NEW PERSPECTIVES ON POLITICAL ECONOMY

A bilingual interdisciplinary journal

Vol. 9, No. 1–2, 2013

CEVROINSTITUT ACADEMIC PRESS

CEVROINSTITUT
[vysoká škola]

NEW PERSPECTIVES ON POLITICAL ECONOMY

A bilingual interdisciplinary journal / Vol. 9, No. 1–2, 2013

New Perspectives on Political Economy is a peer-reviewed semi-annual bilingual interdisciplinary journal, published since 2005 in Prague. The journal aims at contributing to scholarship at the intersection of political science, political philosophy, political economy and law. The main objective of the journal is to enhance our understanding of private property-, market- and individual liberty-based perspectives in the respected sciences. We also belive that only via exchange among social scientists from different fields and cross-disciplinary research can we critically analyze and fully understand forces that drive policy-making and be able to spell out policy implications and consequences. The journal welcomes submissions of unpublished research papers, book reviews, and educational notes.

Published by CEVRO Institute Academic Press

EDITORIAL ADDRESS:

New Perspectives on Political Economy
CEVRO Institute, Jungmannova 17, 110 00 Praha 1, Czech Republic

Manuscripts should be submitted electronically. All manuscripts and correspondence should be addressed to nppe@vsci.cz.
Full text available via DOAJ Directory of Open Access Journals and also via EBSCO Publishing databases.

INFORMATION FOR AUTHORS

Authors submitting manuscripts should include abstracts of not more than 250 words and JEL classification codes. New Perspectives on Political Economy edits for clarity, brevity, and in accordance with the Chicago Manual of Style. Authors should use footnotes rather than endnotes or in-text references, and must include complete bibliographical information. Authors should include information on their titles and professional affiliations, along with e-mail address.

ISSN 1801-0938 (on-line)
ISSN 1804-6290 (print)

AGGREGATES AND METHODOLOGICAL INDIVIDUALISM: A RELATIONAL APPROACH

ALEXANDER WILLIAM SALTER[1]

ABSTRACT

Methodological individualism, coupled with radical subjectivity, leads naturally to skepticism regarding the objective theoretical value of economic aggregates. I restate the role of aggregates in the methodological individualist paradigm, focusing on the Austrian tradition, in a way consistent with Hodgson's (2007) critique and emphasize belief and meaning as the relevant channel through which these aggregates operate. Viewing aggregates this way leads to a relational approach which is consistent with formulations made by scholars working within in the methodological individualist paradigm and answers Hodgson's call for recognition of the importance of interactive relations between individuals.

KEYWORDS

Aggregates, belief, meaning, methodological individualism, subjectivism

---

1 Department of Economics, George Mason University, Fairfax, VA, USA; email: asalter2@gmu.edu.
I thank the Mercatus Center at George Mason University for its support, Will Luther, Virgil Storr, Peter Leeson, and Solomon Stein for valuable feedback on earlier drafts, and an anonymous referee for helpful comments and suggested revisions. Any remaining errors are my own

"The economist is not primarily concerned...with any physical properties of the world as such, but rather the meaningful constructions of social actors." –Peter J. Boettke (1990, 37)

1. INTRODUCTION

Economists who adhere to methodological individualism, especially those of the Austrian school, are typically skeptical of methods in the social sciences which attempt to mimic the natural sciences. A popular manifestation of this skepticism is a critique of economic aggregates, such as the price level or national income, as theoretical constructs able to generate useful information without the necessary context of individual action. As a result, some believe that methodological individualism is too limited a paradigm for the conduct of rigorous social analysis (e.g. Bunge 2000). This position is inaccurate. It is true that methodological individualists, Austrian economists in particular, have critiqued the kind of aggregate-level theorizing exhibited by mainstream macroeconomics. However, a closer reading of eminent Austrian economists such as Mises or Hayek, not to mention modern Austrian methodologists, show that methodological individualism, along with the corollary of radical subjectivity, implies the beliefs of individuals and the meanings they attach to various social constructs are central to social analysis. To the extent that economic aggregates are social constructs, in the sense of their recording and study by professionals and the cognizance which is taken of them by individual economic actors, they certainly fit this description and thus cannot be dismissed. While this extension may seem trivial, Hodgon's (2007) recent critique of methodological individualism warrants an explicit statement of this postulate. Hodgson invokes a "folk theorem" which requires that "all satisfactory and successful explanations of social phenomena (including in economics) involve interactive relations between individuals" (217). The implication is that the methodology advocated by Mises, Hayek, Schumpeter, and others in the Austrian school neglects interactional aspects. My response focuses on the role of economic aggregates which, whatever the particulars of their compilation, are the result of a multitude of interacting individuals. I meet Hodgson's challenge by highlighting the individual mind as the relevant channel through which aggregates operate and impact economic outcomes. This also has the benefit of addressing once again the popular claim that social analysis founded on methodological individualism is unscientific because it disdains quantitative analysis. Specifically I argue there is a distinction between aggregation as a way of theorizing and aggregation as a way of thinking; thus there is also a distinction between what I call the usefulness and meaningfulness of these statistics. I provide a cogent definition of these two measures and argue that the latter, as determined by the individual economic agent, must be taken into account.

This paper is not meant to invalidate previous formulations of methodological individualism but to fill a gap in the recognition of its versatility. I believe there is a fundamental distinction between aggregation as a way of doing economics and aggregation as a way of understanding economics, with the latter occurring in the minds of individual economic actors. In response to the question, "Is methodological individualism inconsistent with aggregation?" I answer, "Not if the individual is the one doing the aggregating."[2] As I will show, this distinction is reconcilable with previous authors' formulations.

Because the term has been interpreted so widely, I first must make clear which definition of methodological individualism I will work with. I hold with the Austrian tradition by defining methodological individualism quite plainly: It is the recognition that only individuals choose, and therefore the social sciences' fundamental unit of study ought to be the individual.[3] Some interpretations of methodological individualism insist it is flawed because it fails to consider environmental and interactional explanations for individual action.[4] Again referring to Hodgson's critique, he asserts that "explanations in terms of individuals alone have never, as yet, been achieved" (2007: 211). However, this seems to be directed at the old neoclassical modeling tradition of agent omniscience and institutional irrelevance, best described as methodological atomism, rather than the Austrian conception (Zwirn 2007). Although Austrian economics emphasizes methodological individualism, it does so in the context of radical subjectivity and the market process (Boettke 1994). It does not assume flawless individuals and context-void action. Lange-von Kulessa (1997) recognizes Hayek's individualism is devoid of such reductionism and emphasizes an evolutionary theory and social context. Boettke (2002) highlights the Austrians' unique theories of information and knowledge, which have as their root the richer conception of methodological individualism. Boettke and Storr (2002) recognize the importance to social analysis of individual embeddedness in society, polity, and the economy. Evans (2010) argues against Hodgson (2007) and recognizes that institutional considerations are perfectly reconcilable with the Austrian conception of methodological individualism. These authors' works, some of which predate Hodgson (2007), satisfy Hodgson's folk theorem on other margins.[5] For my purposes they serve as a defense of methodological individualism upon which I can build my argument of relational aggregates.

Aside from rebutting straw man arguments and defining the position more explicitly, modern developments in the Austrian literature relating to methodological individualism and aggregation have been focused on showing how new historical evidence and theoretical developments are consistent with methodological individualism and radical subjectivity (Keeler 2001; Bismans and Mougeot 2009; Lewis 2008; Aligica and Evans 2009), as well

2 This approach is in no way a concession to behaviorism. For a general refutation of behaviorism see Mises (2007). In addition, Hudik (2011) argues that economics is not a science of behavior in the psychological sense.

3 This does not deny the existence or relevance of social groups; it merely requires the explanation of the groups' actions to be expressed in terms of its constituent members' decision calculus. See Wagner (2010) for a social theory that treats society as a whole as a real entity yet holds that methodological individualism is the proper avenue of inquiry.

4 See also Clark (2003).

5 Other authors recently have sought not to refute but to expand upon methodological individualism by incorporating insights from cognitive science (Nooteboom 2007) and the methodology of critical realism (Lewis 2005). Also Crespo (2002) accepts the basic formulation of methodological individualism but offers an Aristotelian interpretation of Austrian ideas similar to Rothbard's (1976).

as their macro-level implications of dynamism and emergence (Axtell 2007; Seagren 2011), and continuing the battle against mainstream welfare and equilibrium analysis (Higgs 1994; Folmer, Heijman, and Leen 2002; Holcombe 1999; 2008). As such, they are only tangentially related to theoretical issues of methodological individualism and aggregation. It is this gap in the literature I hope to address.

I proceed as follows: In Section 2 I briefly summarize the Austrian literature relevant to my contention that economic aggregates can be reconciled with methodological individualism.[6] I draw special attention to the meanings-belief channel of individual actors. In Section 3 I explicitly formulate the distinction between usefulness and meaningfulness as motivated by the difference between aggregation as method and aggregation as understanding and illustrate this difference by working through an example and employing a thought experiment. I also provide some evidence that this approach is perfectly reconcilable with the methodology of Mises, Hayek, and later-day methodological individualists. In Section 4 I offer some implications of this insight. In Section 5 I conclude.

2. HISTORICAL DEVELOPMENT[7]

MISES

Mises continues in the tradition of Carl Menger and Eugen von Böhm-Bawerk by affirming the validity of methodological individualism. In *Human Action* Mises puts forth praxeology, "the general theory of human action," as the supercategory to the more specific science of economics (2008, 3). Mises plainly spells out the link between praxeology and methodological individualism: "Praxeology deals with the actions of individual men. It is only in the further course of its inquiries that cognition of human cooperation is attained and social action is treated as a special case of the more universal category of human action as such" (41). In refuting analyses of social phenomena which treat the group rather than the individual as the appropriate unit of study, Mises writes, "[A]ll actions are performed by individuals. A collective operates always through the intermediary of one or several individuals whose actions are related to the collective as the secondary source" (42).

Mises's views on methodological individualism lead to his suspicion of quantitative methods in economics (1962, 62-63). Mises's skepticism of statistical measurement for

6 See Boettke, Horwitz, and Prychitko (1986) for an extended discussion of historical evidence as empirical illustration in a similar context.

7 This section's treatment is by no means exhaustive. For an overview of subjectivity and methodological individualism, and the Austrian conception of economic science in general, see Evans (2010), Coyne (2010), Storr (2010), and Stringham (2010); for a more comprehensive exploration of Austrian methodology, see White (1984).

theoretical purposes frequently manifests itself as skepticism of particular economic aggregates. For example, Mises is hostile to the development and use of instruments which purport to measure the price level: "The idea implied in the inappropriate term *level of prices*, as if –other things being equal –all prices could rise or drop evenly, is untenable. Other things cannot remain equal if the purchasing power of money changes" (2008, 223). Mises insists any discussion of the price of money be limited to its purchasing power of various and specific goods and services (339). As a result, we can safely interpret the various occasions on which Mises employs terminology such as "the volume of credit" or "the supply of money" as abstractions for the sake of pedagogical expediency rather than a concession to the validity of measurement or aggregation (568–583).

HAYEK

While Hayek is just as dedicated to methodological individualism as Mises, he emphasizes a different aspect of the epistemic issues of economic science. For Hayek, the social sciences classify rather than explain human action (1943, 7–8), and, as such, any attempt to analyze the phenomena of the social sciences using the methods of the natural sciences is to reduce the whole to the parts, thus overlooking that as emergent phenomena, wholes comprise different analytical categories than the parts which comprise them.[8]

In *The Counter-Revolution of Science*, Hayek further solidifies his objections to applying the methodology of the physical and natural sciences to economics. His argument is largely similar to that employed in "The Use of Knowledge in Society" with added emphasis on the localized knowledge of individual agents as *the* distinction between objective (i.e. scientific) and subjective (i.e. of time and place) knowledge and reaffirming this distinction as the justification for methodological individualism and decentralized analysis (1979, 49–59; 88-89). Specifically, Hayek criticizes the paradigm of scientism, saying

It [the misapplication of methods] is probably responsible for the worst aberrations and absurdities produced by scientism in the social sciences. It not only leads frequently to the selection for the study of the most irrelevant aspects of the phenomena because they happen to be measureable, but also to 'measurements' and assignments of numerical values which are absolutely meaningless (89–90).

Further support for methodological individualism comes from Hayek's assertion that the use of statistics "deliberately and systematically disregards the relationships between the individual elements" (108). He continues by saying, "Statistics may supply us with very interesting and important information about what is the raw material from which we have to reproduce these structures [the structures with which the social sciences are concerned], but it can tell us nothing about these structures themselves" (110). In his particular criticism of the concept of national income, we see Hayek at his most Misesian: "there is no

8 Elsewhere Hayek (1945, 523–524) emphasizes that to overlook micro-level issues by relying on statistical aggregates gives a false sense of stability because doing so ignores this informational difference.

reason to expect that these measurements will ever reveal anything to us which is of significance beyond the particular place and time [Mises's 'historical constellation'] at which they have been made" (110).

It is important to note the framing role Hayek gives to statistics and aggregates in the very next sentence: "That they cannot produce generalizations does, of course, not mean that they may not be useful, even very useful; they will often provide us with the data to which our theoretical generalizations must be applied to be of any practical use" (110). Here Hayek seems to be dancing around the distinction between usefulness and meaningfulness, but he never makes this distinction explicit. Without claiming whether he recognized the distinction, we can clearly see Hayek's defense of methodological individualism both reaffirms and complements Mises's.

LATER TREATMENTS

Several more recent treatments of methodological dualism (Kirzner 1976), measurement (Lachmann 1976; Rizzo 1978), and the logical status of the action axiom (Rothbard 1976) touch on the issue of aggregation as theory vs. aggregation as understanding. Despite the differences in approach in this later literature, we see a clear pattern emerge: a reaffirmation of the individual as the appropriate unit of study coupled with a rejection of statistical techniques and aggregation because they are inconsistent with this methodological primary.

However, there are two works that stand out as foundational to the argument presented in this paper. In outlining the methodology of the Austrian school, Lachmann highlights a chief characteristic as "a distrust of all those formalizations of economic experience that do not have an identifiable source in the mind of an economic actor. Such distrust naturally engenders skepticism about macroeconomic aggregates" (1978a, 2). The sentence on skepticism of aggregates seems a natural progression from the views of Mises and Hayek, but the previous sentence contains an interesting implication. Distrust of formalizations that do not find themselves in an individual's means-ends framework suggests that, if a formalization did "have an identifiable source in the mind of an economic actor," it would be permissible as an explanation of how the individual's state of mind manifested in action. Lachmann's work on expectations (e.g. 1978b, Ch. 2) suggest this interpretation is feasible. Aggregates as understanding can be grounded on the link between interpreted experience and the means-ends framework in question.

The second is Wagner's (2012) work on the relationship between micro- and macro-entities. Wagner (433) suggests that approaches that view macro-entities as scaled-up versions of micro-entities, i.e. that proceed as if "macro is micro addressed in a loud voice," are fundamentally misguided. Macro-entities instead should be thought of as emergent phenomena, unintended consequences of interaction amongst micro phenomena that exist at a separate level of complexity. However, Wagner does recognize that macro phenomena can "supervene" on micro-level actors (434), thus providing a theoretical foundation by which individual actors (micro-entities) can take cognizance of aggregates (emergent macro-entities) without embracing a reductionist approach by conflating the levels of complexity involved.[9]

Ultimately, Lachmann and Wagner provide a methodological and theoretical inroad respectively for the argument to be developed. This argument is firmly grounded in the Austrian "main line" from Mises and Hayek onward. It is with these points in mind that we proceed to unpack the distinction between aggregation as method and aggregation as understanding.

3. THE DISTINCTION BETWEEN USEFUL AND MEANINGFUL

FORMULATION

As we have seen, the Austrian focus on methodological individualism naturally leads to skepticism of the ability of statistical aggregates to reveal anything more than a historical instantiation of particular economic phenomena; as such, the proper use of these statistics is in the hands of economic historians, not theorists attempting to explain human action. Vedder (1997) correctly notes that aggregate statistics can be selectively interpreted to support many different theories, and often different theories cite the same statistics as evidence. As such, methodological individualists are rightly wary of aggregation as method –as a way of doing economics, namely economic theory. Even recent attempts to provide empirical evidence for the Mises-Hayek theory of the business cycle (Keeler 2001; Bismans and Mougeot 2009) agree with Boettke (1994) by claiming their results are illustrative of rather than proof of the theory: "Historical interpretation illustrates the power of the theoretical framework adopted" (Boettke 1994, 5; quoted in Bismans and Mougeot 2009, 242). For this reason modern authors influenced by the Austrian school have used and argued in favor of qualitative research methods, such as interviews and comparative ethnographies (Chamlee-Wright 2010a, 2010b; Storr 2010). These research methods have produced fruitful results because they take methodological individualism seriously, going straight to the individual actors to discover what they think and feel –the data of the social sciences.

However, every economic aggregate, regardless of how it is computed, is a fundamentally relational measure. An aggregate, by definition, supposes a multitude of interacting individuals. What information in particular it captures, and whether that information is

9 As will be discussed shortly, there are parallels between this point an Hayek's arguments in chapter 4 of The Counter-Revolution of Science.

appropriate for the analysis of economic phenomena a priori, is not the issue here.[10] If individuals take cognizance of economic aggregates –if they become both part of their beliefs and something to which they ascribe meaning, *and if individuals then act upon those beliefs* –then it must be the case that these aggregates impact economic outcomes in a way consistent with methodological individualism and do so in an inherently relational manner, thus comporting with Hodgson's folk theorem.

Is it plausible that individuals start thinking in terms of statistical aggregates? We live in a world where the synthesis of neoclassical microeconomics and Keynesian macroeconomics is the dominant economic paradigm. Data on output, national savings, unemployment, and hundreds of other aggregates are available to anyone with access to the internet. Many of these figures also appear daily in the pages of the popular and financial press. Considering the ease with which individual economic actors can access this kind of information, and considering the use of these statistics is given an intellectual sanction by mainstream economic thought (and some heterodox schools such as Post-Keynesianism), it is entirely reasonable to suppose that these aggregates enter the mind of the individual and influence his or her decision process. Once we've moved from the theorizing of academic economists to the thoughts, beliefs, and actions of the individual, we move from aggregation as method to aggregation as understanding, the latter being a purely subjective phenomenon entirely contained within the mind of the actor.[11,12]

Here we are confronted with the chief motivation for this paper: past Austrian economists have focused on showing that statistical aggregates are of limited theoretical use, but this does not imply these aggregates are not meaningful to the individual *qua* actor. To define these terms explicitly, an aggregate is *useful* if it increases our knowledge of economic phenomena without concealing the microfoundations, namely the purposeful actions of individuals, which give rise to these aggregates. An aggregate is *meaningful* if, *regardless of whether it is useful in any objective sense*, an individual actor takes cognizance of it and incorporates it into her decision rule with regards to various actions. Useful corresponds to aggregation as method; meaningful corresponds to aggregation as understanding. The definition of "meaningful" carries with it the requirement that a methodological individualist must consider the impact any and all aggregates which individuals view as meaningful have on that individual's economic calculus; as such, any explanation of human action founded

10 Thus this claim does not invalidate, or even attempt to oppose, Hayek's arguments on the misleading nature of statistics in the social sciences. It simply recognizes that without multitudes of acting individuals, there would be no "data" with which to construct a statistical aggregate.

11 "Understanding" is somewhat of a loaded word. I do not have in mind Mises's verstehen. (See chapter 14 of Theory and History and chapter 2 of Human Action; also Selgin 1990.) When I use the word "understanding" I intend it to be synonymous with "taking cognizance of."

12 The objection that individuals would not think in these terms if academic economists did not first provide the theoretical framework is irrelevant (and also quite possibly mistaken; see the price index example below). Chicken-or-the-egg speculation does not change the fact that this information is readily available, nor is it able to invalidate its transition from inputs into a testable hypothesis (according to the mainstream) to the methodological individualist's data once it becomes the content of an individual's thoughts.

on methodological individualism is incomplete if it does not recognize and incorporate this distinction.[13,14]

As a refinement of the useful/meaningful distinction, consider Hayek's (1979, 62–63, emphasis in original) treatment of "ideas which are *constitutive*" of the phenomenon in question and ideas formed by individuals "about these phenomena and which are not the cause of, but theories *about*," the phenomena in question. In this case, we are not concerned with why an individual has incorporated an aggregate into his means-ends framework, only with the fact that he has and the implications arising therefrom. To use an example that I will elaborate on later in the paper, if an individual incorporates the price level (CPI, GDP deflator, etc.) into his decision calculus, it does not mean that an individual's perception of the price level is essentially constitutive of the price level *qua* aggregate. It does mean that the beliefs formed by the individual about the price level are decision-relevant. Thus the meaning that an individual imparts on a statistical aggregate falls on the "theories *about*" side of Hayek's thought categories.

At first glance it seems there must be a fundamental asymmetry in the distinction –an individual would not consider an aggregate meaningful if he first did not judge it to be useful. This claim overlooks the possibility of strategic interaction amongst individuals: I may not believe Aggregate X is of any use, but if I think everyone else in my community does, it may benefit me to act as if Aggregate X actually does convey useful knowledge. If I am the only such member of the N-sized community, then there are N-1 actors for whom Aggregate X is both useful and meaningful, and myself for whom it is only meaningful. The fraction of the community which plays <not useful, meaningful> versus <useful, meaningful> depends on the belief distribution of that community.[15]

In the following subsections I work through an example and employ a thought experiment, a method supported on both epistemological and methodological grounds (Moss 1997; Aligica and Evans 2009), which I believe will help illustrate the distinction.

Example: The Aggregate Supply-Aggregate Demand Framework

Aggregation allows for the construction of tractable economic models and provides a ready source of data which can then be used to test the relevance of these models. The costs of aggregation include a lack of precision and the likelihood of losing sight of the micro-level causal chains related to individual choice. Methodological individualists in the Austrian tradition insist the benefits derived from aggregation as method are largely illusory while the costs are very real.

---

13 I believe the useful/meaningful distinction is helpful in categorizing the different uses of economic aggregates for the purposes of this paper. I do not intend these terms to take on this definition forever after; as such, they may be considered as 'thought organizers' in the context of this specific argument.

14 The discussion going forward is focused exclusively on aggregation. Although I have tangentially made reference to criticisms of econometrics and empirical methods in economics more broadly, what follows only applies to them to the extent they utilize aggregate statistics. For example, empirical macroeconomics frequently uses econometric modeling techniques. That technique is not relevant to this paper by itself, but the data inputs –aggregates such as national income, unemployment, etc. –are relevant.

15 It is less obvious whether the converse (an individual considering an aggregate useful but not meaningful) is viable.

As an example, consider the standard aggregate supply-aggregate demand (ASAD) framework, characterized by the equilibrium condition $Y = C + I + G + (X - M)$. Students in introductory macroeconomics classes are painfully familiar with the Keynesian cross and the resulting equilibrium: the variables comprising aggregate demand, the right side of the equation, are given as functions of output Y and finding the solution is a matter of quick substitution. Methodological individualists in the Austrian tradition are quick to point out that this simple accounting identity does not and cannot convey the complexities and entanglements of individual elements which lead to the diverse quantity of goods and services an economy produces.[16] Mario Rizzo sums up the objection:

What is aggregate supply? There are no producers of goods-in-general. There are just producers of specific goods aimed at specific customers. (Of course, some guy can run around adding this up in terms of market prices or whatever.) There are no demanders-in-general. There are just demanders of specific goods to be purchased from specific producers.[17]

Moreover, there is no reference to individual actors, except in the background concession that their actions generated the aggregates which are now being used to solve the problem. As such, the problem as formulated is unrelated to the environment in which the individual is imbedded and the choices which she faces –a troubling feature for a model which purports to describe phenomena generated by individual actors. Thus methodological individualists frequently conclude the marginal cost of adopting this framework, which include the obfuscation of individual resource consumption and opportunity cost, exceed the marginal benefits of traction, leading to a rejection of the paradigm.

This analysis of the costs and benefits of a particular framework, however, are founded on usefulness considerations. What we must also consider is meaningfulness –individual actors may still use this information in formulating decisions and choosing courses of action. If an individual thinks in terms of the ASAD paradigm, then aggregation as method has become aggregation as understanding. If an individual uses data on national output (or, what is more likely, an individual component such as consumption expenditure) in making decisions about asset allocation or savings rates, then both requirements –interpersonal relation and consistency with methodological individualism, coupled with radical subjectivity –are satisfied.[18,19]

16 For a complexity/spontaneous order conception of macroeconomics, see Wagner (2012).

17 Mario Rizzo, "Macroeconomics from a Pre-Keynesian Perspective." http://thinkmarkets.wordpress.com/2010/10/21/macroeconomics-from-a-pre-keynesian-perspective/ October 21, 2010.

18 There is also the possibility that, even if the agent believes certain aggregates are meaningful, he will not behave in a way consistent with any existing theoretical model. In this case an Austrian-influenced theorist has fertile ground to work with.

19 It should be noted that individuals or a group of individuals holding flawed economic beliefs, in the sense that those beliefs are meaningful to the individuals but not objectively useful, does not necessarily imply permanently suboptimal economic outcomes. Consider a community of agents with Keynesian priors, but without a centralized apparatus with which to implement either fiscal or monetary countercyclical policy, such as a small and isolated town in the Midwestern United States. A fraction of agents expect their neighbors' time preference to decrease, resulting in higher savings, leading to a negative aggregate demand shock sometime in the future. They "know" that it would be optimal for them to all increase their expenditure to combat the decrease in demand, but lacking a coordination/enforcement mechanism, they each make the individually

THOUGHT EXPERIMENT: PRICE INDICES

Price indices, such as the CPI or PPI, are another example where applying the useful-meaningful distinction yields different insights than considering usefulness alone. Price indices have been criticized for the same reason as other aggregates: in compiling the statistic, we necessarily lose sight of some of the underlying microeconomic forces. In this case, methodological individualists worry about focusing on a generalized price level rather than the relative prices between specific goods and services, especially when the creation of a price index tends to obscure relative price changes. This is true for both real (demand-driven) changes and Cantillon effects. As such, many methodological individualists conclude that price indices do not pass the usefulness test (remember Mises's admonishment from Section 2!). However, we must consider the meaningfulness of price indices as well. In short, we must ask, "Are individuals likely to take this aggregate into account when making economic decisions?" The answer is, "Almost certainly."

Individuals care about the purchasing power of their money. As such, any measure of the purchasing power of money –the inverse of the "price level" –is likely to be both meaningful and useful to them. They can use this information to negotiate cost-of-living increases so their real wages are not eroded by inflation. It is also important for helping an individual decide his or her cash balances. Since two phenomena associated with trade cycles are the wedge between a worker's real wage and his marginal revenue product and an excess demand for money, in this case taking meaningfulness seriously can shed light on the raison d'être of macroeconomic theory.

The robustness of the importance of meaning can be seen through an application in which the aggregate in question arises endogenously, itself the result of purposeful human action in the sphere of catallaxy, apart from the realm of pure economic theory. A short thought experiment will be useful in further solidifying this point. Imagine a world without any kind of a price index. Individuals come into contact with the prices of goods and services they purchase regularly and currently this is their only means of discerning the purchasing power of their money. In this world, agents are likely to expend real resources on search –browsing through catalogues, window shopping, gathering information from friends and

rational decision to cut expenditure and increase their money balances. If the fraction of agents behaving thus is "large enough", the resulting decline in economic activity becomes a self-fulfilling prophecy. Other members of the community, facing hardship, also cut expenditure and increase their money balances. Without countercyclical policy, the prices of goods and services in the community falls until the agents perceive the real value of the savings of their neighbors has increased to the point where they expect their neighbors to begin resuming normal economic activity; as a result, they begin to adjust their activity as well, decreasing their money balances as they begin to purchase their old mix of goods and services once more. From the community's perspective, the shortfall in aggregate demand has corrected itself and life is rosy once more, following a path very similar to that outlined by Rothbard (2000). In fact, the correction process proceeds much along the same way it would have had the agents understood Say's Principle and monetary equilibrium theory, two models much more consistent with methodological individualism. This is of course a highly stylized example and by no means definitive; the impact of beliefs on economic outcomes is a separate research project entirely. However, this example shows it is not trivial that a widely-held nonuseful belief necessarily spells economic doom.

family, etc. –in order to get at least some estimate of their money's ability to command goods and services. One day a clever statistician begins an extensive study of the prices of many goods and services, creating the world's first price index and making the information publicly available. This new information presents an opportunity to the economy's agents: it offers them the possibility to economize on search costs by referring to the new price index when they want information regarding the purchasing power of their money. Of course each individual must make a decision regarding how appropriate this information is for their purchasing patterns and how noisy this new estimate is relative to their old search habits. Nevertheless, at the margin, we should expect some agents (namely those with the highest time opportunity cost) to rely on the new index and use the resources previously spent on search to satisfy more urgently-felt wants.[20] Thus the new price index, although it is obviously imperfect, induces individuals to change their behavior because the information it conveys is meaningful to them. Again we see both relational and methodological consistencies: the relational in one individual's reaction to the purposeful action of another and the methodological in the channel (the individual's beliefs) through which the price index impacts economic outcomes.

CONSISTENCY WITH PREVIOUS FORMULATIONS

As I indicated in the introduction, this approach to aggregates is perfectly reconcilable with methodological individualism. The importance of meaning and its centrality to social analysis was perhaps best stated by Boettke: "Social life is comprised of the *meaningful constructions* of the various actors that dwell within it" (1990, 37, emphasis in original). Nobody can deny that economic aggregates, in the sense that they are consciously compiled and analyzed, are social constructions. The degree to which they are meaningful is the degree to which individuals use this information in attempting to pursue their ends. "This subjectivist perspective is the very basis...of any claim of objectivity that we as social theorists can have" (37). Thus radical subjectivity in the context of methodological individualism is requisite in the sense that any meaning which individuals attach to their actions must be taken as datum. This reasoning also has close ties to the interpretive dimensions of social science (Lavoie 2011) and, since a difference in meaning can lead to a difference in the operationalization of belief, to questions amongst scientists as to which theoretical apparatus ought to be employed (Caldwell 1982).

Indeed, a closer reading of Mises and Hayek shows they laid the epistemological foundation for the investigation of meaning and its implications for economic analysis.[21] For

20 The usual assumptions apply: search is a normal good, and for some agents, the income effect dominates the substitution effect.

21 The following, again, are brief but representative examples. I keep the analysis short because this particular point, using similar evidence, was made by Boettke (1990), which the interested reader should consult for a more thorough treatment.

example, Mises obviously recognizes this point in his discussion of economic calculation in *Human Action*. Economic calculation is concerned with "the analysis of the mental processes performed by acting man in applying quantitative distinctions when planning conduct" (2008, 211). Hayek's oft-neglected work on sensory orders (1976) also entails such an interpretive framework. Most importantly, Hayek recognized that "in the social sciences things are what people think they are" (1943, 1). In light of these views, my argument seems obvious. After all, if individuals find certain economic aggregates meaningful, then it is silly to suggest these aggregates ought to be purged from scholarly analysis. Hopefully, by explicitly stating the link between aggregation and meaning, further critiques of methodological individualism on these grounds will be recognized as a flawed interpretation.[22]

4. IMPLICATIONS

The main implication of distinguishing between aggregation as method and aggregation as understanding, and hence recognizing the difference between usefulness and meaningfulness, is no different from that which methodological individualism has already prescribed: if one desires a good foundation for the social sciences, look to the individual. In this case it merely extends that tenet to aggregate statistics. Taking meaningfulness seriously means letting the individual tell us which aggregates are relevant.

Theoretically, this means nothing more than expanding the realm of permissible "if, then" statements. Specifically, rather than saying "If Aggregate X increases, then..." these statements take the form "If *these specific individuals* think Aggregate X is important, and Aggregate X changes, then..." These kinds of statements are compatible with methodological individualism and even strict apriorism. In the case where a priori theory leads us to a case of conflicting magnitudes, it is perfectly valid to use conditionals to illustrate potential

22 It may be argued that my formulation, built upon the arguments supporting the importance of individual belief and meaning, "proves too much." After all, why limit the extension of meaning to economic aggregates? What if individuals believed occurrences or objects completely unrelated to economics in any objective sense had an impact on economic outcomes, a la Jevons (1878)? Methodological individualists would, of course, have to take these flawed beliefs into account. However, the self-enforcing cycle of beliefs and outcomes could then lead to the conclusion that these extra-economic occurrences impact economic outcomes, and the line between economics and psychology seemingly becomes increasingly blurred. However, as recent work on the economics of unusual beliefs shows (Leeson 2010, 2011), beliefs endogenous to the social system can have both an economic explanation and an economic impact. When the objection is applied to aggregates specifically, the answer is even simpler: economic phenomena occur independently of the study of economics. Whether one believes a specific aggregate carries important information (i.e. is useful in the definition I proposed) or so inherently flawed as to convey nothing intelligible, it is still generated by the actions of economic actors. This generality holds with regards to aggregates in general, and thus I do not need to defend any particular economic aggregate, which is beyond the scope of this paper. The act of measuring it is the beginning of the process by which it transitions from debatable usefulness to definite meaningfulness, but we can be assured we do not have to worry about ending the story with an answer outside the domain of economic science.

outcomes. So long as these aggregates *only* play a role because they influence the action of the individual, we remain on sound theoretical ground.[23]

Empirically, this means going directly to the individuals and discovering which aggregates they use in their capacity as economic agents. We currently see market evidence showing that individuals do take cognizance of aggregate statistics: organizations such as the American Institute for Economic Research (AIER)[24] and Conference Board[25] publish reports which try to anticipate overall trends in business activity comprising leading, coincident, and lagging indicators. While not as technically complex as some econometric models designed for the same purpose, this approach still utilizes correlation amongst aggregates to give their readers an edge in the marketplace. These reports are available for an annual subscription fee. If individuals are willing to pay for the information, it's almost certain they find it meaningful! Even the Mises Institute[26] makes available aggregate market data (presumably for historical illustration rather than inputs into a theoretical model) on current prices, stock market behavior, measures of the money supply, and other macro-level statistics. To the extent that these aggregates enter the minds of individuals and influence their decisions, they become data with which the social sciences, especially economics, are concerned.

Interestingly, mainstream economics has started investigating how agents' beliefs can impact the economy, especially in the context of optimal policy design. This literature incorporates the social planner's uncertainty as to which model correctly specifies agents' beliefs. These methods have been applied to the study of growth (Brock et al. 2003; Doppelhofer et al. 2004) and finance (Avramov 2002), but the work most relevant to my thesis explores individuals' expectations and monetary policy (Levin and Williams 2003; Brock et al. 2007; Cogley et. al 2011). The authors consider various models of individual expectations (forward-looking, backward-looking, or some hybrid) and weight them according to some rule as a way of determining optimal monetary policy when the planner knows the types of agents in the economy but not their particular characteristics. These models best exemplify taking individuals' thoughts and actions seriously since they explicitly recognize that the same individuals acting on the same information can generate substantially different economic outcomes depending on how that information enters into their beliefs. By following these authors' strategic approach, if not their theoretical methods, methodological individualists can gain a better understanding of the impact agents' thoughts can have on economic outcomes by recognizing that some of those thoughts, and hence their actions, are influenced by statistical aggregates.

---

23 Consistent with methodological individualism, this is the sole channel by which a change in an aggregate can result in an individual altering his behavior. For example, if the price level rises, and the individual believes the price level (or rather, its inverse) is a meaningful measure of his money's purchasing power, he will change his behavior at the margin. If he believes the (inverse of the) price level is meaningless, the individual's purchasing power will increase only in the strict definitional sense, and he will not change his behavior at the margin.

24 "Understanding AIER's Business-Cycle Research Methodology." http://www.aier.org/research/business-cycle

25 "Global Business Cycle Indicators." http://www.conference-board.org/data/bci.cfm

26 "Markets and Data."http://mises.org/markets.asp

5. CONCLUSION

Economists in the Austrian tradition have long affirmed that, with methodological individualism as an inviolate primary, quantitative methods which utilize statistical aggregates are not a proper foundation upon which to build economic theory. In doing so they build a chain of logic which shows that the methods of positivism and empiricism are incompatible with methodological individualism, which is the proper frame of reference with which to analyze social phenomena. The conclusion they reach most frequently is that statistical aggregates of the kind which can be found in the ASAD paradigm or in formulations of various price indices are not useful –that is, they do not convey valid economic knowledge (or the costs of that knowledge exceed the benefits) and so they should be disregarded.

However, usefulness is only part of the equation. It is the part of the equation resulting from aggregation as method. Once we consider the role these aggregates play not in theory, but in the minds of the individual actors, we have transitioned to aggregation as understanding. In this case, we must consider meaningfulness as well. As I have argued, meaningfulness –what the information contained in statistical aggregates means to the individual economic actors and how they incorporate this information into their decision calculus –is the channel through which economic aggregates operate. It is fundamentally relational and still consistent with a proper conception of methodological individualism. I have also argued this insight, at a general level, has already been made by previous authors in the tradition of methodological individualism. It thus applies to the specific instantiation of economic aggregates. This postulate is not controversial. After all, failing to take the distinction into account would result in a contradiction: it would entail an affirmation of the contents of the individual's mind as the proper data of the social sciences, but then would likely disregard some of the factors which influence that individual's decision-making process. As such, economists who are also methodological individualists recognize the importance of discovering how individuals use these aggregates since is the beliefs of the individuals and the meaning they attach to those beliefs which is important.

I am not encouraging a methodological transformation to match that of neoclassical or New Keynesian economics; nor am I suggesting the flaws in mainstream economic beliefs and methods ought not be critiqued (Boettke et al. 2011). All I am suggesting is that, since beliefs and meanings of individuals are supreme to those working in the tradition of methodological individualism, aggregates can play a role in the thoughts of economic agents without being a theoretical primary. Extending the implications of belief and meaning to this aspect of the methodological individualist tradition constitutes progress towards a proper recognition of the requirements and implications of the paradigm.

In this paper I have offered two highly stylized examples of how an individual might behave when certain aggregates are meaningful to her but likely nonmeaningful to an economist. I believe from these I have adequately shown that information which economists view as nonuseful can be both useful and meaningful to an individual actor, as well as some possible consequences which result from this divergence of beliefs. These examples were meant to illustrate the difference between aggregation as method and aggregation as understanding by emphasizing the importance of meaningfulness rather than make any claim as to how these specific beliefs impact real economic outcomes. Ultimately it is an empirical question whether an individual thinks Aggregate X is meaningful, and disagreements over the particular cases I presented here do not refute the underlying argument: the meaningfulness consideration reconciles economic aggregates with individual beliefs in a way which is consistent with and highlights the versatility of methodological individualism.

REFERENCES

Aligica, Paul Dragos and Anthony J. Evans. (2009) 'Thought Experiments, Counterfactuals and Comparative Analysis', *Review of Austrian Economics* 22(3): 225–239.

Avramov, Doron. (2002) 'Stock Return Predictability and Model Uncertainty', *Journal of Financial Economics* 64(3): 423–458.

Axtell, Robert L. (2007) 'What Economic Agents Do: How Cognition and Interaction lead to Emergence and Complexity', *Review of Austrian Economics* 20(2): 105–122.

Bismans, Francis and Christelle Mougeot. (2009) 'Austrian Business Cycle Theory: Empirical Evidence', *Review of Austrian Economics* 22(3): 241–257.

Boettke, Peter J. (1990) 'Interpretive Reasoning and the Study of Social Life', *Methodus: Bulletin of the International Network for Economic Method* 2(2): 35–45.

Boettke, Peter J. (1994) ' Introduction', in Peter J. Boettke (ed.) *The Elgar Companion to Austrian Economics*, Cheltenham, United Kingdom: Edward Elgar.

Boettke, Peter J. (2002) 'Information and Knowledge: Austrian Economics in Search of its Uniqueness', *Review of Austrian Economics* 15(4): 263–274.

Boettke, Peter J., Daniel J. Smith, and Nicholas A. Snow. (2011) 'Been There, Done That: The Political Economy of DéJà Vu', Working paper: http://ssrn.com/abstract=1720661

Boettke, Peter J. and Virgil Henry Storr. (2002) 'Post-Classical Political Economy: Polity, Society, and Economy in Weber, Mises, and Hayek', *American Journal of Economics and Sociology* 61(1): 161–191.

Brock, William A., Steven N. Durlauf, and Kenneth D. West. (2003) 'Policy Analysis in Uncertain Economic Environments (With Discussion)', *Brookings Papers on Economic Activity* 1: 235–322.

Brock, William A., Steven N. Durlauf, and Kenneth D. West. (2007) 'Model Uncertainty and Policy Evaluation: Some Theory and Empirics', *Journal of Econometrics* 136(2): 629–664

Bunge, Mario. (2000) 'Ten Modes of Individualism –None of Which Works –And Their Alternatives', *Philosophy of the Social Sciences* 30(3): 384–406.

Caldwell, Bruce. (1982) *Beyond Positivism: Economic Methodology in the Twentieth Century*, Boston: Allen and Unwin.

Chamlee-Wright, Emily. (2010a) *The Cultural and Political Economy of Recovery: Social Learning in a Post-Disaster Environment.* London, United Kingdom: Routledge.

Chamlee-Wright, Emily. (2010b) 'Qualitative Methods and the Pursuit of Economic Understanding', *Review of Austrian Economics* 23(4): 321–331

Clark, Andre. (2003) 'Methodological Individualism, Cognitive Homogeneity, and Environmental Determinism', *Journal of Economic Methodology* 10(1): 79–85.

Cogley, Timothy, Bianca De Paoli, Christian Matthes, Kalin Nikolov, and Tony Yates. (2011) 'A Bayesian Approach to Optimal Monetary Policy with Parameter and Model Uncertainty', *Journal of Economic Dynamics and Control*, forthcomming

Crespo, Ricardo F. (2002) 'Reappraising Austrian Economics' Basic Tenets in Light of Aristotelian Ideas', *Review of Austrian Economics* 15(4): 313–333.

Coyne, Christopher J. (2010) 'Economics as the Study of Coordination and Exchange', in Peter J. Boettke (ed.) *Handbook of Contemporary Austrian Economics*, Cheltenham, United Kingdom: Edward Elgar.

Doppelhofer, Gernot, Ronald I. Miller, and Xavier Sala-i-Martin. (2004), 'Determinants of Long-Term Growth: A Bayesian Averaging of Classical Estimates (BACE) Approach', *American Economic Review* 94(4): 813–835.

Evans, Anthony J. (2010) 'Only Individuals Choose', in Peter J. Boettke (ed.) *Handbook of Contemporary Austrian Economics*, Cheltenham, United Kingdom: Edward Elgar.

Folmer, Henk, Wim J.M. Heijman, and Auke R. Leen. (2002) 'Product Liability: A Neo-Austrian Based Perspective', *European Journal of Law and Economics* 13(1): 73–84.

Hayek, F.A. (1943) 'The Facts of the Social Sciences', *Ethics* 54 (1): 1–13.

Hayek, F.A. (1945) 'The Use of Knowledge in Society', *American Economic Review* 35 (4): 519–530.

Hayek, F.A. (1976) *The Sensory Order,* Chicago: University of Chicago Press.

Hayek, F.A. (1979) *The Counter-Revolution of Science*, Indianapolis, Indiana: Liberty Fund.

Higgs, Robert. (1994) 'Banning a Risky Product Cannot Improve Any Consumer's Welfare (Properly Understood), with Applications to FDA Testing Requirements', *Review of Austrian Economics* 7(2): 3–20.

Hodgson, Geoffrey M. (2007) 'Meanings of Methodological Individualism', *Journal of Economic Methodology* 14(2): 211–226.

Holcombe, Randall G. (1999) 'Equilibrium versus the Invisible Hand', *Review of Austrian Economics* 12(2): 227–243.

Holcombe, Randall G. (2008) 'Advancing Economic Analysis Beyond the Equilibrium Framework', Review of Austrian Economics 21(4): 225–249.

Hudik, Marik. (2011), 'Why Economics is not a Science of Behavior', *Journal of Economic Methodology* 18(2): 147–162.

Jevons, W. Stanley. (1878) 'Commercial Crises and Sunspots', *Nature* 19(472): 33–37.

Keeler, James P. (2001) 'Empirical Evidence on the Austrian Business Cycle Theory', *Review of Austrian Economics* 14(4): 331–351.

Kirzner, Israel M. (1976) 'On the Methodology of Austrian Economics' in Edwin G. Dolan (ed.) *The Foundations of Modern Austrian Economics*, Kansas City, Kansas: Sheed & Ward, Inc.

Lachmann, Ludwig M. (1976) 'Toward a Critique of Macroeconomics', in Edwin G. Dolan (ed.) *The Foundations of Modern Austrian Economics*, Kansas City, Kansas: Sheed & Ward, Inc.

Lachmann, Ludwig M. (1978a). "An Austrian Stocktaking: Unsettled Questions and Tentative Answers." In *A New Direction in Austrian Economics*, Louis M. Spadaro, eds. Kansas City: Sheed Andrews & McMeel, Inc.

Lachmann, Ludwig M. (1978b). *Capital and its Structure*. Kansas City: Sheed Andrews & McMeel, Inc.

Lange-von Kulessa, Juergen. (1997), 'Searching for a Methodological Synthesis –Hayek's Individualism in Light of Recent Holistic Criticism', *Journal of Economic Methodology* 4(2): 267–287.

Lavoie, Don. (2011) 'The Interpretive Dimension of Economics: Science, Hermeneutics, and Praxeology.' *Review of Austrian Economics* 24(2): 91–128

Leeson, Peter T. (2010) 'Ordeals', working paper: http://www.peterleeson.com/Ordeals.pdf.

Leeson, Peter T. (2011) 'Trial by Battle', *Journal of Legal Analysis* 3(1): 341–375.

Levin, Andrew T. and John C. Williams. (2003) 'Robust Monetary Policy with Competing Reference Models', *Journal of Monetary Economics* 50(5): 945–975.

Lewis, Paul. (2005) 'Boettke, the Austrian School and the Reclamation of Reality in Modern Economics', *Review of Austrian Economics* 18(1): 83–108.

Lewis, Paul. (2008) 'Uncertainty, Power, and Trust', *Review of Austrian Economics* 21(2): 183–198.

Mises, Ludwig von. (1962) *The Ultimate Foundation of Economic Science,* Princeton, New Jersey: D. Van Nostrand Company, Inc.

Mises, Ludwig von. (2007) *Theory and History: An Interpretation of Social and Economic Evolution*. Auburn, Alabama: Ludwig von Mises Institute.

Mises, Ludwig von. (2008) *Human Action: A Treatise on Economics (Scholar's Edition).* Auburn, Alabama: Ludwig von Mises Institute.

Moss, L. S. (1997) 'Austrian Economics and the Abandonment of the Classic Thought Experiment', in Keizer, W., B. Tieben and R. van Zjip (ed.) *Austrian Economics in Debate*, London, United Kingdom: Routledge.

Nooteboom, Bart. (2007) 'Methodological Interactionism: Theory and Application to the Firm and to the Building of Trust', *Review of Austrian Economics* 20(2): 137–153.

Rizzo, Mario J. (1978) '*Praxeology and Econometrics: A Critique of Positivist Economics', in Louis M. Spadaro (ed.) New Directions in Austrian Economics,* Kansas City: Sheed Andrews and McMeel.

Rothbard, Murray N. (1976) 'Praxeology: The Methodology of Austrian Economics', in Edwin G. Dolan (ed.) *The Foundations of Modern Austrian Economics*, Kansas City, Kansas: Sheed & Ward, Inc.

Rothbard, Murray N. (2000) *America's Great Depression*, 5th edn, Auburn, Alabama: Ludwig von Mises Institute.

Seagren, Chad W. (2011) 'Examining Social Processes with Agent-Based Models', *Review of Austrian Economics* 24(1): 1–17.

Selgin, George A. (1990) *Praxeology and Understanding: An Analysis of the Controversy in Austrian Economics*. Auburn, Alabama: Ludwig von Mises Institute.

Storr, Virgil Henry. (2010) 'The Facts of the Social Sciences are What People Believe and Think', in Peter J. Boettke (ed.) *Handbook of Contemporary Austrian Economics*, Cheltenham, United Kingdom: Edward Elgar.

Stringham, Edward P. (2010) 'Economic Value and Costs are Subjective', in Peter J. Boettke (ed.) *Handbook of Contemporary Austrian Economics*, Cheltenham, United Kingdom: Edward Elgar.

Vedder, Richard. (1997) 'Statistical Malfeasance and Interpreting Economic Phenomena', *Review of Austrian Economics* 10(2): 77–89.

Wagner, Richard E. 2010. *Mind, Society, and Human Action: Time and Knowledge in a Theory of Social Economy*. London: Routledge.

Wagner, Richard E. 2012a. A Macro Economy as an Emergent Ecology of Plans. *Journal of Economic Behavior and Organization* 82(2–3): 433–444

White, Lawrence. (1984) 'The Methodology of the Austrian School Economists', Auburn, Alabama: Ludwig von Mises Institute.

Zwirn, Gregor. (2007) 'Methodological Individualism or Methodological Atomism: The Case of Friedrich Hayek', *History of Political Economy* 39(1): 47–80.

NONRIVALNESS, SUBJECTIVITY AND CAPITAL – AN OVERVIEW OF THE AUSTRIAN THEORY OF CLUB GOODS

JAKUB BOŻYDAR WIŚNIEWSKI[27]

ABSTRACT

According to neoclassical economic theory, club goods would be underproduced by the market in the absence of a monopoly of force capable of coercing every able member of society to contribute to their provision. By applying both the methodological tools developed by the Austrian School of Economics and the tools used to investigate the institutional robustness of various systems of political economy, I shall argue, first, that the neoclassical characteristics of club goods are based on a number of false assumptions or unacceptable oversimplifications, and second, that even if they were correct as stated, they would not establish the desirability of the existence of a monopoly of force due to the existence of a more efficient, purely market-based alternative. Then I shall apply the results of my argument to the issue of the provision of law and defense, which appears to lend itself particularly well to being a promising case study in this context.

KEYWORDS

Club goods, Capital, Austrian School

27 Department of Politics at Queen Mary, University of London, UK; email: jakub@cantab.net

1. INTRODUCTION

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

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

The former means that the consumption of a unit of a given good by a particular person does not in any way diminish the ability of others to consume that same unit, while the latter means that a given good produces spillover effects, which enable non-payers (most notably the so-called "free riders") to benefit from the good without in any way contributing to its production. Some standard examples of the former type of goods – i.e., pure club goods (nonrival but excludable) – would be TV signals and computer software. Some examples of the latter type – i.e., pure common goods (rival but non-excludable) – would be air and fish in the ocean. Finally, some paradigmatic examples of the goods combining the above features, oftentimes called pure public (Leach 2003, pp. 171–86) or collective (Demsetz 1970) goods include lighthouses and national defense.

It is often claimed that these two characteristics give rise to the corresponding two types of market failure – in the case of club goods some people are excluded from consumption even though they would not generate any additional costs for the producer, while in the case of common goods the social gains, including the gains of free riders, outweigh the private gains of the producer, which undermines the incentive to produce in the first place. Thus, a monopoly of force is expected to intervene and coerce every able member of society to contribute financially in order to secure a sufficient supply of the goods in question. Absent such a monopoly, the argument goes, the results are bound to be sub-optimal. This line of argumentation, first developed in the late 1950s (Bator 1958), came to dominate the "market failure" literature of the succeeding decades (Baumol 1961, p. 268; Arrow 1969, Head 1972, Stiglitz 1989) and continues to be an integral element of economics textbooks (see, e.g., Willis 2002, pp. 161–3; Arnold 2004, pp. 720–3; Ayers and Collinge 2004, pp. 555–9), as well as a focal point of the literature devoted to the so-called "global economic problems" (Sandler 1997, Sandmo 2000).

By applying both the methodological tools developed by the Austrian School of Economics and the tools used to investigate the institutional robustness of various systems of political economy (Boettke and Leeson 2004, Leeson and Subrick 2006), I shall argue, first, that the above characteristics of club goods are based on a number of false assumptions or unacceptable oversimplifications, and second, that even if they were correct as stated, they would not establish the desirability of the existence of a monopoly of force due to the fact that the alleged club goods can be produced more efficiency in a purely market-based system. After developing a general critique and reconstruction of each part of the neoclassical theory of club goods, I shall apply its results to the issue of the provision of law and defense, which I think lends itself particularly well to being a promising case study in this context, since it is often seen as a paradigmatic example of a pure public good (Head and Shoup 1969, p. 567; Bush and Mayer 1974, p. 410; Buchanan and Flowers 1975, p. 27; Samuelson and Temin 1976, p. 159; Cowen 1992) or even a typical club good, which prompted some of those authors who believe that a sufficient amount of non-rival goods can be provided by voluntary means to analogize a monopoly of force to a private club or firm (Buchanan 1965, 1975; Blankart 1994, p. 273; Mueller 1996, p. 81, 301).

Unfortunately, due to space constraints, I will not be able to develop a similar critique of the standard theory of common goods in this paper. This shall be dealt with on another occasion. Let me just signal here that I believe there are at least as many good and strong arguments to be made in that area as there are in what I will concentrate on in the following section.

Having made the above introductory remarks, let us now consider some aspects of the theory under consideration in more detail.

2. NON-RIVALNESS, SUBJECTIVITY AND CAPITAL – THE THEORY

Let us start from an attempt at a reductio ad absurdum: if a viewer in a movie theatre behaves appropriately (i.e., does not talk, eat loudly, etc.), he might be reasonably thought of as not imposing any costs on other viewers, or, in other words, as not in any way diminishing the value of their consumption. Hence, if only half of the tickets for a movie have been sold, the outcome is sub-optimal as long as the remaining empty seats are not filled with additional viewers admitted free of charge. In view of the above, movie theatres should be treated as club goods and thus either nationalized or at least subsidized or heavily regulated by a monopoly of force in order to ensure that no zero-cost consumers are excluded from their use (Hoppe 1989a, pp. 41–2).

It seems plausible to expect that the overwhelming majority of club goods theorists would reject such a conclusion. Since this reaction appears intuitively right, there must be something wrong with the underlying theory. I believe that there are several things wrong with it, and I think that the Austrian appreciation of the elements of value subjectivity and intertemporal coordination in economic processes highlights them particularly well.

As noted by James Buchanan in his summary of the theory of costs, “cost is subjective, it exists in the mind of the decision-maker and nowhere else. (...) [It] cannot be measured by someone other than the decision-maker because there is no way that subjective experience can be directly observed” (Buchanan 1969, p. 43). It might seem that no monetary (or perhaps “tangible”) costs are involved in letting non-payers into the theatre to fill up the hall, but this is actually a misperception, since an external observer is in no position to pass such judgments.

In reality, various individual costs are presumably present in the considered situation. First of all, there might be psychological costs for the viewers associated with decreased comfort brought about by the unexpected letting of additional people into the hall (here we have to remember that the perception of crowding is also subjective). Secondly, there might be costs associated with the perception of being cheated by being treated on a par with non-paying free riders. These latter costs are initially purely psychological and borne out exclusively by the paying viewers, but if one takes into account the passage of time (Lachmann 1986, Kirzner 1992), one should discover that as outraged customers begin to ostracize the theatre and actively discourage their acquaintances from using it, what used to be subjective in the sense of being immaterial and financially impalpable turns into very objective, tangible monetary losses for the theatre owner.

The general inference to be drawn from the above considerations is that non-rival consumption can perhaps be seen as a useful analytical construct, but not as a tool for policy guidance. This is because whether a given good is non-rival can be established only by means of the intellectual division of labour performed by the totality of consumers engaged in voluntary transactions. In other words, the existence of non-rivalness can be borne out by the market process, but neither any of its individual participants nor any outside observer can be (or indeed needs to be) aware of whether the transacted goods have this characteristic or not.

However, it is possible to imagine a variety of club goods theorists who would be quite happy to embrace wholesale behaviourism or physicalism and rely on such doctrines as the basis for insisting that there remains a fundamental difference between the goods whose consumption is physically (and therefore objectively) rivalrous and the goods whose putative rivalness can be inferred only by accepting what they take to be dubious psychological-subjectivist assumptions. Furthermore, let us suppose that such theorists would be willing to bite the bullet and accept the aforementioned reductio ad absurdum by agreeing that movie theatres should indeed by subjected to the control of a monopoly of force. Such indeed would be a consistent decision to be drawn from the conclusion that consumption of movies is physically non-rivalrous.

But having bitten the bullet, they now have to answer the following two crucial questions: how much of the ostensible club good should be produced and how to keep its production within the limits imposed by sound cost accounting? Being maximally sympathetic to an imaginary group of planners willing to grapple with the above problems, and thus granting the institutional framework they have to erect in order to implement their ideas maximal robustness, I am assuming they are fully aware that even though movies themselves are physically non-rival, the same cannot be said about the goods constituting the underlying capital structure. After all, the theatre building has to be maintained continually, the screening equipment has to be conserved and eventually replaced, the management has to compile and update the movie repertoire, etc. It is thus crucial not to confuse the short-term costs of letting an extra person into the hall with the long-term costs of maintenance and management of the relevant capital assets (Brownstein 1980, pp. 101–2).

Now, let us recall that the goal of our planners is to ensure efficient allocation of resources, by which they mean not excluding any zero-cost consumer from enjoying physically non-rival goods. However, since there are other essential costs lurking in the background, some means of covering them have to obtained if production is to be sustained.

The first method that can be resorted to in this context is the quasi-market procedure propounded by Taylor and Lange (Taylor 1929, Lange 1936), based on the attempt to mimic a perfectly competitive market environment, with the monopoly of force assuming the role of a Walrasian auctioneer, who alters the price of a given good in response to consumer reactions. Initially the price is set arbitrarily, but with the subsequent appearance of surpluses or shortages it is adjusted accordingly, downwards or upwards, until the equilibrium price is determined, supply meets demands and efficient allocation is obtained. Furthermore, this price is then supposed to be imputable to the goods constituting the underlying capital structure, which allows for establishing their monetary value and subjecting them to financial profit-and-loss calculation.

Carrying this procedure out effectively might involve a host of separate problems, associated, e.g., with potentially insufficient incentives of the theatre managers (who, unlike private entrepreneurs, cannot benefit from the mobilizing power of the profit motive) or with covering the costs of integrating this particular managerial cell with the broader, vertical structure of the monopolist regulator. However, in the spirit of our methodology, let us assume that the planners can somehow solve these issues effortlessly.

But even given this, there remain significant difficulties with the approach under consideration. Let us start analyzing them by quoting Hayek, who objects to the claim that "the valuation of the factors of production is implied in, or follows necessarily from, the valuation of consumers' goods" by noting that "implication is a logical relationship which can be meaningfully asserted only of propositions simultaneously present to one and the same mind" (Hayek 1948, p. 90). Since in the situation in question none of the consumers (moviegoers) is in a position to challenge the coercive monopolist by becoming a theatre owner or a shareholder, no competitive appraisal of the relevant capital goods can take place, and thus no intersubjectively meaningful cardinal value (price) can be attached to them (Herbener 1996, Reynolds 1998). The appraisal in question can occur only if every individual, having evaluated a certain final good in his consumer's role (and confronted his evaluation with that of the totality of other consumers), can then proceed to become a producer or an entrepreneur and engage in competitive bidding against the rest of the producers and entrepreneurs for the ownership of the capital goods used in production of the aforementioned final good (Mises 1990; 1996, ch. 16). But as long as there exists a "functional" gulf between the monopolist of force, who is the sole owner of a given stock of capital goods, and the consumers who are forcibly prevented from assuming any other role in a given area of economy, the production of any supposed club good is bound not to be efficient, but wasteful and unsustainable in the long run.

Equally importantly, it is necessary to realize that the putative equilibrium price of a final good, determined under conditions of initial ignorance with regard to the monetary value of the relevant factors of production, need not be optimal. In fact, it is very likely to lead to irremediable inefficiency. The entrepreneurial task of, say, the owner of a lemon orchard, is not to sell the entire supply of lemons at such a price that no customer is left empty-handed, but to sell enough lemons at a price sufficiently high to (at least) cover all the expenses associated with maintaining the orchard. In other words, he needs to know the monetary value of his capital assets in advance of determining the price of the final goods he wishes to sell, and only by utilizing his knowledge of the difference between the two can he sustain his enterprise, let alone make it profitable.

However, in the absence of signals associated with "counter-demands" for a given factor of production expressed by other entrepreneurs, based on their anticipations of the future market value of alternative final goods that could be produced with the use of the factor in question, its economic worth necessarily remains unknown, leaving no chance for establishing whether it is used efficiently (Böhm-Bawerk 1894/5). In other words, in the absence of competitive intellectual division of labor capable of establishing a uniform, monetary scale of exchange values expressible in cardinal terms, to which all goods and services can be reduced and which allows for determining the extent to which any given entrepreneur acts in line with consumer sovereignty, the notions of profit and loss, surplus and shortage, and revenue and cost (understood not as an objective physical cost, but as a social opportunity cost) are bound to be logically meaningless (Machaj 2007), and thus entrepreneurially useless. The crucial observation to be made in this context is that the market process of competitive appraisal operates simultaneously at two mutually informative levels – that of final consumption goods and that of factors of production of various orders – and it cannot run smoothly with only one of these levels intact. If one relies on only one of them with the hope that the other is somehow "implied" in the former, then his actions will be necessarily (and fatally) uninformed.

Thus, we can see that the Taylor-Lange quasi-market procedure is crucially defective and that even the aforementioned narrower, "physical" variety of non-rivalness of certain consumption goods is subordinate to the ineradicable rivalness of the underlying capital goods. In other words, the said procedure does not offer the monopoly of force any promising way of managing effectively the production of what it considers to be club goods.[28]

28 Interestingly, and quite tellingly, the Austrian rebuttals to the Taylor-Lange quasi-market solution to the problem of economic calculation under socialism were not addressed in any systematic manner by the sympathizers of the latter. Instead, the neoclassical mainstream largely accepted the alleged viability of the solution in question, thereby declaring market socialists the winners of the original calculation debate (see, e.g., Arrow 1974, p. 5; Lavoie 1985). In addition, the post-Soviet collapse treatments of the topic of market socialism by

Another method that a monopoly of force might resort to would be to dispense with trying to appraise the productive assets in its possession by using the dubious imputation strategy and instead impose a tax on society in order to finance the capital structure needed to produce the supposed club goods. This solution, however, seems even less promising than the previous one, since, unlike the latter, it does not even maintain the connection between the price of final goods and consumer demand demonstrated in concrete, voluntary actions. In other words, the compulsory payment that it proposes – being detached from the market price system – is likely to be completely arbitrary. And even if the payment in question were to be based on the prices prevailing among the private providers of any given club good, its imposition is bound to generate inefficiencies by distorting valuation information in other areas of the market, since a tax levied on other goods and/or their producers' income "will lead to inefficiently small rates of production of these (...) goods" (Demsetz 1964, p. 21).

Could such a trade-off be worthwhile? It appears difficult to conclude that it could, since it implies that society could be better off with a smaller amount of "private" goods (for which demand is voluntarily displayed) and with a larger amount of "public" (club) goods (for which there is no voluntary demand, and which are therefore funded coercively). Such a conclusion runs afoul of the principle of demonstrated preference (Rothbard 1956, Herbener 1997), which says that every free market transaction is a positive-sum game, where all involved parties demonstrate by their uncoerced actions that they prefer the post-transaction state to the pre-transaction state. Given the subjectivist approach to economics, it is thus hard to claim that the existence of monopolistically and coercively produced club goods is preferable on efficiency grounds to their nonexistence coupled with the corresponding existence of a higher amount of competitively and voluntarily produced "private" goods. In sum, the tax-based strategy seems to be as untenable (if not more so) as the Taylor-Lange method.

Finally, since capital assets used in the production of club goods are not open to purchase by individual entrepreneurs, none of them can utilize his personal, "tacit" knowledge of the specific circumstances of time and place (Hayek 1945) in order to cater to the needs, tastes and preferences of any given group of consumers with maximum efficiency. In the case of cinemas this would involve, for instance, diversification and constant updating of the movie repertoires.

Of course, a monopoly of force might try to engage in similar activities in an efficient manner by, for example, decentralizing its decision-making structure and encouraging local cinema managers to utilize their tacit knowledge as far as possible. However, if such managers are to remain managers of publicly owned capital goods rather than their private proprietors, they cannot become completely independent in their decisions – the vertical structure of the public sector requires that the relevant, time- and place-specific information

the neoclassicists (e.g., Roemer 1994 and Stiglitz 1994), while mentioning and acknowledging the significance of some aspects of the abovementioned Austrian rebuttals, nevertheless contain assertions and conclusions that betray a continued lack of understanding of their general import, let alone their finer details (Hill 1997, Wohlgemuth 1997).

be gathered at the bottom and then either sent to the higher authorities for approval of the action plan that involves their utilization or at least periodically reported to those authorities. In both cases such a vertical relationship creates significant transaction costs, perhaps most notably time costs – in the best-case scenario the local managers are thereby slowed down in their decision-making processes, whereas in the worst-case scenario their efforts are rendered completely futile, since the information they collect may routinely become obsolete and useless before the authorities manage to put a stamp of approval on the business plan that draws on them.

Moreover, since in such cases the authorities can access the relevant information only in the form of indirect description rather than in the form of first-hand experience of specific circumstances of time and place, they are usually in no position to assess the accuracy of the local managers' reports and thus the usefulness of any given set of data to the success of the action plan under consideration. If, however, we were to assume that the remedy to this problem would be to give the managers full discretionary powers over the creation and execution of their plans, they would cease to be employees of the public monopoly and become private entrepreneurs instead (Rothbard 1991, pp. 57–60).

Having made the above theoretical points, let us now see how they apply to the operation of the sector which, as I indicated earlier, is typically seen as particularly suited for being controlled by a monopoly of force, namely, law and defense.

3. NON-RIVALNESS, SUBJECTIVITY AND CAPITAL – THE APPLICATION

There is no quick and easy answer to the question of whether law and defense constitute club goods, since they cannot be treated as any sort of homogeneous lump – instead, they come in various forms and categories (Hoppe 1989a, p. 35). What follows is that the relevant economic characteristics of some of them can be more readily identified than those of the others. I shall analyze what I take to be examples of goods belonging to both ends of this spectrum.

The issue seems relatively straightforward in this regard when it comes to a generic service that might be called "the availability of competent people" – in this case, e.g., policemen and judges. One more policeman or one more judge present in region A means one less policeman or one less judge present in region B. One more representative of either of these professions occupied at any given time by person A means one less of such professionals capable of servicing person B at the same moment. Thus, the availability of services offered by people working in these sectors is fully rivalrous. This is because rather than being some monolithic wholes, the sectors in question consist of "specific resources committed in certain definite and concrete ways" (Rothbard 2004, p. 1032). Consequently, it is incorrect to claim that without ceding their management to a monopoly of force any zero-cost consumers will be inefficiently excluded from their use, since there are no such consumers.

The situation could seem to be somewhat different with respect to what might be termed "mid-range" protective services – for instance, the presence of surveillance cameras in a given area. It appears that no additional costs are generated by the fact that a camera observes an extra person. At the same time, the ex ante benefit of deterring criminals and the ex post benefit of their easier identification and apprehension seem to remain intact. Does that mean that surveillance cameras constitute an example of a club good?

My answer is negative – I contend that the above impression of non-rivalness is illusory for two main reasons. Firstly, the above brief remarks disregard the influence of the dimension of time and the corresponding phenomenon of crowding. As certain areas become more frequented due to their reputation for being safe, the human traffic in them gets much denser and thus more difficult to monitor effectively. And while it seems reasonable to conclude that such a change is likely to make certain sorts of crimes (e.g., shop robbery, car theft) less frequent, it might facilitate undertaking other kinds of criminal activity (e.g., assault, pick pocketing). In any event, it is not implausible to argue that increases in human traffic in area A should lead to an increase in the number of cameras in the same region – and hence to an increase in the relevant costs – which highlights the rivalrous character of the amenity in question.

Secondly, and perhaps more importantly, even prior to the occurrence of crowding, surveillance can perhaps be treated as temporarily non-rival, but the capital structure needed for its operation cannot. This is a general point that I already gestured towards in the previous section, and I think of it as universally applicable in the field under consideration. If we look at the right type of cost – that is, not the cost of letting an extra person enjoy any given amenity, but the cost of creating that amenity in the first place – we have to conclude that every good whose building materials are not available in superabundance is in an important sense rivalrous.

It is particularly worthwhile to notice that the above observation applies also to what might be termed "long-range" protective assets – e.g., anti-ballistic missiles and nuclear weapons (thought of as deterrents) – as well as to their legal counterparts,[29] such as the institutions responsible for promoting and reinforcing the concept of the rule of law (Hayek 1960, 1973). Admittedly, in this context it is impossible to envisage the phenomenon of crowding to have any relevant effect on the degree to which the above elements can successfully perform their intended functions. And yet, neither their creation can be accomplished nor their operation can be maintained costlessly. Moreover, if these goals are not only to be achieved, but also to be achieved effectively, then it is crucial not only to realize that the procedures that have to be undertaken to this end are costly, but also to determine which of them (and there is an endless number to choose from) is least costly or at least inexpensive enough to be sustainable.

To be successful in this task, one needs to have a meaningful price system to rely on, a price system reflecting the relative scarcities of goods and the social demand for them. Such a system, however, as mentioned in the previous section, can emerge only in a freely

29 Counterparts in terms of the range at which they operate rather than the mode in which they operate.

competitive environment of private property rights and the voluntary exchange of property titles. Competition should be seen in this context as the process whereby subjective appraisals are turned into intersubjective exchange ratios, or, in other words, as the process whereby prices are rationalized. Thus, it is perfectly legitimate to view competition as, to echo Hayek's (2002) words, a "discovery procedure", a process as rivalrous as it is cooperative, in which "each and every type of productive service is objectively appraised in monetary terms according to its ultimate contribution to the production of consumer goods" (Salerno 1990a, p. 36).

As should have already become clear from the above remarks, the management of production by a monopoly of force is antithetical to the existence of any meaningful price system, since it is also antithetical to the existence of free competition. This applies to every area of service, including law and defense. What should perhaps be mentioned in this connection is that trying to wed these two modes of production by allowing a competitive private sector to arrive at market prices and then instructing the public officials to copy them for the purpose of developing efficient public policy is problematic as well, since covering the costs of the eventual implementation of that policy would require taxing the market participants, which would necessarily degrade valuation information in the taxed industries and thus distort the price mechanism.

Lastly, it should be noted that even if it were granted for the sake of argument that law and defense are non-rival, it would not follow that they could be assumed to be universally regarded as goods. This, in turn, implies that their coercively funded, monopolistic production could actually be regarded by certain individuals as a "bad". There exist anarchists who oppose every form of initiatory violence and thus regard levying forced contributions as an unacceptable encroachment on legitimate property rights (Rothbard 1981). There exist pacifists who consider the existence of vast military arsenals, even if ostensibly accumulated for defensive purposes only, as necessarily increasing the risk of armed conflict.[30] There exist those who see the monopolistic production of the putative club goods as creating worse free-rider problems than their decentralized, private production does (de Jasay 1989). None of these groups can be declared to benefit from judicial or protective dirigisme. To claim otherwise is to disregard the teachings of subjectivist economics and subscribe to an unfounded psychological assumption that an individual's costs and benefits can be measured by or shifted to a third party. Alternatively, it might indicate contravening the principle of Wertfreiheit (Rothbard 1973b, Block 1975) and asserting that individuals can be coerced for their own good, which moves the asserter from the realm of positive political economy into the realm of normative ethics.

30 Some of the public goods theorists seem to understand this point clearly. See, for instance, the following quotation: "In the case of a pure public good, voluntarism may be absent, since the good may harm some recipients (e.g., defense to a pacifist, fluoridation to someone who opposes its use)" (Cornes and Sandler 1986, p. 159). However, this supposed understanding does not stop them from maintaining that something that is harmful for some people may nonetheless be regarded as a "pure public good", a conclusion I find logically incoherent insofar as the existence of "pure public goods" is supposed to be beneficial to payers and non-payers alike, and these two categories exhaust the set of potential recipients, thus logically implying that, in the context at hand, the set of harmed recipients is empty.

4. CONCLUSION

In conclusion, law and defense do not differ from other scarce goods in terms of rivalness. Moreover, they are similar to all other scarce goods in that if their production is detached from the market price system, their relative worth vis-à-vis other goods, as well as their most cost-efficient production method, cannot be determined. Finally, the subjective nature of benefits and losses makes it impossible to presume that to the extent that consumption of these goods can be considered as temporarily non-rival, being able to so consume them is unanimously accepted as advantageous.

Now, it is an entirely different question whether in the cases where the market price system reveals the above information to the producers of protective and judicial services, they are able to generate sufficient revenue to cover all the necessary expenses, or whether free-rider problems are bound to make their enterprises unsustainable in the long run. My own opinion is that there exist excellent grounds for asserting that the market system, unlike a monopoly of force, can deal with free-riders swiftly and effectively, but, as I indicated earlier, due to space constraints, I have to leave further elaboration of that contention for another occasion.

REFERENCES

Arnold, R. A. (2004), *Economics* (Mason, OH: South-Western).

Arrow, K. (1969), 'The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Nonmarket Allocation', in *The Analysis and Evaluation of Public Expenditure: The PPB System*, vol. 1, U.S. Joint Economic Committee, 91st Congress, 1st Session (Washington D.C.: U.S. Government Printing Office).

Arrow, K. (1974), 'Limited Knowledge and Economic Analysis', *American Economic Review*, 64 (1), 1–10.

Ayers, R. M. and Collinge, R. A. (2004), *Economics: Explore and Apply* (Upper Saddle River, NJ: Prentice Hall).

Bator, F. M. (1958), 'The Anatomy of Market Failure', *Quarterly Journal of Economics*, 72 (3), 351–79.

Baumol, W. J. (1961), 'Review of *Politics, Economics and Welfare*', in *Economic Theory and Operations Analysis* (Englewood Cliffs, N.J.: Prentice-Hall).

Berglas, E. (1976), 'On the Theory of Clubs', *American Economic Review*, 66, 116–21.

Blankart, C. B. (1994), 'Club Governments versus Representative Governments', *Constitutional Political Economy*, 5 (3), 273–86.

Block, W. (1975), 'On Value Freedom in Economics', *American Economist*, 19, 38–41.

Boettke, P. J. and Leeson, P. T. (2004), 'Liberalism, Socialism, and Robust Political Economy', *Journal of Markets & Morality*, 7 (1), 99–111.

Böhm-Bawerk, E. (1894/5), 'The Ultimate Standard of Value', *Annals of the American Academy of Political and Social Science*, 5, 149–208.

Brownstein, B. (1980), 'Pareto Optimality, External Benefits and Public Goods: A Subjectivist Approach', *Journal of Libertarian Studies*, 4 (1), 93–106.

Buchanan, J. M. (1965), 'An Economic Theory of Clubs', *Economica*, 32, 1–14.

Buchanan, J. (1969), *Cost and Choice* (Chicago: Markam Publishing Co.).

Buchanan, J. M. (1975), *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago: University of Chicago Press).

Buchanan, J. M. and Flowers, M. R. (1975), *The Public Finances: An Introductory Textbook* (4th ed., Homewood, Ill.: Richard D. Irwin).

Bush, W. and Mayer, L. (1974), 'Some implications of anarchy for the distribution of property', *Journal of Economic Theory*, 8, 401–12.

Cornes, R. and Sandler, T. (1986), *The Theory of Externalities, Public Goods and Club Goods* (Cambridge: Cambridge University Press).

Cowen, T., (1992), '*Law* as a *Public Good*: The Economics of Anarchy', *Economics and Philosophy*, 8, 249–67.

De Jasay, A. (1989), *Social contract, free ride: A study of the public goods problem* (New York: Oxford University Press).

Demsetz, H. (1964), 'The Exchange and Enforcement of Property Rights', *Journal of Law and Economics*, 7 (1), 11–26.

Demsetz, H. (1970), 'The Private Production of Public Goods', *Journal of Law and Economics*, 13, 293–306.

Hayek, F. A. (1945), 'The Use of Knowledge in Society', *American Economic Review*, 35, 519–30.

Hayek, F. A. (1948), *Individualism and Economic Order* (Chicago: University of Chicago Press).

Hayek, F. A. (1960), *The Constitution of Liberty* (Chicago: University of Chicago Press).

Hayek, F. A. (1973), *Law, Legislation and Liberty* (Chicago: University of Chicago Press).

Hayek, F. A. (2002), 'Competition as a Discovery Procedure', *The Quarterly Journal of Austrian Economics*, 5 (3), 9–23.

Head, J. G. and Shoup, C. S. (1969), 'Public Goods, Private Goods, and Ambiguous Goods', *Economic Journal*, 79, 567–72.

Head, J. G. (1972), 'Public goods: The polar case', in R. M. Bird and J. G. Head (eds.), *Modern fiscal issues: Essays in honour of Carl. S. Shoup* (Toronto: University of Toronto Press), 7–16.

Herbener, J. (1996), 'Calculation and the Question of Arithmetic', *Review of Austrian Economics*, 9 (1), 151–62.

Herbener, J. (1997), '*The Pareto Rule and Welfare Economics*', *Review of Austrian Economics*, 10 (1), 70–106.

Hill, P. J. (1997), 'An Economist's Surprise', *Liberty*, 10 (3), 69–70.

Hoppe, H-H. (1989), 'Fallacies of the Public Goods Theory and the Production of Security', *Journal of Libertarian Studies*, 9 (1), 27–46.

Hummel, J. R. (1990), '*National Goods Versus Public Goods: Defense, Disarmament, and Free Riders', Review of Austrian Economics*, 4, 88–122.

Kim, O. and Walker, M. (1984), 'The Free Rider Problem: Experimental Evidence', *Public Choice*, 43, 3–24.

Kirzner, I. M. (1992), *The Meaning of Market Process* (London: Routledge).

Lachmann, L. M. (1986), *The Market as an Economic Process* (Oxford: Basil Blackwell).

Lange, O. (1936/7), 'On the Economic Theory of Socialism', *Review of Economic Studies,* 4, 53–71; ibid. 5, 132–42.

Lavoie, D. (1985), *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (Cambridge: Cambridge University Press).

Leach, J. (2003), *A Course in Public Economics* (Cambridge: Cambridge University Press).

Leeson, P. T. and Subrick, J. R. (2006), 'Robust Political Economy', *Review of Austrian Economics*, 19 (2–3), 107–111.

Machaj, M. (2007), '*Market Socialism and the Property Problem*', *Quarterly Journal of Austrian Economics*, 10 (4), 257–80.

Malkin, J. and Wildavsky, A. (1991), 'Why the traditional distinction between public and private goods should be abandoned', *Journal of Theoretical Politics*, 4 (3), 255–78.

McNutt, P. (1999), 'Public Goods and Club Goods', in B. Bouckaert and G. De Geest (eds.), *Encyclopedia of Law and Economics* (Edward Elgar Publishers, UK and University of Ghent, Belgium).

Mises, L. (1920) [1990], *Economic Calculation in the Socialist Commonwealth* (Auburn, Ala.: Ludwig von Mises Institute).

Mises, L. (1966), *Human Action: A Treatise on Economics* (Chicago: Henry Regnery).

Mueller, D. C. (1996), *Constitutional Democracy* (Oxford: Oxford University Press).

Musgrave, P.B. and Musgrave, R.A. (1980), *Public Finance in Theory and Practice* (London: McGraw Hill).

Olson, M. (1971) [1965], *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, Mass.: Harvard University Press).

Ostrom, E. (1990), *Governing the Commons: The Evolution of Institutions for Collective Action* (Cambridge: Cambridge University Press).

Reynolds, M. O. (1998), 'Impossibility of Socialist Economy, or, A Cat Cannot Swim the Atlantic Ocean', *The Quarterly Journal of Austrian Economics*, 1 (2), 29–43.

Roemer, J. E. (1994), *A Future for Socialism* (Cambridge: Harvard University Press).

Rothbard, M. (1956), 'Toward a Reconstruction of Utility and Welfare Economics', in M. Sennholz (ed.), *On Freedom and Free Enterprise: Essays in Honor of Ludwig von Mises* (Princeton, NJ: Van Nostrand), 224–62.

Rothbard, M. (1962) [1970], *Man, Economy, and State: A Treatise on Economic Principles* (Los Angeles: Nash Publishing).

Rothbard, M. (1973), 'Value Implications of Economic Theory', *The American Economist*, 17, 35–39.

Rothbard, M. (1981), 'The *Myth* of *Neutral Taxation*', *Cato Journal*, 1, 519–64.

Rothbard, M. (1991), ‘The End of Socialism and the Calculation Debate Revisited’, *Review of Austrian Economics*, 5 (2), 51–76.

Salerno, J. (1990), ‘Postscript: Why A Socialist Economy is “Impossible”’, in L. Mises, *Economic Calculation in the Socialist Commonwealth* (Auburn, Ala.: Ludwig von Mises Institute).

Samuelson, P. A. (1954), ‘The Pure Theory of Public Expenditure’, *Review of Economics and Statistics*, 36, 387–9.

Samuelson, P. A. (1955), ‘Diagrammatic Exposition of a Theory of Public Expenditure’, *Review of Economics and Statistics*, 37, 350–6.

Samuelson, P. A. and Temin, P. (1976), *Economics* (10th ed., New York: McGraw-Hill).

Sandler, T. (1997), *Global Challenges: An Approach to Environmental, Political, and Economic Problems* (Cambridge: Cambridge University Press).

Sandmo, A. (2000), *The Public Economics of the Environment* (Oxford: Oxford University Press).

Stiglitz, J. E. (1989), ‘Markets, Market Failures, and Development’, *American Economic Review*, 79 (2), 197–203.

Stiglitz, J. E. (1994), *Whither Socialism?* (Cambridge, Mass.: MIT Press).

Taylor, F. M. (1929), ‘The Guidance of Production in a Socialist State’, *American Economic Review*, 19 (1), 1–8.

Willis, J. (2002), *Explorations in Microeconomics* (Redding, CA: North West Publishing).

Wohlgemuth, M. (1997), ‘Has John Roemer Resurrected Market Socialism?’, *Independent Review*, 2 (2), 201–24.

"PEOPLE, YOUR GOVERNMENT HAS RETURNED TO YOU!" THE CZECH CONSTITUTION OF 1992 AS RETURN TO CONSTITUTIONAL TRADITION[31]

GWENDOLINE TUMA[32] AND NIKOLAI G. WENZEL[33]

ABSTRACT

Unlike many of its Eastern European neighbors, the Czech Republic originates from a healthy constitutional tradition. Upon the creation of Czechoslovakia and through the modern day, the Czech Republic has had four constitutions, with major amendments to the documents of the Communist era. Three constitutions, from 1920, 1948, and 1960, served as guidelines for the creation of the 1992 constitution. Because the Czech Republic had not foreseen the Velvet Divorce from Slovakia, government officials found themselves in a rush to create a constitution for the new Czech state. The new document responded to the many injustices of the Communist era and adopted most of the precedents set in the 1920 constitution. The Czech Republic's democratic and constitutional past sets it apart from other Eastern European countries, especially in terms of contemporary political and economic liberty.

KEYWORDS

Constitutional Culture; Constitutional Adoption; Post-Soviet Constitutionalism; Czech Republic

31 „Václav Havel, President of Czechoslovakia, in his 1990 New Year's Address. Havel was adapting words from the seventeenth-century Czech scholar Comenius originally quoted by Tomáš Masaryk in his inaugural address as first President of Czechoslovakia, in 1918" (Ash 1999, epigram).

32 Hillsdale College, Hillsdale, Michigan, USA

33 Florida Gulf Coast University, Fort Myers, Florida, USA; email: nwenzel@fgcu.edu

1 INTRODUCTION

The Czech Republic boasts a strong constitutional and democratic history, despite totalitarian occupation under the Third Reich and the Soviet Union. The leaders who advocated for Czechoslovak independence during World War I were impressed with the democratic values of the West and envisioned an ethical, humanist, and democratic political system for Czechoslovakia. Under their authority, Czechoslovakia shined among its Eastern European neighbors as a successful constitutional nation. Although socialism (of both the National- and Soviet varieties) undermined the established democratic principles, the Czech leadership returned to the principles of the interwar period after the fall of communism. For this reason, the Czech Republic's rankings from various indices of political and economic freedom surpass those of most of its Eastern (and even Western) European neighbors. A democratic tradition as well as a Western-minded culture aided the Czech Republic in transitioning from a communist political system to a stable democracy. Section two offers theoretical background on constitutional culture – the set of thoughts, feelings and attitudes about constitutional constraints that ultimately determines whether a given constitution will stick. Section three examines Czech constitutional history, with a particular emphasis on the constitutional culture underlying the formal constitution. Section four focuses on the 1992 Czech constitution as the culmination of almost a century of constitutional efforts. The final section concludes, with a brief comparative discussion.

2. CONSTITUTIONAL CULTURE

Instead of the more typical analysis of constitution as contract,[34] we understand constitutions primarily as coordination devices for mutually beneficial exchange (Hardin 1999; see also Hayek 1960 and 1079 [1973, 1976, 1979]). Successful coordination around a constitution requires a willingness to be bound[35] with informal norms as the ultimate guardian of constitutionalism. Because constitutions are mere parchment, informal mechanisms become the ultimate preserver of constitutional order. Whereas contracts rely on a combination of internal constraints and external enforcement mechanisms, a constitution is the formal enforcement mechanism of last resort: there can be no outside appeal to any other formal institution beyond the constitution itself. Hardin (1988) explains that "without support from relevant people, perhaps often in the grudging form of those unable to co-ordinate in refusing support...rules would not be worth the paper on which they are recorded."

34 See, e.g. Buchanan (1990 and 2000 [1975]) or Brennan and Buchanan (1985). For commentary and critique, see Hardin (1988), Gordon (1976) or Voigt (1997).

35 See Elster 2000, or, again, Hardin 1999.

This informal constraint can be defined as constitutional culture. Existing attempts at defining constitutional culture offer a useful start.[36] But existing approaches all limit the concept of constitutional culture to situations where the country accepts constitutional constraints. Defining constitutional culture as a culture that accepts constitutional constraints is simply too limiting, as it does not explain constitutional failure.

Constitutional culture includes the implicit and explicit, stated and unstated, conscious and subconscious, thoughts, feelings, beliefs, and norms the predominant group in a country holds about the nature, scope and function of constitutional constraints. It reflects the most basic beliefs and attitudes about constitutional organization, not just the constitutional text itself, "but the entire network of attitudes, norms, behaviors and expectations among elites and publics that surround and support the written instrument" (Burnham 1982, 82). For definitional and methodological details, see Wenzel 2007 and 2010a.

Constitutional culture gains particular importance when we look at constitutional stickiness.[37] To stick, a constitution must match the underlying constitutional culture. If it does not, the informal will reject the formal. Rejection can occur for a variety of reasons, ranging from the cultural to the philosophical. For example, a constitutional culture might reject constitutionalism entirely – perhaps because of opportunism or fatalism, or perhaps because constitutionalism is seen as an unfair thwarting of the popular will. Likewise, a constitutional culture might reject a specific constitution.

A constitution will fail if it is perceived as a foreign graft onto a constitutional culture that formally rejects it. If constitutional culture and the formal constitutional system are radically mismatched, the culture will reject the foreign transplant completely. Thus the Philippines rejected its post-World War Two constitution (see Wenzel 2010b) and thus Argentina rejected its 1853 constitution (see Wenzel 2010c).

3. CZECH CONSTITUTIONAL HISTORY: CULTURE AND PARCHMENT

1. Czechoslovakia, 1918–1938: Independent, Constitutional, Democratic

The Czechoslovak state was established at the end of World War I upon consultation with US President Woodrow Wilson in 1918. Tomáš Masaryk, known as the „President-Liberator," and his pupil, Edvard Beneš, envisioned a nation in which the Czechs and Slovaks joined in a political union with Western political foundations. While every other Eastern European nation in the interwar period fell into various forms of authoritarian government (see Fisher 2006, 26, or Ash 1999, 126), Czechoslovakia built a parliamentary democracy that sustained it until 1938. Táborský (2007[1945], 154) ascribes this success not to the constitutional parchment, but to the underlying constitutional culture, „to factors which

36 See, e.g. Ferejohn et al. (2001, especially 10 and 14); Mazzone 2005; Friedman 1975, Kahn 1999 or Levinson 1988; see also Merriam 1931.

37 On institutional stickiness generally, see Boettke *et al.* 2008

have not… much to do with the written rules of the Constitution, and which in some cases have even developed in opposition to them."

Czechoslovakia's democratic tradition originated within the Austro-Hungarian Empire. Even greater was the Czechoslovak people's love of freedom, which strengthened after three hundred years of Austro-German domination (Táborský 2007[1945], 155). The Czechoslovaks were characterized as a people jealous, and thus protective, of their rights. Their sensitivity to their promised rights and justice made them determined to build a nation that protected rights and embodied justice. The Czechoslovaks were also a strongly nationalistic people. In 1860, they founded the organization *Sokol*, which attracted people who loved their nation and wished to achieve independence from the Austro-Hungarians. The Czechoslovak *Sokol* not only offered recreational opportunities, it also encouraged forums to discuss political philosophy, such as democratic thinking and unity. *Sokol* encouraged Czech nationalism and boasted the membership of Masaryk and Beneš.

Furthermore, the Czechoslovaks represented various different cultures. This diversity resonated within the new nation in which a respect for the rights of minorities was upheld. The minorities' privileges „were greater than the privileges accorded to national minorities in [almost] any other state" (Táborský 2007[1945], 12). The 1920 Constitution reflected this philosophy.

Czechoslovakia maintained a reputation as one of the most constitutional and democratic nations in Europe, but also as „the most Western of all the so-called Eastern European countries" (Ash 1999, 130). Led by Masaryk, „both a philosopher and a politician with a consequent democratic orientation" (Berglund and Dellenbrant 1994, 143), Czechoslovakia embraced Western political theory, ethics, and humanism. Masaryk (1938, 12) argued that good politics should be ethical and humanitarian:

> *Democracy means the abolition of degrading misery; in a republic, in a democracy, it must not be possible for individuals or ranks to exploit their co-citizens. Not organization, and not a privilege, not aristocratic coercion, but mutual service. Democracy needs leaders, not masters.*

Masaryk's dedication to these values helped drive the Czechoslovak movement to adopt Western values and a constitution. Masaryk and Beneš strove to create a solid constitutional foundation for a lasting Czechoslovak state, in spite of political pressure from neighboring countries. Each drew from his experience abroad–in France, Great Britain, Russia, and the United States–to develop a constitution that embodied Masaryk's humanism and attachment to democracy.

The Constitution of 1920 followed the example of democracies in Great Britain, France, and the United States. It was founded on the theory of natural rights and the doctrine of the separation of powers. The Constitution's principles of republicanism, democracy, and parliamentarism followed France's precedent, as explained by Táborský (2007[1945], 129): "The Constitution is perhaps nearest to that French individualistic republican liberalism so admired by the Czechoslovak Constituent Assembly, and which was looked upon at the time as the most developed system of republican parliamentary democracy."

Masaryk and Beneš believed that a parliamentary democracy would fit the Czechoslovak culture best, considering that its democratic traditions stemmed from European roots.

Economically, the Czechoslovaks pursued Western capitalism (it helped, of course, that „Bohemia...was the most prosperous part of the Austro-Hungarian empire" (Howard 1993, 3). The 1920 Constitution emphasized the importance of private property, more so than any other right.[38] Parliament had the power to limit property in only very few cases, leaving "no doubt that the whole Czechoslovak economic order is based upon private capital and private enterprise. Here again we can trace the influence of western European liberalism" (Táborský, 2007[1945], 130). Moreover, economic and social rights were only hinted at in the new constitution. Safeguarding these would have introduced unending political and philosophical disputes (ibid): "Faithful to their western models and having other urgent problems on their minds, the framers of the Constitution did not attempt to cut through the tangle of complex economic and social questions but left them for the deliberations of future legislators.[39]

In practice, the system became more presidential, and centralization overtook local autonomy. This trend may be attributed to the leadership that was envisioned for the nation. Because Masaryk and Beneš invested themselves into the Czechoslovak nation, decisions and leadership were centralized on their expertise and their understanding of Western political systems allowed them to lead the Czechoslovak nation for almost 20 years.

Additionally, the U.S. provided an example for the Czechoslovak nation within the legal and electoral system. The Czechoslovaks borrowed judicial review, becoming the first country in continental Europe to adopt that practice (Calda 1999, 3). The document also drew from the U.S. Constitution to practice popular sovereignty and republican representation; according to the Czechoslovak constitution, „Czechoslovakia was a democratic republic in which the supreme power belonged to the people" (Berglund and Dellenbrant 1994, 144). This was especially important given the legacy of Austro-Hungarian tutelage. Because the creation of Czechoslovakia merged many different cultures together, such as the Germans, Bohemians, Moravians, Slovaks, and Hungarians, it became necessary to keep a multiethnic character in mind. Czechs and Slovaks made up only two-thirds of the Czechoslovak population (Bergenon 1978), and special attention was paid to the protection of individual rights, including the rights of minorities. Masaryk hoped that such protection would prevent future disenfranchisement of minorities. In spite of the divisions, Masaryk (1934, 78) still wanted to unify the nation:

> *There is no Slovak nation...the Czechs and Slovaks are brothers. Only cultural level separates them – the Czechs are more developed than the Slovaks, for the Magyars*

38 Others have pointed to the Civil Code that the Czechoslovak Republic inherited from the Austro-Hungarian Empire – rather than the 1920 Constitution as an intermediary – as the source of respect for property rights. We thank an anonymous referee for emphasizing this.

39 For details on negative v. positive rights, see e.g. Rand 1966

[Hungarians] held them in systematic unawareness. We are founding Slovak schools. We much await the results; in one generation there will be no difference between the two branches of our national family.

Czechoslovak politics differed in its treatment of minorities. As stated earlier, minorities were viewed as equals under the 1920 Constitution; the state made an effort to integrate them, not only politically, but also culturally. The Germans, for example, "were not only permitted to organize their own parties but were also, after 1926, always included in governing coalitions as junior partners" (Leff 1997, 29–30). Maintaining political equality in this way set a precedent for future democratization, even though the Communist Party "scornfully dismissed [it] as 'bourgeois-democratic'"(ibid). Since the founders of the Czechoslovak constitution emphasized the necessity of a unified and equal state, they outlined the structure as unitary, instead of federal, in the 1920 Constitution. As can be seen through organizations such as *Sokol*, the Czechoslovak Provisional Assembly protected nationalism since it played an important role in the creation of the Czechoslovak state. The presentation to the Provisional Assembly argued:

There is not the slightest basis for federalism in our past history. Dicey says that the precondition for federalism is where there are nations who want to be joined without unity. And this is something we do not have...Therefore, there is no incentive, nor the least basis, for some kind of federal structure...to be created. (Sidor 1943, 104)

In developing a unitary state, the Czechoslovaks integrated the diverse backgrounds of the populations making up the new Czechoslovakia. This success reinforced free institutions, a feature unique to Eastern European nations in the interwar period. Most found themselves under authoritarian rule (whether from within or from Nazi Germany or Soviet Russia) that did not end until the fall of communism in 1989. Czechoslovakia's free institutions were ultimately destroyed only by outright foreign invasion.

3. 1938–1989: FROM NAZI OCCUPATION TO SOVIET COMMUNISM

Although Czechoslovakia thrived politically throughout the interwar period, Masaryk's Republic was seriously challenged by outside political forces: the pressure from the territorial demands of the Third Reich and the subsequent Munich Treaty destabilized the Czechoslovak Republic. In 1938, the Nazis "created a Protectorate of Bohemia and Moravia where Czech institutions were formally preserved–but with all the power in the hands of the 'protectors' (Berglund and Dellenbrant 1994, 146),

The Red Army "liberation" of 1945 did not immediately seek to start a revolution and change the democratic system that preceded the occupation of the Third Reich. Instead, the Soviets were careful to start by restoring the old constitutional system. In the first years, the

Communist Party took care to hide its motivations and keep its influence from becoming transparent. In April 1945, the Czechoslovak cabinet created the Košice Program, within which the many parties of the National Front worked out the republic's new constitution. Because the Program was part of the Soviet agenda, the communists took care to treat the Czechoslovak parties as "equal in rights and responsibilities" (Berglund and Dellenbrant 1994, 147). In exchange for equal rights, parties were required to pledge allegiance to the Košice Program. That Program aimed to reform social and economic institutions, culminating in the nationalization of various industries.

May 9th, 1948 was deliberately chosen as the inception of the new constitution, because it was the anniversary of the Czechoslovak "liberation" from Nazi Germany by the Red Army. The new constitution was based off of the Soviet Constitution of 1936, but it was not a verbatim copy. The communists argued that the new constitution must reflect the local state of development, as well as "the people" in a people's republic. The constitution "did not entirely abolish the old fundamental laws but incorporated many of their features, especially the provisions with regard to legislative, executive, and judicial power and the political rights of citizens" (Skilling 1952, 201). It also created a new national economic system and defined the "social and economic rights" of citizens.

The communists ensured that their ascent to power was supported by the Czechoslovak citizens. Their agenda was initially moderate, reminding citizens that their interests were at the forefront of new policy and that their political precedents would be valued. Nevertheless, the new constitution "declared legally invalid the Constitution of 1920, as well as all constitutional and other acts inconsistent with the new Constitution or with the principles of the people's democratic order" (ibid). Thus were the Masarykian political values of democracy eradicated.

The Constitution of 1948 was explicit in listing the freedoms ensured to the Czechoslovak citizens. Acknowledging political rights first, the constitution included uncommon freedoms, such as the freedom of conscience. Although the constitution granted "personal freedom," it did not detail what that entailed. Furthermore, the communist drafters implemented a very elaborate version of "social rights," which "include[d] the right to work, to just payment, to leisure and to the protection of health...right to education and equal rights for women" (Skilling 1952, 206). Using the Soviet constitution and doctrine as a guideline, the drafters sought to develop a more socialist political and economic system. The new constitution also imitated the Soviet document in providing "an extensive statement of duties–the duty to work, to defend the state, to uphold the constitution and the laws, to preserve public property, and to discharge all public functions" (Novotný 1960). These duties contrasted with the Constitution of 1920, in which the sole required duty was that of military service. In stating these duties, the new constitution subtly but firmly shifted the status of Czechoslovaks from citizens into servants of the state.

By taking a furtive approach to establishing socialism, the Communist Party ensured its own success. July 11, 1960 marked the day the new constitution was ceremoniously and unanimously approved. Czechoslovakia celebrated that day, becoming the first Soviet satellite to document the triumph of socialism with a new constitution. As the preamble of the

1960 constitution states, “Socialism has conquered in our land...The people’s democracy as a path to socialism has fully proved itself; it has led us to the victory of socialism.”[40] The Communists referred to the new constitution as a document that cleanses “our state of various ‘birthmarks’ of the past, comprehensible in a transitional period [such as] liberal, pseudo-democratic principles of the division of power” (Skilling 1962, 145). Since it was important to ensure a smooth transition from democracy to communism, the communists felt obliged to pay lip service to the procedures of the 1920 constitution. These precedents, these “’birthmarks of the past,” were now replaced by a more current and relevant constitution.

Although there was great fanfare in the adoption of the 1960 Constitution, it introduced very little real reform. Czechoslovakia was now officially a socialist state, yet it retained the same political structure from 1920, most specifically the one-man presidency, whereas most other East European communist states and the Soviet Union adopted a State Council. Communist President Antonín Novotný justified the one-man presidency, saying that it had „become in the eyes of the working people a characteristic feature of the Czechoslovak state“ (Novotný 1960). Even though the communists hoped to reorder the political and economic system to resemble the system of the Soviet Union, they still took care to implement their doctrine around existing Czechoslovak culture and traditions. This approach ensured relative success in completing a smooth transition to communism.

While respecting traditions (if only for the sake of a smooth transition and political stability), the Communist Party still wished to instate reforms that would fix the problems of the „liberal, pseudo-democratic principles.“ The 1948 Constitution still permitted individual private property; in the 1960 version, this „was omitted, although small private enterprises not employing the labour of others were permitted (art. 9) and ‚personal ownership of consumers‘ goods‘ was guaranteed (art. 10)“ (Skilling 1952, 161).

The 1960s were a period during which President Dubček, who succeeded Novotný following his resignation, attempted to create “Socialism with a human face.” These reforms developed into the Prague Spring, a period that highlighted the immense discontent with Novotný’s regime and the stagnant economy, the celebration of freedom of expression, and the articulation of Slovak national ambitions.

The Soviet Union and its satellite states heavily criticized the renegade Czechoslovakia. In August, Warsaw Pact forces invaded the country, returning strict Communist occupation for the next 20 years. The Prague Spring’s failure motivated reformers to attempt to preserve some of the reform efforts. These achievements translated into the 1968 Act on the Czechoslovak Federation, which also assuaged Slovak fears of Czech domination in the National Assembly. Two national governments were established, the unicameral National Assembly was replaced with a bicameral Federal Assembly, and dual citizenship was created. The Act, however, “failed to resolve the real issue... the federal structure set up by the 1968 amendment was never tested in practice, because the bicameral Federal Assembly was reduced to a rubber-stamping organ” (Mathernová 1993, 476). Just two months later,

40 „Ústava Československé socialistické republiky,“ 1960 <http://www.psp.cz/docs/texts/constitution_1960.html>

the Federal Assembly adopted more constitutional laws that effectively undermined the previous amendment. Václav Havel referred to 1968 as the time when history stopped and the country was put to sleep for 20 years – and the Act of Federation was, naturally, an important (if unintended) precursor to the Velvet Divorce of 1992.

4. FROM THE FALL OF COMMUNISM TO THE VELVET DIVORCE: THE CONSTITUTION OF 1992

Czechoslovak communism fell with Soviet communism (see Ash 1999) in 1989, but tensions quickly emerged. Slovakia was ready to terminate the union shortly after the Velvet Revolution of 1989, and the Slovak National Council unveiled a separate and completed constitution in September 1992. The Czech Republic, on the other hand, had remained hopeful for unity throughout the summits, believing that it could find a constitution that would fit both the Czechs and the Slovaks. By October 1992, that effort proved to be in vain. The Czechs now had three months in which to create a constitution that would carry them through reconstruction and the dismantling of communist institutions. January 1, 1993 marked the beginning of separate Czech and Slovak Republics and the dissolution of Czechoslovakia.

Insider reports show that "the easiest agreement in the end was to follow the1920 Constitution" (Stein 1997, 57). The document was also a stalwart of Czechoslovakia's lost democracy: "This made good sense and for the Czechs it fit well with the aspirations of the Czech Republic to step into the shoes of the democratic, internationally respected, pre-World-War II Czechoslovakia" (ibid, 68). As Howard (1993, 5), summarizes, "Czechoslovakia...cherished the legacy of a vibrant, functioning democracy in the years between the world wars."[41] In addition to following the 1920 Constitution's precedent, the Czech Republic adopted the 1991 Charter of Fundamental Rights and Basic Freedoms. The Charter was initially drafted to apply to the entire Czechoslovak nation; after its dissolution, Slovakia integrated the basic provisions of the Charter in its constitution. The Czech Republic, however, took the Charter a step further, preserving the document in its entirety and declaring "the Charter of Fundamental Rights and Freedoms as a part of the constitutional order of the Czech Republic."[42] The Charter displayed the strong reaction to the 50-year occupation of the Czechoslovak nation and can be compared to the United States Bill of Rights.

The 1920 Constitution provided a strong precedent and stable foundation for a country that had just emerged from a half century of communism. Much of the 1960 constitution

41 Alas, if Czechoslovakia as a whole cherished this legacy, there were differences between the Czech lands and Slovakia. The former moved immediately to constitutional democracy, while „Slovakia had to pass through the dark valley of Vladimir Meciar's semi-authoritarian regime before having its own belated ‚revolution of catching up' in 1998" (Ash 1999, 167); see also Fisher's (2006, 126) blunt assessment that the Meciar government evinced a „lack of respect for democracy."

42 Charter of Fundamental Rights and Freedoms, Ústavní Soud České Republiky, http://www.usoud.cz/view/czech_charter, accessed 9/30/2012

was abrogated; out of 106 Articles, only 17 remained (Calda 1999, 7). The framers and legal advisors worked swiftly, passing a Czech constitution on December 16, 1992.

The Czech constitution's framers returned their country to a sovereignty reserved for the citizens. Returning to these principles proved to be an advantage to the Czech state. Within months of reinstating a democratic constitution, the Czech Republic became the first post-communist nation to show economic and political stability.

The 1920 Constitution carried proportional representation and the role of a single presidency within the parliamentary system into the 1992 constitution. The presidency evolved into a stronger position, "in large part attributable to the strong position of Prime Minister Klaus during the drafting of the Constitution" (Stein 1997, 62). The first Czech president, Václav Havel, was tasked with "'breath[ing] life into his office' by capitalizing on the precedent of the monarchical presidency of T.G. Masaryk and on his own broad popularity" (Stein 1997, 63). Generally, the 1989 revolution appealed specifically to the memory of Masaryk (Ash 1999, 84) and the 1920 constitutional framework.

The 1992 constitution also introduced new democratic provisions in order to create a balanced representative government. The new electoral law imitated that of the United States, in which one third of the Senators must be elected every two years. Furthermore, the Czech constitution offered different systems of representation: the Assembly of Deputies reflected proportional representation, while the Senate used the first-past-the-post system.

5. CONCLUSIONS: THE CZECH REPUBLIC IN COMPARATIVE CONTEXT

To be sure, this is not fundamentally a comparative paper on Eastern European constitutionalism.[43] However, it is helpful to frame the Czech Republic in regional context – and various regional rankings corroborate our story of Czech exceptionalism. Excluding the Baltic States which were outright incorporated into the Soviet Union, we can focus on five other post-communist Central and Eastern European countries: Slovakia, Poland and Hungary, Romania and Bulgaria.

First, the Czech Republic has the highest score possible (along with all but Romania and Bulgaria) in political rights and civil liberties (in the "Freedom in the World 2011" survey[44]). Refining this analysis, we turn to the Economist Intelligence Unit's *Democracy Index 2010*[45], which assesses democracy based on civil liberties, stability, corruption, and other related factors. The Czech Republic ranks 16th out of 167 in the world – slightly above the United States and surpassing the democracy rankings of many Western European

43 For such work, see, e.g. Howard 1993, Schwartz 2000, or Priban 2004; see Mathernova (2003) on Czech constitutionalism, 1989–1992; on the 1989 revolutions, see Ash 1999; for superb comparative work on post-communist Slovakia and Croatia, see Fisher 2006 ; on more general comparative constitutionalism, see Billias 1990, Blaustein 1992, Friedrich 1967 or Bellamy 1996; for an excellent regional overview (with an emphasis on economic ideas), see Aligica and Evans 2009.

44 www.freedomhouse.org, accessed 6/8/11

45 Democracy_Index_2010_web[1].pdf, accessed 6/8/11

nations, such as the United Kingdom and France. Regionally, the Czech Republic is the only "full democracy"; its fellow post-communist countries are all "flawed" democracies, ranging from Slovakia's ranking of 38th, through a cluster in the 40s, and Romania at 56th. Adding to our constitutional story, the most relevant variable in the democracy ranking is that of political culture (which is, of course, intimately tied to constitutional culture)[46]. Not surprisingly, the Czech Republic ranks highest, with a score of 8.13/10; it is followed by Slovakia, Poland and Hungary in the 7-point range, and Romania and Bulgaria in the 6-point range. It is no coincidence that the "Programmatic Principles" of the revolutionary Civic Forum, as drafted by future Prime Minster Vaclav Klaus, featured "rule of law with an independent judiciary" and "free elections" as the first two points on its platform (Ash 1999, 103–104).

Moving from political manifestation to underlying cultural explanation, Mathernová (2003, 61) explains that the "Czechs, originally Protestant and now largely secular with some Catholic population, cherish the democratic ideals of a civil society, liberalism, and individual rights. In contrast, one of the dominant factors in the Slovak society is a traditional, socially conservative form of Catholicism." One anecdote seems to capture the Czech attitude. After the Velvet Divorce of 1992, the Czech Republic adopted enthusiastic, forward-looking symbols; Slovakia, by contrast, adopted backward-looking symbols of past oppression and lingering grief (Fisher 2006, 81). Not surprisingly, the Czech Republic leapt forward into free-market democracy, while Slovakia endured six years of Mečiar hiccups.[47]

Second, moving from political to economic liberty, the Czech Republic ranks the highest in the 2011 *Index of Economic Freedom,*[48] at 28th in the world, and the only post-communist country in the region to be ranked "mostly free" (all the others are ranked as "moderately free"). It is followed by Slovakia at 37th and Hungary at 51st, with the others in the 60s. This is not surprising, given the link between sound constitutional environments and economic freedom.[49] Beyond theory, one can turn to history. The French classical-liberal political economist Frédéric Bastiat had been translated into Czech as early as 1923, and free-market economists Milton Friedman, George Stigler and James M. Buchanan had followed through the 1960s and 1970s (Aligica and Evans 2009, 146); Ash (1999, 87) adds that free-market economists Milton Friedman and F.A. Hayek influenced the Czech transition from communism. Aligica and Evans (2009, 146) cite the Czech Republic as a post-1989 "market-fundamentalism" example; the first Prime Minister, Václav Klaus, was a devoted friend of free markets. Economic freedom and responsibility appear to be deeply ingrained in Czech culture, as evinced by one very telling anecdote: Ash (1999, 107) reports that the anti-communist strikes of 1989 were mostly symbolic (if effective), as workers made up lost time during evenings and weekends!

46 See Wenzel 2007 or Wenzel 2010a.

47 This ties in with the general literature on the "political economy of forgiveness," which indicates that countries that move forward, rather than dwelling resentfully on the past, tend to do better, as explained, e.g., by Boettke and Coyne 2007.

48 http://www.heritage.org/index/ranking.

49 See, e.g., Scully 1992 and, more generally, the New Development Economics literature, e.g. Boettke et al. 2003.

Third, the theoretical link between economic freedom and economic performance is well established, as evinced by the *Index of Economic Freedom* cited above. It comes as no surprise, then, that the Czech Republic should rank first among its neighbors, at a GDP/ capita of roughly $25,000/year.[50] The Czech Republic is followed closely by Slovakia (at roughly $22,000), then Poland and Hungary in the high teens, and Romania and Bulgaria in the low teens.

In the short span of 20 years, the Czech Republic has demonstrated a successful democratic system that surpasses many of the very countries after which the Czech political system was modeled. The Czech Republic struggled through different political systems, beginning with the Austro-Hungarian Empire, the interwar period of Czechoslovakia, the tyrannical dirigisme of Nazi and Soviet Socialism, and finally, a democratic and free country since 1989. Ultimately, however, the ethics, humanism, and freedom of the West triumphed as the new Czech Republic readopted the 1920 Constitution, as developed by Tomáš Masaryk and Edvard Beneš, to escape damaging socialist traditions. In contrast with the other former Soviet satellites, the Czech Republic had a developed democratic and constitutional tradition, and a culture that was sympathetic to Western political philosophy. Consequently, the Czech Republic managed to preserve its democratic culture of constitutionally limited government throughout a half century of socialism.

50 Depending on whether one uses IMF, World Bank or CIA Factbook figures

REFERENCES

Aligica, P.D. and A.J. Evans (2009), *The Neoliberal Revolution in Eastern Europe: Economic Ideas in the Transition from Communism*, Cheltenham, UK and Northampton, MA: Edward Elgar

Ash, T.G. (1999), *The Magic Lantern: The Revolution of '89 Witnessed in Warsaw, Budapest, Berlin and Prague*, New York: Vintage Books

Bellamy, R. (ed.) (1996), *Constitutionalism, Democracy and Sovereignty: American and European Perspectives*, Brookfield, VT: Ashgate Publishing Company.

Bergenon, G. (1978), "1918–Czechoslovakia–1968," *International Journal*, Autumn 1978, 822

Berglund, S. and J. Dellenbrant (1994), *The New Democracies in Eastern Europe* (Cambridge: Cambridge University Press

Billias, G. (ed.) (1990), *American Constitutionalism Abroad: Selected Essay in Comparative Constitutional History*, Greenwood Press.

Blaustein, A. (1992), *Constitutions of the World*, Fred B. Rothman & Co.

Boettke, P. and C. Coyne (2007), "Political Economy of Forgiveness," *Society*, Volume 44, Number 2 (January/February 2007)

Boettke, P., C. Coyne and P. Leeson, "Institutional Stickiness and the New Development Economics," *American Journal of Economics and Sociology*, 2008, 67(2): 331–358.

Brennan, G. and J. Buchanan (1985), *The Reason of Rules: Constitutional Political Economy*, Cambridge: Cambridge University Press

Buchanan, J. (1990), "*The Domain of Constitutional Economics*", Constitutional Political Economy, Vol. 1, No. 1, 1990)

Buchanan, J. (2000[1975]), *The Limits of Liberty: Between Anarchy and Leviathan*, in The Collected Works of James M. Buchanan, Volume 7, Indianapolis: Liberty Fund

Burnham, W. (1982), "*The Constitution – Capitalism and the Need for Rationalized Regulation*," in Robert A. Goldwin and William A. Schambra (eds.), *How Capitalistic is the Constitution?*, Washington, DC: American Enterprise Institute,

Calda, M. (1999), "Constitution-Making in Post-Communist Countries: A Case of the Czech Republic," Atlanta: American Political Science Association

Elster, J. (1993), "Constitution-Building in Eastern Europe: Rebuilding the Boat in the Open Sea," 71 *Public Administration* 169–217

Elster, J. (2000), *Ulysses Unbound*, Cambridge: Cambridge University Press

Ferejohn, J., J. Rakove, and J. Riley (2001), *Constitutional Culture and Democratic Rule*, Cambridge: Cambridge University Press, Cambridge (MA)

Fisher, S. (2006), *Political Change in Post-Communist Slovakia and Croatia: From Nationalist to Europeanist*, New York: Palgrave MacMillan

Friedman, L. (1975), *The Legal System: A Social Science Perspective*, Russell Sage Foundation, 1975

Friedrich, C. (1967), *The Impact of American Constitutionalism Abroad*, Boston: Boston University Press.

Gordon, S. (1976), "*The New Contractarians*", The Journal of Political Economy, Vol. 84, No.3 (Jun. 1976), pp. 573–590

Hardin, R. (1988), "*Constitutional Political Economy – Agreement on Rules", British Journal of Political Science*, Vol. 18, No. 4 (Oct. 1988), pp. 513–530

Hardin, R. (1999), *Liberalism, Constitutionalism and Democracy*, Oxford: Oxford University Press

Hayek, F.A. (1960), *The Constitution of Liberty*, Chicago: University of Chicago Press

Hayek, F.A. 1979 [1973, 1976, 1979]. *Law, Legislation and Liberty*, Chicago: University of Chicago Press

Howard, A.E.D. (ed.) (1993), *Constitution Making in Eastern Europe*, Washington, DC: Woodrow Wilson Center Press

Kahn, P. (1999), *The Cultural Study of Law*, Chicago: University of Chicago Press

Knight, F. (1939), "*Ethics and Economic Reform I. The Ethics of Liberalism*", Econometrica, New Series, Vol. 6, No. 21 (Feb. 1939), pp. 1–29.

Leff, C. (1997), *The Czech and Slovak Republics*, Boulder: Westview Press

Levinson, S. (1988), *Constitutional Faith*, Princeton: Princeton University Press

Masaryk, T. (1934) *Spisy* vol. 2 (Prague: n.p., 1934) 78.

Masaryk, T. (1938), *Masaryk on Thought and Life*, New York: The Macmillan Company

Mathernová, K. (1993), "Czecho?Slovakia: Constitutional Disappointments," in Howard, A.E.D. (ed.) (1993), *Constitution Making in Eastern Europe*, Washington, DC: Woodrow Wilson Center Press

Mazzone, J. (2005), "*The Creation of a Constitutional Culture*", Tulsa Law Review, Vol. 40, 2005, p. 671

Merriam, C. (1931), *The Written Constitution and the Unwritten Attitude*, New York: RR Smith

Novotný, A. (1960), *Rudé právo*, (n.p.)

Priban, J. (2004), „Reconstituting Paradise Lost: Temporality, Civility and Ethnicity in Post-Communist Constitution-Making," Law & Society Review, Volume 38, Number 3

Rand, A. (1966), „The Rights of Man" in *Capitalism: The Unknown Ideal*. New York: Signet

Schwartz, H. (2000), *The Struggle for Constitutional Justice in Post-Communist Europe*. Chicago: University of Chicago Press.

Scully, G. (1992), *Constitutional Environments and Economic Growth*, Princeton: Princeton University Press.

Sidor, K. (1943), *Slovenská politika na pôde pražkého snemu (1918-1938)*, vol. 1, Bratislava: Andreja

Skilling, H.G. (1952), "The Czechoslovak Constitutional System: The Soviet Impact," *Political Science Quarterly*, June 1952

Stein, E. (1997), "Out of the Ashes of a Federation, Two New Constitutions," *The American Journal of Comparative Law*, Winter 1997

Táborský, E. (1944),"Czechoslovakia's Experience with P.R.," *Journal of Comparative Legislation and International Law*.

Táborský, E. (1945[2007]), *Czechoslovak Democracy at Work*, Great Britain: Táborský Press

Voigt, S. (1997), "Positive Constitutional Economics: A Survey", *Public Choice* 90:11–53, 1997.

Wenzel, N. (2007), "Beyond Parchment, Beyond Formal Rules: Constitutional Culture and Constitutional Political Economy", *Ama-Gi, The Journal of the Hayek Society of the London School of Economics*, Volume 8, Issue 1, Summer Term 2007

Wenzel, N. (2010a),"From contract to mental model: constitutional culture as a fact of the social sciences", *Review of Austrian Economics*, Vol. 23, No. 1

Wenzel, N. (2010b), "Constitutional Culture in Japan and the Philippines: Success and Failure in Post-War Constitutional Choice," *Pacific Focus*, Vol. 25, No. 3 (Dec. 2010)

Wenzel, N. (2010c), "Constitutional Culture and Parchment: Post-Colonial Constitutional Choice in Mexico and Argentina," *Historia Constitucional*, No. 11, 2010.

BOOK REVIEW

THE NEW LOMBARD STREET: HOW THE FED BECAME THE DEALER OF LAST RESORT BY PERRY MEHRLING, 2010. PRINCETON AND OXFORD: PRINCETON UNIVERSITY PRESS, 174 P

Much of this slender book centers on the tensions of the two opposing views of money in the economy. The view of *economics* peers through the veil of money to see how capital investments in the past determine present prospects. The view of *finance* focuses on the present valuation of future projects. Both views largely take money as a given, and ignore its different forms and the institutions that allocate it. Perry Mehrling, a professor of economics at Columbia University, focuses on where the two views meet: in the present. Common at the Fed's conception, the "money view" has returned and allows us to bridge the gap where finance and economics meet.

The money view harks back to the American economist Harold Moulton who focused, like many other economists, on the role of commercial banking in capital formation. By relying on the "shiftability" (salability) of long-term securities rather than self-liquidating short-term loans, American banks of Moulton's time were able to participate in financing long-term investments. Moulton's shiftability view was once accepted doctrine until a nasty Depression and a World War intervened. Modern policymakers focus on the rate of interest in an attempt to create a perfectly liquid system. While Moulton's policy would balance the elasticity of credit with the discipline of the investors, the modern view attempts to keep the bank rate of interest aligned with Wicksell's natural rate.

In laying the groundwork for an updated lender of last resort, Mehrling is careful to illustrate the institutional changes that have occurred in central banking since Bagehot's time. Dollars have replaced pounds and gold as settlement standards. Repurchase agreements (repos) have replaced bills of exchange as financing requirements have shifted from buying real goods to holding financial assets. Bagehot's central bank used the traditional discount rate to manage the system, while today the Fed focuses on overnight lending, and does so only indirectly by using the Treasury repo market to control the supply and demand of underlying deposits to be borrowed or lent in the federal funds market. This gives rise to the largest difference between Bagehot's time and the modern system – "under modern conditions, the Fed is *always* lending freely" (p. 27). The only constraint is that the Fed only lends to its primary dealers, only against Treasury securities as collateral, and only at the Treasury repo rate that corresponds to its federal funds rate.

It is in this distinction that the Fed has moved from being a lender of last resort to a dealer of last resort during the recent crisis. The Fed's recent policies are Bagehotian in every sense, except that the penalty rate on its loans fell to almost zero. Even this is a response to an institutional curiosity of the changing world over the past 150 years. The Fed, unlike the nineteenth-century Bank of England, faces no reserve constraint in its gold holdings.

The triumph of the shiftability view can be traced to the 1935 Bank Act, whereby the Fed opened itself to any "sound" collateral instead of limiting itself to self-liquidating paper. Private dealers were originally to provide shiftability, secure in knowing that the discount window was available if they got into trouble. By 1937 the Fed had committed itself to maintaining "orderly conditions in the money market" (p. 48) generally, and consequently, assigned itself the role of security dealer.

The historical account is flawless and quite readable, and it is only where Mehrling ventures to present and future policy changes that ambiguities arise. If the Fed is to become the dealer of last resort it must do so only to support healthy bank lending and not to promote imbalances or bubbles. In an earlier discussion (pp. 12–17), Merhling discusses the opposing views on bubbles – a Hawtreyan bubble is inherently unstable and should be reined in; a Schumpeterian bubble represents dynamic growth and should be encouraged. What stance the central bank takes will depend on identifying what type of bubble is at hand, and Mehrling finds interest rate policy alone unable to contain the resulting collapse that occurs. Yet, in advocating the Fed shift to concern itself with the elasticity of credit and not focus on the interest rate exclusively, one gets the opinion that Mehrling ventures too far into the across the money view, and leaves the economics behind. The result is that he focuses fully on the financial aspects of the bust. Serving as dealer of last resort may support asset prices and maintain an appearance of liquidity, but the bust will also have real misallocations of capital in the economy. These will not be evaded by maintaining liquidity; indeed, these misallocations may be exacerbated if overpriced assets are not able to fall in value to signal their ex post success or failure as investments.

In committing to act as dealer of last resort, the Fed is accepting that it can recognize a disorderly market from an orderly one and intervene to rectify things. Yet, as Mehrling recognizes, "how is the Fed supposed to know when the market is 'disorderly', and how is it supposed to know what kind of intervention is needed?" (p. 48). Such interventions can occur only with some idea that asset prices are disequilibrated, though as recent events well show, there is considerable disagreement as to what constitutes a correct asset price.

The book has several tangential digressions, both good and bad. That the Great Depression demonstrated the "failure of the decentralized market system" (p. 60–61), oversimplifies and overstates the case. The influence of Jacob Marschak, Harry Markowitz and James Tobin in integrating money into a general equilibrium analysis is well-done, and the influence of John Gurley and Edward Shaw in modernizing and stressing the institutional framework that the money market functions within fuses the academic and applied monetary policy worlds together seamlessly (p. 63–65). The creation of financial products as unintended consequences of untimely regulations is timely at this juncture of ever-increasing levels of regulation, e.g., swaps as a response to post-War capital controls (p. 72), credit default swaps as a response to central banks not being interested in fostering market liquidity for private debt (p. 83–84), or Regulation Q's interest rate ceiling fostering money market mutual funds (p. 89).

Channeling Hyman Minsky, one underlying theme in Mehrling's analysis is that capital markets are inherently unstable. Due to this continual instability, the Fed must stand ready to allocate liquidity to the dealer network to avoid illiquidity *cum* insolvency crises. Mehrling doesn't give the reader much substantiating evidence for the inherent instability of credit, instead relying on vague references to Minsky's work. As a result his attitude towards the Fed's more recent interventions and expanded balance sheet is much more optimistic than this reviewer's. The Fed has recently allocated an additional $2 trillion to the dealer network; Mehrling never mentions the mechanics of reversing these transactions when the time arises. Perhaps that is because he believes the time will never arise – after all, credit is, according to him, inherently unstable. Maybe so, though I doubt it, and such a claim requires more justification than Mehrling provides to believe this "inherent instability" hypothesis.

Likewise, Mehrling never answers why taxpayers should be on the hook for bank losses should continued bailouts arise. He downplays the role of capital in safeguarding solvency, and instead relies on the dealer of last resort to take its place. It might be true that Fed allocated liquidity can replace capital to stabilize the banking system, though it seems too much like a free lunch for this reviewer. Shareholders have a role in the financial system as well – they aren't passive investors, but allocate funds according to expected profits and, perhaps especially as of late, losses.

Like so many historical exposes, *The New Lombard Street*'s termination leaves the reader thinking "the more things change, the more they stay the same." The Fed's recent shift to shifting its assets to provide market liquidity is not so different from how the Fed operated at its inception, and that the intervening years have been the unorthodox ones. In advocating the Fed embrace its renewed role as dealer of last resort, Mehrling makes the case that there is historical precedent available, as well as a healthy dose of academic debate over the past century to support it. Yet in this final policy recommendation, one can't help but have some hesitation. A great deal of recent attention has been placed on the moral hazard of the Fed serving as lender of last resort for the banking system. Do we really want to promote the moral hazard of the Fed acting as dealer of last resort through the repo market?

David Howden
Chair of the Department of Business and Economics, St. Louis University – Madrid Campus, Madrid, Spain,
dhowden@slu.edu

LIST OF ARTICLES