recapitalization by the Treasury is a straightforward process, allowing the Fed to operate with increased assurance that future losses will not lead to insolvency. The European Central Bank (ECB), conversely, lacks this same insulation from market forces, leaving it with no automatic fiscal support availability. This results in relatively fewer options for "unconventional" monetary policy compared to its American counterpart.

4 We need not address the problem of central banks indebted in foreign-denominated or indexed liabilities. Maxwell Fry (1992), Bagus and Howden (2014) and Willem Buiter (2008) address recapitalization difficulties for central banks constrained by these conditions.

5 The Federal Reserve Act prohibits the Fed from buying bonds directly from the Treasury (with the exceptiozn of rolling over existing securities). From this the Fed gains an element of independence from the Treasury as it must turn to the open market to purchase government debt.

The Fed currently enjoys a profit spread on the difference between currency purchased from the Mint at cost, and sold to the banking system at par. This profit spread can be increased by decreasing the cost of money supplied to the Fed. The increase in Fed profits can be used to recapitalize itself, instead of being remitted to the Treasury at year end.

There are significant difficulties with this type of recapitalization scheme. First, it falls into the category of "too little, too late." Devastating effects may already have been incurred by the time a central bank suffers balance sheet insolvency, making this alternative "too late." Confidence or credibility in the central bank policies as well as currency may evaporate quickly as the quality of its balance sheet decreases (Bagus and Howden 2009a, b). In such circumstances, immediate and strong action is necessary to maintain confidence and credibility. Escape from a liquidity trap imposed by the ZLB involves a central bank credibly promising to be irresponsible with its future inflation path (Krugman 1998). With a full depletion of the central bank´s monetary policymaking abilities, this credible commitment will be lost with detrimental effects on future potential monetary policy – even in the case of a recapitalization. Recapitalization by this method will also be "too little" as it will only provide a diminutive amount of cash to the central bank. Annual seigniorage in the United States is approximately $25 billion annually, which currently amounts to less than 1% of the Fed's assets. If the Fed's cash flow problem is not too pressing, a gradual recapitalization by allowing it to keep this seigniorage will be possible. A more severe loss in the central bank's capital through asset losses will require a more substantial recapitalization measure than this method can provide.

More importantly for the analysis at hand is that any recapitalization by the Treasury will impose a cost on the nation´s finances. By selling currency to the central bank at cost, seigniorage normally collected directly by the Treasury will be forwarded to the central bank. This loss of Treasury funding will not be problematic provided that the central bank emerges solvent. Such a scenario merely shifts the Treasury´s budget constraint out into the future. Consider that the Fed remits all net-profit to the Treasury at year-end. If the Treasury gave notes and coins to the Fed at no cost (instead of its current 4-cent premium), the profit spread would still be remitted eventually to the Treasury: when the central bank returns to profitability these remittances to the Treasury would be resumed. The only adverse effect will be *when* the Treasury realizes the seigniorage profit on note and coin issuance. The increased seigniorage profits will allow the central bank to compensate for asset loses in the meantime.

Second, prior to the Fed entering insolvency a reduction or cessation of the remittance payment of its operating profits may be undertaken. The Treasury may forego the remittance of net interest earned on holding government bonds in order to recapitalize it. This remittance is best viewed as a tax on the central bank, as the amount and enforcement of the payment are controlled directly by the Treasury (Buiter 2008: 6). This remittance has been positive every year of the Fed´s existence, though this need is not always the case. The Treasury can make, at any time, the transfer payment negative (effectively eliminating it for a period). The result is a recapitalization mechanism that involves no structural changes to fiscal or monetary authority operating procedures, nor legislative changes to the scope of their operations. As this need not be solely a one-time occurrence, the Treasury can slacken the central bank´s

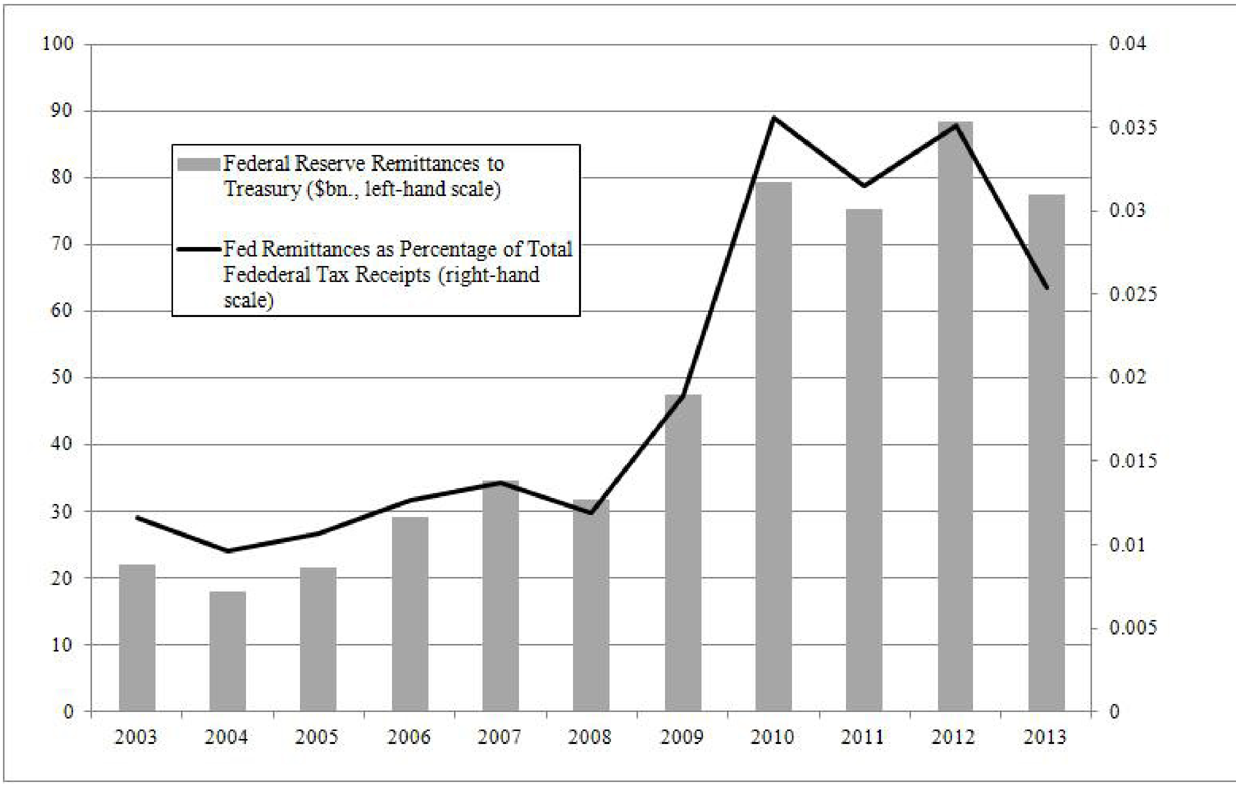

Figure 1: Fed remittances to the Treasury

operating constraint as a one-time aid, or as ongoing assistance.[6]

Two specific effects hinder the fiscal authority´s policy objectives. First are the losses incurred as a result of the lack of central bank remittances that are no longer forthcoming. The Treasury can normally expect a sizable funding source by these Fed remittances. Since 2010, for example, the Fed has remitted to the Treasury over $75 billion each year, and has accounted for approximately 3.5% of the Federal government's tax-sourced operated funds (figure 1). Although small in relation to the Treasury´s total budget, these remittances still represent a sizable funding source, especially during times of crisis. As the Treasury´s budget constraint is under considerable pressure during crises due to declines in other tax revenues, any additional funding source relieves its budget strain.

The corollary to this loss of funding is that interest paid on Treasury debt is increased if these remittances end. Foreigners and domestic agents purchase Treasury issued debt. When domestic savers increase their purchases they crowd out private investment. In either case – whether foreign or domestic savers purchase the bonds – interest must be paid accordingly. In the case of domestic savers, government bonds held by the Fed mitigate this effect. As the Fed remits all net profits back to the Treasury, any bonds held by the Federal Reserve System can be issued

6 Buiter (2004; 2005; 2007; 2008), Alain Ize (2005) and Sims (2004; 2005) provide detailed analyses of this mechanism to recapitalize the central bank by shifting its intertemporal budget constraint. This makes it possible that a central bank's present net worth be negative, while maintaining solvency provided the present value of future seignorage is greater than the sum of the future transfer payments to the Treasury and operating expenses (Buiter 2008). With the possibility of a negative transfer payment to the Treasury, a central bank's net worth will allow for continued operations.

essentially interest free (less the operating expenses of the Fed). The Treasury´s interest charge is reduced accordingly, allowing it to issue a larger amount of bonds (at the same interest charge) than would otherwise be the case lacking these Fed holdings.

As the Fed halts the net profit remittance to the Treasury, the Treasury finds itself paying an increased amount of interest on its outstanding debt. The Fed remitted $77.7 billion to the U.S. Treasury in 2013. A Treasury-enacted cessation of this remittance payment would decrease its own funding by the same amount in an attempt to replenish the central bank's capital.

Last, if the central bank finds itself to be balance sheet insolvent, the Treasury may find it necessary to recapitalize it directly. There are two specific avenues that it can pursue. First, a diversion of existing funds can be channeled to the central bank, thus replenishing its reserves. Alternatively, if funding cuts cannot be made anywhere else, the Treasury may decide to increase its debt issuance by the amount necessary for a recapitalization.

Diversion of existing funding creates a strain on the fiscal authority´s objectives. Either this diversion causes existing projects to accept budget cuts or proposed projects will need to be forgone. Depending on the specifics of the trimmed-down projects, drastic changes to the economy may result from this reduced fiscal spending.

These three recapitalization schemes – through foregone seigniorage revenue, forgone interest remittances or through a direct recapitalization – all negatively affect the Treasury´s finances. The latter alternative is especially controversial as it depends on what one´s beliefs are concerning the multiplier effect of fiscal spending. The first two, however, represent salient issues not commonly addressed. The loss of seigniorage, although minor, could represent a decrease in resources at exactly that time when it is least welcome. Alternatively, the increase in interest charges incurred on Treasury issued debt would occur as a secondary effect, with a tightening of the fiscal authority´s budget constraint. In all of these cases a transfer of funds from the fiscal to the monetary authority leaves the Treasury with a tightened budget constraint.

Interest Rate and Inflationary Effects on the Treasury

Central bank recapitalizations affect Treasury interest charges in two ways. First, halting the net profit remittances from the central bank effectively increases the amount of interest *paid* on Treasury debt. Second, an increased bond issuance implies upward pressure on prevailing interest rates.

While the U.S. Treasury collects less than 4 percent of seigniorage revenue today directly through currency issuance, almost 100 percent is indirectly collected through the Fed´s net profit remittance. The Treasury can use this seigniorage as a means to reduce the burden of the national debt (Thomas Sargent and Neil Wallace 1981; Douglas Waldo 1984; Wallace 1984). An informal, and indirect, tax is placed on currency users with the proceeds funneling to the Treasury´s coffers for eventual use. Any revenue from a tax on the monetary base (i.e., seigniorage), however, is in modern economies a small fraction compared to the size of total government revenue.

Alternatively, the decrease in purchasing power is an additional type of seigniorage that can be used as a means to reduce the burden of the national debt (Jeremy Siegel 1979: Robert Eisner and Paul Pieper 1984). The absolute size of the government´s debt is generally many multiples larger than the size of the monetary base being inflated. Inflation-induced changes in the real value of debt will far outweigh the revenue effect from direct seigniorage.

There is one specific result of monetary policy at the ZLB that affects fiscal policy in previously unexplored ways. To decrease real interest rates sufficiently, the central bank must provide an inflationary shock, or, at the very least, the expectation that future inflation will prevail. One significant problem with private sector beliefs at the ZLB is that they are not easy to affect (Svensson 2003: 150). Svensson´s (2003) "foolproof" way exit the liquidity trap at the ZLB largely relies on credible central bank inflationary threats. Particularly, it must commit to continued and elevated inflation targeting as a way to exit the situation successfully.

Somewhat paradoxically, credibility is largely a product of track record. One significant problem with the focus on credibility is that a central bank builds credibility by pursing low inflation targets, not high ones (Marvin Goodfriend 2007: 63). Most central bankers undertake large efforts trying to anchor consumer expectations to low inflation rates creating problems when they try to change them to the upside. Credibility is also a product of transparency and competence (Moscarini 2007). With the aid of the fiscal authority both of these are easily changed. What is needed is the credibility to act irresponsibly: a large amount of resources are necessary to signal this possibility. Anyone can act irresponsibly; to do so *credibly* and in a controlled manner (i.e., not triggering hyperinflation) requires resources (Peter Stella 2005). Besides the existing assets of the central bank, the fiscal authority can provide these resources.

The return to inflation that is essential for the continued operations of the fiscal authority rests in the hands of the central bank. Credibility is the key. There is no better way to ensure credibility of this institution than by having a guarantee that it will continue on its chosen policy path, regardless of the circumstances. Specifically, a central bank will undertake operations that are typically viewed as detrimental to the solvency of its balance sheet. By guaranteeing the central bank against insolvency, the fiscal authority can increase confidence among market participants that the central bank´s words will be put to action: it will be able to not just talk the talk, but also walk the walk when the time arises.

To some it may seem paradoxical that a Treasury backed by the wealth of a nation would place its own assets at risk by guaranteeing such an undertaking. It is precisely because the central bank´s inflationary policy reduces the real value of its debt that the fiscal authority´s own longevity is promoted. Unconditionally supporting the central bank is in its best interest.

In a typical "tit for tat" arrangement, the Treasury can give the central bank the ability to act irresponsibly, thus mitigating the credibility issue. In return, the Treasury will see the real value of its nominally-denominated debt reduced through the prolonged inflation provided by the central bank's newfound source of irresponsibility.

Aggravating the Phillips Curve

Unanticipated money supply shocks cause real effects due to sluggish short-term price changes. *When* you receive access to increased funds via an inflated money supply matters almost as much as *if* you get access to these funds at all. Normally, the Treasury allocates funds directly for its own fiscal projects. As it is a primary user of these funds, an unperceived increase in the money supply will allow it to conduct fiscal policy at existing prices. These prices will be lower than the future inflated prices. Consequently, the fiscal stimulus may have a strong initial effect, as the Treasury is able to allocate funds to projects before the price changes caused by its actions have taken effect. This is one justification for the existence of the short-run Phillips curve whereby inflationary pressures boost short-term output in government-approved projects.

With funds previously earmarked for fiscal projects redirected to the monetary authority to prevent insolvency, the situation is altered. Now a portion of Treasury funding no longer enjoys the first-mover advantage regarding price changes. The central bank gains access to the newly appropriated funds and this will only filter its way to the Treasury later. The recapitalization of the central bank will have occurred with the implicit reason of saving the financial system from meltdown and contagion. If this also salvages the financial system, the funds will eventually find their way back to the Treasury's coffers through tax revenue.

This process may require, however, a prolonged amount of time. The current crisis, for example, has seen an increase in excess bank reserves. The unique outcome is that the increase in excess reserves are surely being held because of increased uncertainty.[7] This is also exactly what the Treasury would like to see done with the assets that the Fed has purchased to expand its own balance sheet. While the Treasury is not currently receiving any stimulus from these excess reserves, it will eventually be able to realize increased tax revenue once the reserves are lent out and invested.

In the meantime the Treasury will be forced to make do with decreased fiscal policy effectiveness. Instead of being the first user of any increased funds in the money supply – e.g., through an increase in government debt issuance, the Treasury will only become a later user. This later date involves the crux of the problem as it may imply an inflated price level that. As a result, a dollar of fiscal policy will not go as far as it did before. The decrease in the purchasing power of a dollar through inflation reduces the effectiveness of fiscal policy accordingly.

To the degree that more Treasury funding must be allocated to the central bank to avoid insolvency, fiscal stimulus will be of reduced effectiveness. Inflationary adjustments between the time the Treasury recapitalizes the central bank and when it finally recuperates this "investment" will place upward pressure on the price level. Each dollar of fiscal stimulus will have a diminished effectiveness compared to if it were used directly on fiscal activity.

A Conclusion, and a Melding of Policy Options

The zero lower bound of interest rates creates a liquidity trap; monetary policy by itself is unable to perform its stated goals. This paper has reviewed some of the more salient features that collaboration between monetary and fiscal authorities implies, and which have been largely overlooked until now. One result of recent unorthodox monetary policies is that several central banks are now facing the possibility of balance sheet insolvency, while many others are faced with the possibility that their policies will be sterile in light of the ZLB.

With the threat of central bank insolvency looming large, three effects will hinder fiscal authorities as they recapitalize their monetary counterparts.

First, the Treasury can shift resources to

7 Alternatively, Todd Keister and James McAndrews (2009) provide evidence that the total level of reserves held is not endogenously determined by the banking system, but is exogeneously determined by the Fed. The high level of excess reserves tells us little about individual bank expectations, but much about the size of the Fed´s initiative.

the central bank during a recapitalization in one of three ways.

1) The Fed purchases notes and coins directly from the Bureau of Minting at a fraction of its cost. The seigniorage profit it earns on the difference is usually remitted back to the Treasury at year-end. Remittance of seigniorage can be halted in the event of a required recapitalization. The result is a reduction in one funding source that the fiscal authority currently enjoys (albeit, a relatively small source).

2) The Fed remits net profits, including profits earned on government debt, back to the Treasury at year end. The Treasury may gradually recapitalize a central bank by halting this payment, allowing its balance sheet to be rebuilt slowly. A significant funding source will be lost in this case, and the Treasury will have to either find alternative funding sources (e.g., higher taxes) or decrease fiscal outlays to compensate.

3) Central bank insolvency may be so imminent that a direct recapitalization by the Treasury seems warranted. Indeed, some central banks may now find themselves near to this position. This decrease in Treasury resources will imply, as in the previous outcome, either increased deficit spending or decreased fiscal stimulus. If the former option is pursued, the Treasury must be prepared to issue bonds at higher interest rates than before. A strain on Treasury funding occurs exactly when a recession has already caused other funding sources – mainly the tax base – to decrease.

The second effect hindering the fiscal authority as it recapitalizes its monetary counterpart is that when constrained by the ZLB, fiscal support aids central banks and gives their policies credibility. Commitment to pursue reckless monetary policies is one of the few ways that a central bank can escape a liquidity trap. A lack of success implies either failure (as the best-case scenario) or insolvency (in the worst-case). By guaranteeing a central bank, the fiscal authority can help ensure that the central bank achieves its inflationary goals. In return, the fiscal authority receives a continual reduction in the real debt burden through inflation.

Finally, we have seen that any Treasury recapitalization of a central bank will imply reduced effectiveness of its fiscal policies. As the price level will adjust prior to undertaking any fiscal investments, each stimulus dollar will have reduced effectiveness compared to if the Treasury had used it directly.

A Treasury recapitalization of the monetary authority may not be necessary, as there is one unexplored alternative still open. The central bank may pursue an unorthodox, and wholly fiscal, procedure of assigning a tax to the money it issues. In this way, it may recapitalize itself without external assistance. More importantly, the Treasury can avoid any negative fiscal effects if such a path is pursued.

How would such a tax work? Buiter and Nikolas Panigirtzoglou (1999), Goodfriend (2000) and Buiter (2009: 25-28) propose taxing monetary transactions and bank reserves. Such a tax allows for negative nominal interest rates, which may allow the central bank the ability to use negative real interest rates to escape the liquidity trap.

Although offering much aesthetic appeal, this solution is less than feasible. While this option is technically possible on electronic transactions and bank reserves, consumer cash usage is decidedly more difficult to tax. Technological innovations such as notes embedded with electronic chips or a lottery to determine what numbered notes in a series to be retired each period may make this option available someday (Svensson 2003: 154). Fiat money derives its value from the public's acceptance as a medium of exchange, aided by its status as legal tender. A critical degradation in fiat money's acceptability may occur if some notes are systemically deprived of their legal tender status, with detrimental effects on its value. Additionally, such an action would create great inconveniences in differentiating between notes of the same denomination, but trading at different discounts. Public resentment toward a system making one person's dollar bill worth more than another's also adds a flavor of political infeasibility.

Until such a time that the monetary authority is able to implement fiscal policy directly and independently, we will have a separation of the functions. Given this limitation, we see a clear motivation for collaboration between the fiscal and monetary authorities, especially when constrained by a crisis.

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James Buchanan and Contractarian Anarchy

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Abstract: This paper traces the normative side of James Buchanan's individualist-subjectivist-contractarian position. The literature on anarchy and radical self-governance treats Buchanan's position, and social contract theory more generally, as a rival rather than allied branch of analysis. However, I argue that Buchanan's normative position, if taken to its logical conclusion, yields conclusions commensurate with anarchy. Buchanan's theory of individual sovereignty suggests that political action is justified only to the extent that it adheres to a social contract that meets the requirements of conceptual unanimity. It also suggests individuals have the right to secede from communities they feel no longer adhere to the social contract. These beliefs form the foundation of a social contract theory deserving the label "anarchic."

Keywords: anarchy, Buchanan, federalism, individualism, secession, self-governance, social contract, sovereignty

"To the individualist, the ideal or utopian world is necessarily anarchistic in some basic philosophical sense." — James Buchanan

1.Introduction

Is the contractarian political economy of James Buchanan at odds with anarchy, i.e. self-governance in absence of a sovereign? James Buchanan's own writings on the subject seem to answer a definitive "yes." In Buchanan's (1972) analysis of the protection of property rights under anarchy, he argues that prisoners' dilemma scenarios abound. The way "out of the jungle" is through the contract theory of the state, which, in providing an external enforcer, can sustain the Pareto-superior equilibrium associated with property rights protection. He is even more explicit in his most extensive treatment of the subject, *The Limits of Liberty*. Buchanan (2000 [1975]: 5-6) acknowledges that an anarchic society, where nobody holds coercive power over any other, is a worthy ideal but cannot be realized in practice: "The anarchist utopia must be acknowledged to hold a lingering if ultimately spurious attractiveness. Little more than casual reflection is required, however, to suggest that the whole idea is a conceptual mirage…If there is even one person who thinks it appropriate to constrain others' freedom to their own life-styles, no anarchic order can survive in the strict sense of the term." Having ruled out the possibility of "ordered anarchy," Buchanan proceeds to elucidate his version of contractarian political economy. What follows is a delicate balancing act between the choice of rules during the "constitutional moment" wherein the enforcement and dispute resolution rights of individuals are ceded to the state, and the difficulty of constraining the state to its constitutionally-mandated activities once such power has been granted. Although Buchanan's later writings suggest he thought the case against ordered anarchy might not be as open-and-shut as he previously supposed (e.g. Buchanan 2004, 2005), he remained a staunch social contractarian.

The modern literature on the political economy of self-governance has largely agreed that Buchanan's contractarianism (and social contract theory more generally) is a competitor to, and not reconcilable with, ordered anarchy. The response essays in Stringham (2005) and the literature surveyed in Powell and Stringham (2009) largely focus on mechanisms that enable social cooperation under the division of labor to proceed, and even flourish, without a monopoly enforcer. While the extent to which these results are generalizable is hotly debated, the conclusion of this literature with respect to Buchanan's work is clear: There is no need for a hypothesized "constitutional moment" where the rules of the game are formally set. The claim that the market process cannot be the source of its own order is, at least in certain settings, demonstrably false (Boettke 2005).

The incompatibility of Buchanan's social contractarianism and ordered anarchy affirmed above resulted from differing positive positions in political economy. But does this conclusion hold if we turn our attention to the normative side of Buchanan's works? Buchanan often described himself as a "philosophical anarchist," a position that is evident in his sympathy with the normative vision of a radically free society. This stems from Buchanan's normative dedication to the sovereignty of the individual:

> *"The justificatory foundation for a liberal social order lies, in my understanding, in*

the normative premise that individuals are the beings who are entitled to choose the organizational-institutional structures under which they will live. In accordance with this premise, the legitimacy of social-organizational structures is to be judged against the voluntary agreement of those who are to live or are living under the arrangements that are judged. The central premise of individuals as sovereigns does allow for delegation of decision-making authority to agents, so long as it remains understood that individuals remain as principals." (Buchanan 1999: 288)

Buchanan's emphasis on agreement is the normative foundation for his contractarianism, and thus the exchange of rights and duties during the constitutional moment during which the social contract is drafted. His position is noteworthy when juxtaposed with the two most popular works on society without a sovereign. Rothbard's (1982) *The Ethics of Liberty* and Friedman's (1989 [1973]) *The Machinery of Freedom* provide a natural rights and consequentialist defense of a society without a sovereign, respectively. Buchanan's dedication to individual sovereignty prevents him from embracing a theory of the good external to the evaluations of individuals. Rothbard's theory, founded on natural law that commands the assent of all based on reason, and Friedman's, which rests on evaluation of consequences by someone external to the social process, thus are unacceptable to Buchanan.

Buchanan's positive disagreements with these works are well-documented (Buchanan 1974, 2000 [1975]: 9), and this disagreement itself has normative implications. Rothbard assumes that the moral law will command universal assent (or else hostile actions from those who do not assent to the moral law will be crushed by those who do), resulting in a uniform legal code across society. Friedman instead considers legal pluralism, with agreements between competing defense agencies yielding heterogeneous law. It is important to realize, regardless to what extent legal structures as envisioned by Rothbard or Friedman can actually exist, that competition in legal code provision resulting in libertarians' vision of a free society is a hypothesis, not a conclusion.[1] Given this, it is worthwhile to consider to what degree Buchanan's normative position is compatible with a free—that is, anarchic—society.

I will address this question by taking Buchanan's normative priors of individual sovereignty and contractarianism-from-agreement and pushing them to their logical conclusion. I will not attempt any defense of these priors, instead focusing on where the logic of Buchanan's position leads. The exercise is heavily influenced by Lomasky's (2005) "Libertarianism at Twin Harvard" and Stringham and Zywicki's (2011) "Hayekian Anarchism." Lomasky's paper, which explores the degree to which Rawls' and Nozick's social theories can yield the conclusions of the other, motivates my concern with examining whether Buchanan's normative position can result in conclusions more popularly held by Buchanan's social-intellectual "adversaries." Stringham and Zywicki's paper, which shows how Hayek's arguments can be used to support conclusions Hayek explicitly rejected, provides intellectual symmetry to my attempt to separate Buchanan's personal conclusions from the conclusions one can reach by following Buchanan's position to its logical conclusion.

Having outlined and motivated the paper's thesis, in the next section I will elaborate on Buchanan's normative priors. In Section

1 For example, people may be willing to pay more for paternalistic laws than those who oppose them are willing to pay to defeat them.

3 I discuss the federalism and exit in post-constitutional choice, showing how they can yield an anarchist social contract. In Section 4 I anticipate possible objections. In Section 5 I conclude. While I occasionally may discuss positive aspects associated with these ideas, it is only because I will use them to better elaborate the normative issues involved.

2. Foundations

The foundations of public choice economics and the economics of nonmarket decision making—methodological individualism, rational choice, and politics as exchange—laid down by Buchanan and Tullock (1999 [1962]) are primarily known as the “tight priors” of modern political economy. However, these premises can also be treated as the foundations of Buchanan's normative individualism-subjectivism-contractarianism. This section explores these foundations as laid out in Brennan and Buchanan's (2000 [1985]: Ch. 2) treatment of the normative presuppositions of constitutional political economy.

Brennan and Buchanan first make the important distinction between noncontractarian and contractarian constitutionalists (Brennan and Buchanan 2000 [1985]: 24-25). This point is crucial since the distinction highlights the authors' commitments to individualism. For example, one could be a natural law constitutionalist, or a conservative constitutionalist. These positions would recognize the distinction between the choice over rules on the one hand, and strategic behavior within the established rules on the other. But their normative justification for the established rules of conduct arises from “right reason” in the first case, and tradition/evolutionary selection in the second. In contrast, “[t]he critical normative presupposition on which the whole contractarian construction stands or falls is the location of value exclusively in the individual human being” (Brennan and Buchanan 2000 [1985]: 25). Any source of values external to the individual evaluator is not permitted. This core proposition simultaneously roots the individualism and subjectivism of contractarian constitutionalism.

Of course, society is made up of many individuals. If the source of value lies in the individual, how are different individuals' values, which almost certainly will differ, to be reconciled? Privileging one individual or group of individuals over others, by virtue of their virtue, enlightenment, etc., cannot be permitted, since this implicitly abandons the subjectivism-individualism prior. Each individual, then, must be treated equally: “Consistency requires that all persons be treated as moral equivalents, as individuals equally capable of expressing evaluations among relevant options” (Buchanan and Brennan 2000 [1985]: 26). The way forward is the establishment of the basic framework of rules by unanimous consent. Individuals in equal moral standing, in laying down the rules, in effect exchange rights and privileges to arrive at the institutional framework that structures subsequent activity.[2]

These presuppositions are used to ground the normative legitimacy of the state. But already it is obvious that Brennan and Buchanan are using “state” in a slightly idiosyncratic manner (Brennan and Buchanan 2000 [1985]: 26). The

2 Unanimity as the ideal for establishing the rules of collective action need not extend to unanimity as the decision rule within collective action processes itself. In fact, individuals almost certainly will decide unanimously not to require unanimity at the post-constitutional stage, given such a requirement necessitates high decision-making costs (Buchanan and Brennan 2000 [1985]: 32; see also Buchanan and Tullock 1999 [1962]).

normative foundations of their politics-as-exchange paradigm legitimizes institutions and practices of collective action, but their ultimate justification cannot be found anywhere other than the intersubjective agreement of the participating individuals. The state is not sovereign; nor is any of its subsidiary organizations. Individuals retain their sovereignty, and the institutions of the state must be justified by the appeal to (at a minimum) hypothetical consent.[3] This conception of sovereignty is, at the very least, out-of-step with much of the post-Westphalian conceptions of sovereignty, and even the narrower subset of democratic theories of sovereignty that vests sovereignty in "the people" in their collective, rather than individual, capacities.

In particular, the role that unanimity plays in the analysis distances Brennan and Buchanan's conception of sovereignty and the state away from more familiar formulations (e.g. Brennan and Buchanan 2000 [1985]: 26). The legitimacy of the vehicle for collective action rests on the agreement of *all* parties involved at the constitutional moment. This follows naturally from contractarian priors. A contract, in order to be legitimate, requires the parties to that contract to have entered voluntarily. If the social contract, which justifies the vehicle of collective action, is to be anything other than an inappropriate metaphor, it too must be voluntarily adopted. In line with the refusal to privilege one individual or group of individual over others, the social contract must be voluntarily accepted by all.

3. Enforcing the Social Contract—Federalism and Exit

The established social contract serves two related functions in Buchanan's framework. The first is the institutionalization of predictability. Individual behavior is extremely difficult to anticipate, absent some shared social norms (formal or informal). The social contract, by specifying the particular rules that will then govern the socioeconomic "game," enables individuals to anticipate how others will behave, which in turn enables them to reach higher-welfare outcomes. It is important to realize that, in many cases, the content of the rule is much less important than the codification of the rule, per se. This is the case in many social interactions characterized by coordination games, as Brennan and Buchanan (2000 [1985]: 10-16) show using the example of traffic rules. The nexus of agreement formed by the exchange of rights at the constitutional moment serves as the establishment of a formal focal point, future reference to which enables mutually beneficial exchange among individuals.[4]

The second function is the normative analog of the first. Since the social contract was reached (or was so conceptually, at least) via the unanimous consent of individual sovereigns, it commands normative assent for the same reason that any other contractual arrangement voluntarily entered into commands normative assent.[5]

Buchanan's concerns do not end here, however. Even after an "ideal" scenario, there is the very real possibility that the institutions of collective exchange will overstep

3 As Buchanan (2001 [1977]: 404) said in an earlier paper: "Ultimately, the social contract offers the *only* bridge between the consent of those who are governed and the possible or potential legitimacy of the entity that purports to exercise powers of governance" (emphasis added).

4 Leeson (2009) demonstrates that the contractarian basis for governance, rather than being a mere analytic device, has historical relevance.

5 In "The Libertarian Legitimacy of the State," Buchanan (1977) counters Nozick's entitlement-distribution justification of the minimal state with his own contractarian perspective.

their bounds. The troubling possibility of an unrestrained Leviathan is a major concern of Buchanan's research agenda (see the second half of *Limits of Liberty*, for example). Buchanan is no naïve constitutional fundamentalist. He understands the social contract will not enforce itself. There are thus positive and normative concerns with ensuring that the contractually-established institutions of collective action do not overstep their intended bounds and begin working for special interests at the expense of the (individually-evaluated) welfare of all.

Since by definition there is no organization that can keep the outcomes of collective action within the initially-agreed bounds without itself being subject to capture by special interests, the enforcement of the social contract falls to those who are party to it. Buchanan's contributions to our understanding of political federalism, especially the essays late in his career, provide insight as to how he envisioned this to be achieved. Buchanan (2001 [1995]: 69) explicitly puts forth federalism as a mechanism for reducing the possibility of political exploitation, and argues in favor of a federal governance structure during the constitutional moment. Buchanan has in mind constitutional provisions that severely restrict the central government's "domain of action" (Buchanan 2001 [1995]: 70). The central government would be strong enough to prevent the several local territories from enacting policies preventing the free flow of resources across borders, but other than this would have a very limited sphere of activity.

But this is still begging the question. What exactly prevents the central government from growing beyond its constitutional limits and encroach on the territory of the several sub-polities? Buchanan's answer here is crucially important, since it provides the link between the familiar theories of contractarianism and defenses of self-governance:

> The separate states, individually or in groups, must be constitutionally empowered to secede from the federalized political structure, that is, to form new units of political authority outside of and beyond the reach of existing federal government. Secession, or the threat thereof, represents the *only* means through which the ultimate powers of the central government might be held in check. Absent the secession prospect, the federal government may, by overstepping its constitutionally assigned limits, extract surplus value from the citizenry almost at will, because there would exist no effective means of escape (Buchanan 2001 [1995]: 70-71, emphasis added).

Buchanan's defense of secession in the context of federalism is so important because he openly admits it is the only real check the sub-polities have against the central government. In the remainder of the article, Buchanan discusses the impacts of federalism in positive terms based off of the analytics of Tiebout (1956), but he is never far from the normative consideration he spells out early in the paper, i.e. the prevention of the exploitation of the citizenry.[6,7]

Buchanan's discussion of secession is important because it highlights the extraordinary differences arising from alternate conceptions of democratic sovereignty.[8] Traditional conceptions of

6 See also Buchanan (1995/1996) and Buchanan (1996) for similar arguments. The earlier piece is interesting due to the discussion in the Postscrip. Here Buchanan engages in a brief dismissal of anarchy, instead arguing for the maximization of individual sovereignty. As I will argue later, this distinction is largely superficial.

7 One could think of the resulting group of decentralized polities as a network of governance "clubs." Leeson (2011) considers questions of constitutional effectiveness in clubs vs. governments. Leeson and Coyne (2012) employ a framework for comparing the efficacy of social rules with and without government.

8 I am using "democracy" in its Tocquevillian sense, meaning "self-governance" rather than the far

democratic sovereignty vest sovereignty with the undifferentiated mass of the coalition-carrying collective, typically a majority. Secession under this theory of sovereignty is either outright forbidden, or requires the explicit consent of the ruling powers-that-be. In contrast, Buchanan's conception, which vests sovereignty always and everywhere in the separate individuals party to collective action, affirms the viability and permissibility of genuine exit as a mechanism that is normatively reflective of (and positively effective in the realization of) individual sovereignty. The only consent required is the consent of those who wish to secede, achieved through whatever method the social contract stipulates.

But conceptually, how large must the subset that wishes to secede be? Given Buchanan's dedication to individual sovereignty, it seems there is only one answer consistent with his normative framework. Rothbard (2004 [1962]: 1051), in asking the question, provides the answer:

> If Canada and the United States can be separate nations without being denounced as being in a state of impermissible "anarchy," why may not the South secede from the United States? New York State from the Union? New York City from the state? Why may not Manhattan secede? Each neighborhood? Each block? Each house? Each person? But, of course, if each person may secede from government, we have virtually arrived at the purely free society, where defense is supplied along with all other services by the free market and where the invasive State has ceased to exist.

The questionable viability of Rothbard's dichotomy in the final sentence aside, he has arrived at a critical insight. If it is the case that the only normative legitimacy for what we call "politics" lies within a framework of established rules that must, at minimum, command conceptual unanimity, and if the "right of secession down to the level of the individual" is upheld, it seems in a very meaningful sense we have arrived at contractarian conception of anarchy. Instead of being opposed to radical self-governance, the social contract—at least normatively—properly constructed becomes a mechanism by which it may be achieved.[9]

more common (and more narrow) "one man, one vote."

4. Possible Objections

Several objections can be raised to the line of argument I have drawn. I will address those I perceive as the most damning here. First, and most obvious, individuals in an actual or hypothetical constitutional moment may unanimously choose to vest sovereignty in "the people," conceived collectively. In short, individual sovereigns might renounce their sovereignty. As mentioned before, this would severely curtail, if not outright eliminate, the normative justification for secession. Secession is the final plank on the bridge to contractarian anarchy; without it, contractarian anarchy falls apart.

Buchanan implicitly addresses this argument in a different context. In likening the establishment of an authoritarian social contract to a slave contract, Buchanan (2001 [1987]: 171), rejects the legitimacy of such a contract. Slavery contracts are invalid, according to Buchanan, "because [they] do not allow for a post-contract viable exit option". As such, it does not represent an acceptable exchange of rights. Individual sovereignty simply cannot be renounced.[10] While this

9 Despite their hostility to traditional social contract theories, de Jasay (1997, 2008) and Narvson (2002, 2008) can be read as "fellow travelers" of this line of thought.

10 Those familiar with the natural rights literature will have encountered similar arguments, although Buchanan obviously is not using natural rights as the

point is not ironclad, the implied symmetry to contracts in general (in which parties exchange titles and/or rights, frequently with contingency clauses specifying punishment for parties that do not meet their obligation(s), *but still allow parties the option to break the contract and incur this punishment*) is consistent with Buchanan's "politics as exchange" normative hard core.

Second, relationships between new and old communities post-secession are under identified. Presumably, subgroups that choose to secede have, while they were a member of the larger community, contributed to the provision of goods with some degree of publicness. How are use rights and cash flow rights to be apportioned among those who secede and those who do not? What must individuals do in large communities to accommodate those individuals in smaller, secession-generated communities? These are interesting and complicated questions, and it is likely the social contract will contain some provision for answering them. However, while questions of practicality are obviously important, they in and of themselves do not indict the contractarian-anarchic logic of Buchanan's position. An impractical alternative is, conceptually, still an alternative.

Third, asserting the viability of secession may be question-begging. Individuals declaring their independence from a community they perceive to be practicing discriminatory politics is of little use if that community can compel obedience by force. In addition to the counterargument made in the preceding paragraph, it is important to note the possibility of communities preying on each other is a concern in any realistic world (Leeson 2007). Of those who call for vesting domestic governments with sovereign authority, very few also call for the creation of an international sovereign to enforce "good" behavior amongst sub-polities, although this is what the logic of this position implies if taken to its conclusion. As such, it is unclear what damage this objection can do against contractarian anarchy specifically.

5. Conclusion

Buchanan would probably be troubled by the conclusions reached here. Despite becoming somewhat more sympathetic to anarchy late in his career[11], Buchanan never backed away from unanimity as a conceptual ideal, whose applicability to real-world politics and policy was primarily as a normative benchmark rather than an obtainable goal.[12] Despite this career-long antipathy, Buchanan's normative individualism-subjectivism-contractarianism can, when taken to its logical conclusions, serve as the foundation for philosophies of radical self-governance. With its foundations in individual sovereignty, collective action justified only as the result of consenting rights exchanges among several sovereign individuals, and explicitly preserved right of exit, Buchanan's take on social contract theory does much to deserve the title "anarchic." Contractarian political philosophy along Buchanian lines thus has the potential to be a complement to, rather than just a substitute for, scholarship of a free society.

In fact, it is likely that contractarian anarchy has the potential to be among the most fruitful of ideas, in terms of securing real-world change. Peter Boettke (2010: 290),

foundation for his reasoning.

11 "As I now reflect on...anarchy, I now realize that we were perhaps too influenced by the Bush–Tullock presumption to the effect that the behavioral hypotheses used were necessarily empirically grounded" (Buchanan 2004: 268). Buchanan here is backing away slightly from his earlier, far more pessimistic conclusions on anarchy reached during the 1970's. See also Buchanan (2005).

12 Stringham (2013) provides a concise summary of this partial turnaround.

albeit in another context, has emphasized the importance of doing "rational choice as if the choosers were human, and institutional analysis as if history mattered." We live in a post-Enlightenment world, and the imperative of subjecting fundamental social institutions to scrutiny by reason pervades the popular, professional, and academic mind. As such, Buchanan's contractarianism fits some of the most closely-held normative priors of those Buchanan would insist must consent to the kind of society he envisioned. As out-of-favor as the ideas of strict federalism and secession are, convincing enough people that Saga-period Iceland, medieval Ireland, or the 19th-century American West represent viable blueprints for social reform is even further beyond the pale.[13] The most likely avenue for advancement towards the free society is through constitutional moments. Buchanan's ideas, taken to their logical if radical conclusion, have the greatest potential to bridge the gap between radical self-governance in theory and in practice.

13 Of course, the proper takeaway from these historical case studies is the ability of spontaneous order to resolve social dilemmas. They are not meant to be "do it yourself" kits for reform. Unfortunately, this is how most of those who hear about these cases interpret them.

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Literature and Liberty: Essays in Libertarian Literary Criticism by Allen Mendenhall

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Allen Mendenhall, *Literature and Liberty: Essays in Libertarian Literary Criticism* (Lanham, MD: Lexington Books, 2014)

The anti-capitalist and pro-socialist biases of many literary critics today are well-documented, but there are signs that the study of literature may be opening up to libertarian approaches. Allen Mendenhall represents a new generation of scholars whose exposure to Austrian economics has given them the intellectual tools they need to challenge Marxist, neo-Marxist, and quasi-Marxist analyses of literature. As both a student of literature and a practicing lawyer, Mendenhall brings genuine interdisciplinary training to the subjects he covers, several of which fall into the burgeoning field of law and literature. Eschewing the kind of jargon that infects many discussions of literature these days, Mendenhall writes clearly and effectively. Although this book has a polemical intent, and

Mendenhall does not shy away from attacking well-known contemporary literary critics, he is not hostile to his intellectual opponents and actually tries to build bridges to the people against whom he is arguing.

Literature and Liberty is wide-ranging in its subject matter, moving from an opening essay on Emerson and individualism to a concluding essay on "Literature, Transnational Law, and the Decline of the Nation-State." Along the way Mendenhall deals with a number of issues, including contemporary efforts to clean up the racist language of Mark Twain's *Adventures of Huckleberry Finn* and a topic I find particularly intriguing—Henry Hazlitt as literary critic. Hazlitt is of course best-known for his economic writings, such classics as *Economics in One Lesson*. But he was the great-great-grandnephew of the famous British literary figure William Hazlitt, and, true to the family heritage, in 1933 he published *The Anatomy of Criticism*, a dialogue on literary criticism. Hazlitt appended two essays in the book, "Literature and the 'Class War'" and "Marxism or Tolstoyism?" As Mendenhall observes, Hazlitt turns out to have been prophetic in understanding the ways in which Marxist determinism and reductionism would come to distort the analysis of literature in the second half of the twentieth century.

The longest and perhaps the most impressive essay in Mendenhall's book is entitled: "Law and Liberty in E. M. Forster's *A Passage to India*." Here Mendenhall demonstrates that libertarianism and Austrian economics can make a contribution to one of the favorite fields of the academic left, postcolonial studies. One of the primary charges literary critics make against capitalism is that it was complicit in the development of European imperialism. Noting the role of businesses such as the infamous East India Company in the British Raj, study after study has presented colonialism as growing out of the free market ideology of nineteenth-century England. This argument fundamentally misreads the situation, mistaking what free market theories were fighting *against* for what they were fighting *for*. British colonialism was based on the economic doctrine known as mercantilism—exactly what Adam Smith's *Wealth of Nations* was written to refute. In fact, the greatest opponents of British imperialism in the nineteenth century were the so-called Manchester liberals, free trade advocates such as Richard Cobden and John Bright. They despised the East India Company and everything it stood for, specifically the granting of trading monopolies to individual businesses—the very opposite of the free trade policy Cobden and Bright championed.

Mendenhall reads Forster's famous novel about colonial India as growing out of the classical liberal tradition in Britain and its staunch anti-imperialism. Mendenhall shows that Forster's narrative develops a critique of the application of Benthamite utilitarianism to Indian society. Bentham is often mistaken for a free market theorist because of some of the economic policies he advocated, but in fact he is an example of the kind of social engineer mentality that Friedrich Hayek continually inveighed against. Followers of Bentham, who were in fact involved in the East India Company, viewed colonial India as a vast social laboratory, in which they could experiment with various Benthamite schemes for bringing civilization to oriental savages (as they viewed them). Among these schemes was the project of imposing the English legal system on Indian society—to which these laws were largely alien and in many respects unsuited. As Mendenhall analyzes *Passage to India*, Forster portrays the inevitable clash between the abstract, rigid, and would-be universal principles of English justice and a diverse Indian social world that was much more fluid and adapted to local circumstances. In particular, Mendenhall shows how Hindu religious beliefs resisted the imposition of alien English principles on India: "Brahman served, on a rhetorical or metaphorical level, to challenge the Benthamite system that celebrated a different variety of inclusion: one with prerequisites for admission—adherence to British rules, submission to British centralized authority, and participation in British mercantilism." It may come as a shock to leftwing literary critics, but in fact the spirit of imperialism is the antithesis of the spirit of free markets.

In short, Mendenhall makes it clear that classical liberalism and its libertarian offshoots are actually quite compatible with the multicultural ideal that is promoted in postcolonial studies today (this is what I mean when I speak of his building bridges to his opponents). As so often happens, by mistaking crony capitalism for genuine capitalism, literary critics fail to understand the liberating power of a free market economy. In his essay on Geoffrey of Monmouth's *History of the Kings of Britain*, Mendenhall again beats the academic left at its own game, by showing how the law can be appropriated as a tool of oppression by the state. In essay after essay, Mendenhall makes the case for using libertarian theory and Austrian economics to gain fresh perspectives on literature. One can only hope that his book will open the eyes of other young scholars to the rich potential of this new approach to literary studies.

Capital in the Twenty-First Century by Thomas Piketty

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Thomas Piketty, Capital in the Twenty-First Century, (*trans.*) Arthur Goldhammer (Cambridge, MA: Belknap Press, 2014)

An academic journal is not usually the place to find a review of a book that skyrocketed to the top of *The New York Times* best seller list. Yet that is what we have here with Thomas Piketty, a French economist whose English edition of his book, *Capital in the Twenty-First Century*, has stirred both the economics and policymaking worlds. It is not hard to see why. Not only is the book written in a clear and flowing prose, it taps the egalitarian mood that has captured the Western democracies since the recent financial crisis, doing so with strikingly high ambition. Like Karl Marx, whose theories Piketty is revising and updating, the professor of the Paris School of Economics aims at nothing less than to decipher the fundamental laws of capitalism as well as show the way to a more just society. Despite the impressive assemblage of economic data that Piketty marshals, he fails on both those tasks.

The descriptive task is largely taken up with accounting for the historical shifts in the weight of capital in economic life. Piketty defines capital as any ownable non-human good promising future benefits that can be traded on a market. Falling under this conception are those material items universally classified as capital, such as buildings, plants, machinery, and tools. Also included are titles to these goods, financial assets like stocks, bonds, and mutual funds along with that most basic of financial assets, money of course, held mostly in bank accounts. Added, too, are immaterial goods like patents, copyrights, and trademarks. To keep consistent with national accounting standards, Piketty excludes durable household goods from capital, though he does include residential housing since it offers future services to its owners. Land, distinguished by the classical economists among three factors of production, is instead subsumed under capital on the grounds that it is hopeless to separate the value that nature has by itself conferred on a particular parcel of the earth and that which human effort has added to it. Notably, Piketty goes against the reigning trend of designating the education, skills and training that a person may have acquired as human capital. His reasoning is that human capital cannot be traded (at least not in the societies of our day that prohibit slaveholding) and so is not part of the market. Only work effort can be the subject of market exchanges. The labor traded here constitutes the other factor of production alongside capital bringing about goods and services in the economy.

So far, there's nothing terribly objectionable here. But the analysis quickly starts to break down after Piketty tries to add up the market values of all capital items attributable to a particular country into a single variable called national capital. In turn, this figure is expressed as a ratio to national income, the latter understood as the value of goods and services that a country produces in a given year beyond what is needed to maintain its capital base. He reckons national income to be equal to annual GDP minus 10% for depreciation plus net earnings generated from abroad by domestic individuals and firms. Part of his exploits in data collection is that Piketty manages to provide the capital/income ratio for several leading nations going back centuries, in the case of France and Britain all the way to 1700. By his estimates – which he concedes are fraught with uncertainty -- the capital/income ratio was stable at around seven times national income in both France and Britain throughout the 18th and 19th centuries. Afterwards, with the onset of World War I, the ratio trended downward, reaching a low of just under three in 1950 before rising to five to six times national income. In the United States, reflecting the fact that it was a developing nation during the 19th century, the capital/income ratio increased from three in 1770 to five in 1930. It then descended to slightly under four by 1950 before heading back towards the higher levels seen earlier. What Piketty takes away from all this is that we are in danger of returning to the 19th century universe in which Marx wrote, back when capital supposedly reigned supreme and a rentier class enjoyed a life of leisure financed by the returns on their inherited assets at the same time that workers were forced to make do with the relatively meager wages their labor obtained.

An aggregate figure denoting a society's level of capital can be illuminating. Though capital is heterogeneous – each instance of it having different uses depending on its place in the pattern of production – market prices offer the best available means of gauging how the present configuration of capital goods is adapted to the future demands of consumers that those goods are ultimately designed to meet. Rising values suggests that the capital stock is well-adapted to the future, whereas decreasing values indicate that forecasting errors have been made that need to be corrected through the liquidation and redeployment of assets. Taking this into account, as well as the fact that market valuations of capital can be distorted by the state's influence over interest rates, an aggregated number can additionally offer a rough proxy of the extent to which capital is deployed in the prevailing modes of production. A well-capitalized economy, after all, means that labor can be rendered more productive so as to afford everyone a higher standard of living.

All that can be gleaned, therefore, from Piketty's description of the capital/income ratio is that Western economies had attained a seemingly high level of development heading into the 20th century. At which point, obviously, a series of unforeseen events, including two global conflagrations and a prolonged depression, greatly weakened the capital structure. So we are now simply back closer to where we were before these catastrophes befell us -- each and every one of them, it needs be said, the result of events originating from the political sphere. That suggests we should consider the actions of governments more than just exogenous shocks in trying to explain major trends in the factors of production. This would be more promising than emphasizing tendencies intrinsic to the market economy allegedly favoring the predominance of capital.

To dissuade us from thinking that we have merely returned to a more normal condition, Piketty warns us that it is likely that capital's ascent will continue to historically unprecedented levels. The theoretical basis for this vision of the future is what Piketty calls the second fundamental law of capitalism:

$$\beta = s/g$$

The symbol β stands for the capital/income ratio, s is the savings rate, while g is the growth rate of national income. The latter is partly a function of population growth, in that more people implies that more goods are produced. As Piketty estimates that population growth will decline in the 21st century, g is expected to fall. Nor does he believe that national income will increase enough per capita to make up for this, as he notes that growth rate has ranged around 1 to 1.5% per year since 1700. He sees little reason to believe this will henceforth defy the historical pattern. A decisive consideration for Piketty is that the return on capital, denoted by r and estimated at 4-5% per annum, has in the past demonstrated a pronounced tendency to be greater than g. Insofar as $r > g$, owners of capital can more readily afford to reinvest a portion of their returns and thereby add to capital at a faster pace than the rest of the economy. Ergo, the capital/income ratio must rise.

We need not get into the question whether the causal relationships implied by the $\beta = s/g$ equation make sense – for example, how exactly is capital inversely related to economic growth? The fundamental mistake that Piketty commits is to treat capital as essentially homogeneous. Only on this assumption could it make sense to hold that, say, a 1% increase in the savings rate is going to lead to some proportionate increase in the capital/income ratio. The fact that the wide diversity of capital goods can be made commensurable by money prices does not mean they cease to encompass that diversity. It remains the case that the value of an additional capital good will depend on how well it fits in entrepreneurial projects to anticipate prospective consumer wants, and not simply on the amount of money allocated to it. The future of capital cannot be glimpsed through an equation.

The moral part of Piketty's analysis comes to the fore in the second half of the book. Peering within capital, he finds that its ownership has come to be concentrated in fewer and fewer hands since the early 1970s. Compounding this, we are told, is that earnings from labor have also become more unequally distributed. Having now reached the same extreme levels witnessed in the 1920's, a smaller group is left with the wherewithal to accumulate capital from their paycheques. As Piketty hammers these points home with a cavalcade of graphs showing in every which way that inequality is on the rise, the distinct impression is given that the reader is supposed to yield to the onslaught of data and straightaway conclude that we have a grave injustice before us that demands a redistributive solution. Yet "ought" cannot be derived from "is", or at least not in this cursory way. Piketty recognizes this: "Inequality is not necessarily bad in itself: the key question is to decide whether it is justified, whether there are reasons for it" (p.19). Still, though he promises to explore this philosophic issue, he does shockingly little to establish that the inequality he details poses a moral dilemma.

He pursues various tracks. One is to appeal to the authority of the French revolution and, more precisely, the official expression of its principles, the 1791 Declaration of the Rights of Man and of the Citizen. Indeed, Piketty opens his book by invoking the first article of that document stating that "social distinctions can be based only on common utility". When it comes time, however, to delineate what exactly is meant by "common utility", Piketty devotes a mere page to the topic, while turning to another authority, namely John Rawls and his difference principle, according to which inequalities are only justified if they work to the benefit of the less advantaged. Even if we accept Rawls as our moral touchstone, Piketty never shows that the less advantaged have become worse off amid the evolution of capital. The indication he gives is that they own as relatively little capital now as they always have. The less advantaged, in other words, continue to rely almost entirely on their labor, but that buys much more nowadays than it did in decades and centuries past.

Another tack is to invoke democracy. Not only does he argue that it is characterized by an overriding commitment to equality, he invokes the spirit of Jurgen Habermas in trusting to the processes of democratic deliberation to resolve moral questions concerning the economy. Besides the fact that democracy is also devoted to liberty, isn't that regime to be evaluated by a higher criterion and, therefore, properly viewed as the subject, rather than the source, of moral judgment? Finally, Piketty raises the specter of political instability should existing inequalities go unaddressed. Tellingly, this is one point for which he is unable to muster any data. Neither does he take into account the middle class, whose share of capital has augmented in the 20th century, and whose resulting political influence helps forestall tensions between the haves and have-nots, as Aristotle long ago observed.

As a result, Piketty is on shaky moral ground by the time he elaborates his proposal to impose a global capital tax. Nonetheless, the proposal is illuminating in revealing the ultimate logic of the political quest for equality. Realizing that people will try to avoid the tax by shifting their capital to less burdensome locales, Piketty asserts the necessity of a tax cartel among states in which they agree to share banking and investment information about anyone holding capital assets within their respective jurisdictions . If the social democratic state is to succeed in its drive to further equality, it cannot permit anyone to escape its clutches. That is a far scarier prospect than the inequality that so worries Piketty.

Boom and Bust Banking
by David Beckworth (ed.)

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David Beckworth (ed.), *Boom and Bust Banking: The Causes and Cures of the Great Recession* (Oakland, CA: The Independent Institute, 2012)

Lehman Brothers filed for bankruptcy five years ago last September and people still wonder what happened. There have been documentaries and books aplenty, pointing the finger at Wall Street greed and lack of regulation.

For a real understanding of what happened, the essays in The Independent Institute's *Boom and Bust Banking: The Causes and Cures of the Great Recession* are essential. The volume features multiple authors but puts the blame for the crisis with one institution--the Federal Reserve.

While many free market economists and writers have fingered the central bank as the villain for the crash, *Boom and Bust* provides a more nuanced analysis with some surprising insights.

The Fed-held-rates-too-low-for-too-long explanation is told often but Lawrence H. White argues the central bank's rate policy actually influenced what type of mortgages were originated during the boom. The Fed's aggressive forcing of the Fed Funds rate down from 2001 to 2004 made adjustable rate mortgages (ARM) attractive relative to the more traditional 30-year mortgages.

In February of 2004 the Maestro himself told a Credit Union National Association audience, "American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage." Lenders had already complied with the market share for ARMs going from 11 percent in 2001 to 40 percent in 2004.

The Fed's low rates and its promise to keep them low led investors to fearlessly play what is known as the carry-trade: borrow at low short-term rates and invest long-term. Diego Espinosa explains Wall Street answered the call with the securitization of mortgages ultimately including the subprime variety dressed up with a triple A rating.

One explanation never found in the Austrian economics literature on the crash is that the Fed actually tightened in 2008. This would comport with Austrian theory as an explanation for the crash. However, the standard narrative is the Fed frantically lowered Fed Funds rates. Scott Sumner tells us real interest rates as measured by the yields on Treasury Inflation-Protected Securities (TIPS) actually soared from less than one percent in July 2008 to four percent in December of 2008. Cheap credit was choked off by higher real rates.

Sumner cites an interesting quote from Milton Friedman about tight and loose money. "I thought the fallacy of identifying tight money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die."

Friedman is the primary focus of Jeffrey Rogers Hummel's chapter comparing the free market champion with the current Fed Chair Ben Bernanke and the central bank's increasing role as central planner. While many Austrians focus on the supply of money, Hummel discusses the demand. As was the case in the Great Depression, the velocity of money plunged in the Great Recession (and still is). Velocity is something the Fed can't print.

Hummel writes that Alan Greenspan faced three crises during his tenure--the October 1987 stock market crash, the Y2K threat, and the 9/11 attacks. Greenspan flooded the financial system with money each time. Bernanke, while known as "helicopter Ben, actually tightened in 2008, by selling Treasury securities.

Greenspan increased the monetary base at an average rate of 7.54 percent during his 19 years at the Fed. Bernanke increased the base just 2.24 percent at the end of August 2008. "Bernanke was not injecting liquidity, just redirecting it," Hummel explains.

With this redirection the Fed under Bernanke became a central planner, managing the money supply to allocate credit in the direction it deems critical. The Fed, writes Hummel, "has become similar to Fannie and Freddie, with the important distinction that the Fed has greater discretion in subsidizing a wider variety of assets."

Bernanke is no helicopter pilot dropping bales of cash haphazardly, but is "Bailout Ben" carefully directing the nation's savings to the financial system.

George Selgin describes this central planning Fed as *inherently destabilizing* in the book's final chapter. This is anathema to financial writers and government cheerleaders who sleep better at night knowing the PhDs at the Eccles Building are on the job.

While the central bank monopoly allows banks to create credit beyond sustainability, banks in a free banking system are linked like "prisoners in a chain gang," writes Selgin, "escape is impossible for any single prisoner acting alone, and hardly less so for the group as a whole," because coordinating their steps is so difficult. The greater the gang, the more difficult the escape. The presence of a central bank undoes this check on credit creation and allows the chain gang to act as one.

Walter Bagehot is often viewed as a supporter of central banking, his quote about these banks lending freely in a crisis from his book *Lombard Street* being evidence. However, in his chapter Selgin sets the record straight. Bagehot was no fan of central banking, believing, "central banks were financially destabilizing and hence undesirable institutions," writes Selgin, "and that it would have been far better had England never created one."

Sadly, history has been written with central banks being required as lenders of last resort, citing the words of Bagehot. His exact words were instead, "I have tediously insisted that the natural system of banking is that of many banks keeping their own cash reserve, with a penalty of failure before them if they neglect it."

Past is prolog because history is constantly misinterpreted. Five years after the crisis America's financial system is bigger and just as precarious. The six largest banks are 37 percent larger and comprise 67 percent of bank holding company assets. All of this engineered by a central bank that itself has grown from less than $800 billion in assets pre-crisis to more than $3.6 trillion today. But more important than its size the Fed has grown in power and visibility, evidenced by the drama over who will fill the shoes of Time's 2009 Person of the Year.

The essays in *Boom and Bust* carefully place the blame for the '08 crash where it belongs. It was not greed or animal spirits but the creature that government created 100 years ago: the same perpetrator that will cause the next crisis.

Mises Canada