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ARTICLES

Salerno: Böhm-Bawerk's Vision of the Capitalist Economic Process: Intellectual Influences and Conceptual Foundations

Simpson: Austrian Trade Cycle Theory and Rationality

Bagus: Monetary Reform and Deflation – A Critique of Mises, Rothbard, Huerta de Soto and Sennholz

Wenzel: Postmodernism and Its Discontents: Whither Constitutionalism After God and Reason?

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Böhm-Bawerk's Vision of the Capitalist Economic Process: Intellectual Influences and Conceptual Foundations

Joseph T. Salerno[i]

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Abstract: This paper is a prologue to Böhm-Bawerk's mature vision of the capitalist economic process which he elaborated in *The Positive Theory of Capital* originally published in 1889. It deals with the intellectual influences and fundamental concepts that conditioned and infused this vision. By scrutinizing these influences in conjunction with his obscure first monograph published in 1881, we gain important insights into a number of heretofore neglected or under-appreciated aspects of his later work. First, Böhm-Bawerk's theoretical system emerged from the nineteenth–century German subjective-value tradition in which he was immersed, and he saw his first task as correcting and completing the German "theory of goods" in order to provide a solid conceptual foundation for his planned future analysis of capital and interest. Second, the economists who had a formative influence on his thought extended beyond Carl Menger. Third, the Böhm-Bawerkian theoretical structure was founded on a view of the economic world pervaded with non-calculable, systemic uncertainty in which the facts and values relating to future goods were a matter of subjective interpretation and conjecture. This latter point is particularly important because many modern Austrians treat Böhm-Bawerk as an equilibrium theorist deficient in mathematical skills. Finally, the theory of goods as reconstructed by Böhm-Bawerk was clearly the point of departure for formulation of economics as a science of human action by his student Ludwig von Mises.

[i] Graduate Program Chair, Department of Finance and Economics, Lubin School of Business, Pace University, New York, NY 10038, jsalerno@pace.edu.

Böhm-Bawerk's scientific lifework forms a uniform whole. As in a good play each line furthers the plot, so with Böhm-Bawerk, each sentence is a cell in a living organism, written with a clearly outlined goal in mind... He was a theorist, born to see – and to explain – large relationships; to seize instinctively but with a firm hand, on the threads of logical necessities... He gave us an all-embracing theory of the economic process – one of the great analyses of economic life on the scale of the Classics and Marx – conceived on a Mengerian foundation and developed from the point of view of the one problem whose solution seemed to be still missing... The theory of the socio-economic process is, in Böhm-Bawerk's pages, unfolded for the first time as an organic whole of valuations and "objective" facts... (Schumpeter 1969, pp. 146-47, 189)

1 Introduction

Eugen von Böhm-Bawerk (1851-1914) has been justly recognized and celebrated as the founder of Austrian capital and interest theory and as the first economic theorist to discover the main significance of the phenomenon of time preference for the determination of the interest rate. However, few beyond his direct students, such as Schumpeter (1969), Ludwig von Mises (1978, pp. 39-41; 1990) and Richard Strigl (2000), have come close to appreciating the full scope of Böhm-Bawerk's contribution to economic theory and his central role in the emergence and development of the early Austrian school. Friedrich A. Hayek (1992, p. 112), who for more than a decade toiled in the field of Austrian capital theory, was also cognizant of Böhm-Bawerk's seminal work in elaborating and systematizing the central core of Austrian value and price theory. Of economists who reached maturity after World War 2, Murray N. Rothbard was profoundly influenced by Böhm-Bawerk's overall body of work. Even more than Mises, who adumbrated the capitalist economic process in much broader strokes, Rothbard closely followed Böhm-Bawerk as a meticulous system-builder who placed the theory of production at the center of his analysis of the market economy.[1]

[1] Of the twelve chapters of Rothbard's treatise, *Man, Economy and State* (Rothbard 1993), five chapters, encompassing 30 percent of its 987 pages, are devoted to production theory. Moreover, the book's index lists 39 separate page references to Böhm-Bawerk, second in number only to references to Rothbard's mentor, Mises. In sharp contrast to Böhm-Bawerk and Rothbard, Mises in his own treatise, *Human Action*, provides very skimpy detail on crucial areas of production theory. In fact in one of his regular letters to the directors of the Volker Fund reporting on the status of the manuscript

This paper is in the nature of a prologue to Böhm-Bawerk's mature vision of the capitalist economy and deals with the intellectual influences and fundamental concepts that conditioned and infused this vision. By scrutinizing these aspects of Böhm-Bawerk's thought, we gain important perspective on his contribution. In particular, this endeavor sheds light on a number of heretofore neglected or under-appreciated points. First, Böhm-Bawerk's theoretical system emerged from the nineteenth-century German subjective-value tradition in which he was immersed, especially its foundational theory of goods. Second, the economists who had a formative influence on him during the maturing stages of his thought extended beyond Carl Menger. Third, the Böhm-Bawerkian theoretical structure was founded on a view of the economic world pervaded with non-calculable, systemic uncertainty in which the facts and values relating to future goods were a matter of subjective interpretation and appraisement. The treatment that Böhm-Bawerk afforded to these topics was much more penetrating and systematic than Menger's because it evolved out of Böhm-Bawerk's efforts to correct and complete the German theory of goods in order to provide an unshakeable conceptual foundation for his analysis of capital and interest. Indeed, in a sense, Böhm-Bawerk's mature vision of the capitalist economic process represented a logical unfolding of German goods theory. Finally, the theory of goods as reconstructed by Böhm-Bawerk was clearly the point of departure for Mises's formulation of economics as a science of human action.

Section 2 of the paper explores the primary influences on Böhm-Bawerk's intellectual development. Investigation into Böhm-Bawerk's endeavor to reconstruct and elaborate the theory of goods as the conceptual foundation for his system is undertaken in Section 3. This method of investigating Böhm-Bawerk's intellectual development by analyzing chronologically his important publications of the 1880's leading up to his *magnum opus*, *The Positive Theory of Capital* (Böhm-Bawerk 1959) published in 1889, mirrors the step-by-step procedure by which Böhm-Bawerk painstakingly

that would become *Man, Economy and State*, Rothbard (1954) lamented, "Mises has very little detail on production theory, and as a consequence it took me many false starts and lots of what turned out to be wasted effort, before I arrived at what satisfied me as a good Production Theory." Also, when asked the question, "Is there any doubt that Mises was your primary influence?" Rothbard (1995, p. 2) responded: "I didn't think so, but Joseph Salerno once gave a talk in which he said *Man, Economy, and State* is more Böhm-Bawerk-oriented than Mises's *Human Action.* I never thought of it that way, but it may be true. When I was spelling out capital theory, I used Böhm-Bawerk primarily. I didn't think about it since I thought Mises was a Böhm-Bawerkian and didn't see any contradiction."

formulated his theory of the capitalist economy. Thus, according to Böhm-Bawerk (quoted in Hennings 1997, p. 65):

> I had perceived the outlines of my theory of capital as early as 1876 [mentioning them in an unpublished essay]... I did not want to imperil my ideas by an undue, immature, and incomplete formulation. They were to be offered to the public when I was able to offer them as a finished product in harmony with a system of well-founded economic principles. Hence I worked for ten years at the foundations of my theory by elaborating the theory of goods (1881), by scrutinizing critically earlier capital theories (1884), and by developing the theory of value (1886) – in preference to striving for popularity, as I could easily have done, by publishing original but still immature ideas ten years earlier.

2 Intellectual Influences

Böhm-Bawerk's primary influence was, of course, Carl Menger, the founder of the Austrian school of economics. Furthermore, his unique vision of the capitalist economic process can be interpreted as a logical development of the foundational ideas on goods, economizing, value, time and uncertainty, exchange and the pricing process laid out by Menger (1981) in his path-breaking *Grundsatze der Volkwirtschaftslehre* (*Principles of Economics*) published in 1871. Nonetheless, all of these ideas, including even the notion of marginal utility, were already current in the German subjective-value tradition, which stretched back to the first decade of the nineteenth century and took its main inspiration from J.-B.Say (Palyi 1928; Streissler 1990; Hennings 1997, pp. 26-52). Menger's great achievement was to integrate these concepts in such a way as to provide the outlines of a theoretical organon based on marginal utility that could be used to systematically analyze the causal processes determining real prices in all goods and factor markets in the economy (Salerno 1999).

Like Menger, Böhm-Bawerk was also steeped in the German subjective-value tradition and certainly absorbed much of it from the latter. However, Menger and Böhm-Bawerk had disparate personal influences in their formative student years, and the latter read Menger's *Principles* only after he had already completed his studies at the University of Vienna. Moreover, he probably did not make Menger's personal acquaintance until 1875 and might not have been in close contact with him until after

1877 (Hennings 1997, p. 10). Menger's early influences were Peter Mischler (1821-64), his German-born economics professor during his undergraduate years at the University of Prague from 1860 to 1863, and Wilhelm Roscher (1817-1894), the author of the leading German economics textbook of the day to whom Menger dedicated his *Principles*, in which Roscher is also the most frequently quoted author (Streissler 1990, pp. 33-39, 52-53).

In contrast to Menger, Böhm-Bawerk's introduction to the German subjective-value tradition in all likelihood initially came from the Swabian native Albert E. F. Schäffle (1831-1903), who had immediately preceded Menger in the economics chair at the University of Vienna and whose tenure as professor (1868-1872) coincided with Böhm-Bawerk's enrollment as an undergraduate there. Böhm-Bawerk reportedly developed a serious interest in economics during this time and his course of study would, therefore, have involved obligatory attendance at Schäffle's lectures on political economy (Hennings 1990, pp. 9, 46, 176). Another important influence on Böhm-Bawerk in his years as a maturing economist was Karl Knies (1821-1898), who was the most theoretically oriented economist of the older German historical school and whose seminar in Heidelberg Böhm-Bawerk attended for a year during 1875-1876 (Streissler 1990, pp. 34-35; Hennings 1997, p. 10).[2]

A brief overview of Schäffle's and Knies's thought will help illuminate the unique design of the theoretical architectonic that Böhm-Bawerk constructed on conceptual foundations derived from Menger's innovations in goods and value theory, which will also be briefly reviewed.

2.1 Albert Schäffle

Schäffle was one of "the two most strongly subjectivist authors" in the German branch of the Say tradition (Streissler 1990, p. 53) and "it was mainly through the agency of Schäffle that the Continental tradition of classical thought was known in Austrian

[2] There is no evidence that Roscher, the other leader of the older historical school, had much of a direct influence on Böhm-Bawerk, despite the high esteem in which Menger held him and the fact that Böhm-Bawerk attended his seminar in Leipzig in 1877 (Hennings 1997, p. 10; Streissler 1990, p. 34 fn.10). Short overviews of the career and work of Knies, Roscher and Schäffle can be found in Mai 1975, pp. 127, 195, 200. Roscher's work is also reviewed in Blaug 1986, pp. 207-208.

universities in the 1870s" (Hennings 1997, p. 46). Schäffle also evoked a great deal of attention in Austria in 1870 with a series of public lectures criticizing socialism in the wake of widespread labor agitation in Vienna of the late 1860's (Hennings 1997, pp. 54-55).

In his textbook of 1867, Schäffle denounced the Ricardian tradition as "chrematistic," unduly concerned with objective properties of commodities, and emphasized instead the subjective nature of goods and their value. Like the typical German textbook writer in this tradition, including Menger, the primary concept for Schäffle was that of goods, from which the concepts of economizing and subjective use value were then deduced.[3] Thus Schäffle (quoted in Streissler 1990, pp. 53, 43) wrote:

> All goods become comparable in terms of value. Value [is] the significance of a good in the economic calculation of man. All economic calculation tries to determine the smallest sacrifice necessary for full satisfaction... Value [is] a relationship between all goods in human consciousness... [it is] predominantly of a *subjective* nature. It exists in a consciousness of purpose in matters economic.[4]

Schäffle viewed prices as determined by supply and demand and as the objective manifestation of value reflecting the community's opinion about the values of goods.[5] As such, prices govern all economic activities, especially production. Costs are defined as value foregone, although Schäffle stopped just short of developing the full opportunity cost principle. All prices, including factor prices, are determined by

[3] Recall that in Menger's *Principles* (Menger 1981) chapter 3 on "The Theory of Value" is preceded by chapter 1 on "The General Theory of the Good" and chapter 2 on "Economy and Economic Goods." "Commodities" or goods with objective exchange value, the central concept of the British Classical School, do not make their appearance until chapter 7, "The Theory of the Commodity." In general, as Streissler (1990, p. 49) explains: "A standard German textbook will treat goods first, then wants, then the economy, as Rau already does in 1826; Menger uses the same sequence of subjects... Roscher uses the series wants, goods, value, wealth, and the economy. These are called 'the *fundamental* concepts' in German economics."

[4] Note that Schäffle's definition of value as "a relationship between all goods in human consciousness" with its emphasis on the ranking of goods is more correctly formulated than one current Austrian definition of value as "the relationship between a human mind and an object." As Guido Hülsmann has pointed out, it is impossible for an individual to "value" a single object since all values are relative. As we shall see below, Böhm-Bawerk gave the nineteenth-century German "theory of economic goods" its most sophisticated formulation, and it was this theory that Mises elaborated and systematized into a general theory of means and ends or "human action."

[5] The following outline of Schäffle's economic thought where not specifically attributed is drawn from Hennings 1997, pp. 31-32, 37, 54-55, 86-87.

an all-embracing competitive bargaining process for which Schäffle coined the term *Preiskampf*.[6] The competitive bargaining process operates to equilibrate supply and demand in the short run and drive prices toward marginal costs in the long run. Schäffle was so eager to emphasize the interdependence of competitive price determination in the economy that he unfortunately used awkward and strained organicist analogies for which he was ridiculed and which obscured this vitally important element of his work. Consistent with his focus on competitive process, Schäffle conceived of rents and quasi-rents as compensation for the most efficient allocation of available resources, a reward for progress and efficiency, and "thus the major element making for dynamic change in the economy" (Hennings 1997, pp. 32-33).

In commenting on the debate over the fate of the working class under capitalism that raged in the 1860s between German social democrats led by Ferdinand Lassalle and German laissez-faire liberals led by Hermann Schulz-Delitzsch, Schäffle sought to illuminate the *Wertfrei* economic principles involved.[7] In criticizing Lassalle's position, he resorted to the concept of a "temporal structure of the economic process" developed by one of the eminent pioneers of the German subjective-value tradition, F. W. B. Hermann (1795-1868).[8] Elaborating on this concept, Schäffle (quoted in Hennings 1997, p. 37) characterized the function of capital and the capitalist-entrepreneur in proto-Böhm-Bawerkian terms:

> It is the particular way in which labour's services are temporally structured, in which production is separated in time and space … which conditions the peculiar position of workers in the economy, and which points to the basic reason for the position of the entrepreneur … who advances out of his capital, in the form of wages, the value of labour's services which are not yet consumable.

He went on to argue that if the capitalist did not perform this function, then the laborer would have to acquiesce in a lengthy wait for his labor product or else the

[6] The use of this term as a standard to judge Schäffle's influence on later economists has been suggested by Hennings 1997, p. 90, fn. 48. The term was used regularly by Böhm-Bawerk and his own student H. von Schullern-Schrattenhoffen as well as by Friedrich von Wieser, Gustav Gross and Victor Mataja, all of whom were also taught by Schäffle. The word was not used by Menger and was mentioned but not used much by Menger's student, Robert Zuckerkandl.

[7] Capsule summaries of the views of Lassalle and Schulz-Delitzsch can be found in Mai 1975, pp. 131, 202.

[8] For a summary of Hermann's career and intellectual contributions, see Mai 1975, p. 110.

division of labor would be impossible. Thus capital was necessary for exploiting the benefits of the division of labor. Furthermore, it is by virtue of his capital-advancing role that the entrepreneur becomes the director of production and pivotal agent of income distribution. Schäffle concluded that Lassalle's call to abolish entrepreneurship was wrong because the entrepreneur was indispensable to the proper operation of the economic process. Schäffle also took Schulz-Delitzsch to task for confusing credit and capital and, in doing so, briefly hinted at the systematic difference in value between present and future goods. According to Schäffle (quoted in Hennings 1997, p. 37), credit involves "an exchange between values with different maturities," which occurs "whenever aims in the future are attained by sacrifices in the present."

Finally, Schäffle propounded a remarkably precocious position on welfare economics that anticipated the position adumbrated by Murray Rothbard (1997) nearly a century later. Schäffle had argued that the equilibrium adjustment of demand and supply brought about by the *Preiskampf* operating under perfectly free trade is a position of maximum social welfare. To give a flavor of Schäffle's views on this issue it is worth quoting the summary by Böhm-Bawerk (2005, pp. 133-3):

> We remember that both parties to an exchange must achieve a gain that consists of the value differences of the goods given and received in exchange. Of course, the gain is all the greater the greater this value difference. Now unhampered competition brings about that the competitors *with the greatest value difference* actually make the exchange, that is, those buyers who attach highest value to the desired good when compared with the medium of exchange, and those sellers who ascribe lowest value to the exchange good when compared with the price received. Therefore, it seems that self-interest in the market place automatically and unwittingly assures achievement of highest possible exchange gains and thus greatest total gain for the economic well-being of society. There is, so it seems, economic harmony between the individual interests of the successful traders and the common interest of society.
>
> This thought was expressed repeatedly in the remarkable writings of Schäffle on the formation of price. In it he maintains that the "natural exchange value" as it emerges in the market with "normal economic competition" equates supply

> and demand "most usefully" and "socially most beneficially," and thus "produces the *greatest socially possible quantity of pure utility*."[9]

Böhm-Bawerk (2005, pp. 134-136) proceeded to rebut Schäffle's position, but his counterexamples were predicated on his failure to perceive that values are strictly relative and subjective and so cannot be interpersonally compared, despite the fact that this was the implication of his own theory of exchange and price.

2.2 Karl Knies

As noted, Karl Knies was the second direct and early influence on Böhm-Bawerk's intellectual development.[10] Although a founder of the older historical school, Knies was one of the leading theoreticians in German economics and, by the time Böhm-Bawerk attended his seminar, he had already published the first volume of his three-volume treatise on money and credit. This volume contained "a full-fledged theory of capital" which was oriented toward addressing the anti-capitalist criticisms of Marx and Rodbertus. In addition to a discussion of the role of capital and interest in production, Knies devoted a long chapter to a detailed analysis of the role of credit in an economy containing a temporal structure of production. He also explicitly propounded the idea that the common element in all forms of capital is the relationship to the satisfaction of future wants. While Knies does not advance any major new ideas on capital and interest in his treatise, he does provide a systematic and comprehensive summary of the ideas of previous writers in the German subjective-value tradition, particularly Hermann, Hans K. von Mangoldt (1824-1868), and Schäffle.[11]

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[9] This is not to imply that Schäffle was a proponent of laissez-faire policies. He was an interventionist who believed that in practice the *Preiskampf* was hampered by monopolistic elements and, therefore, he apparently favored "social" policies aimed at transforming the labor market. Although an early proponent of *Sozialpolitik*, however, Schäffle the consummate theoretician never joined the historicist dominated *Verein für Sozialpolitik* (Hennings 1997, pp. 37, 46, 54-55, 86). Also see Schäffle 1894, pp. 94-96, 125-27.

[10] The summary of Knies's contributions contained in this paragraph is based on Hennings 1997, pp. 33, 37-38, 55-56.

[11] Curiously, in his voluminous writings, Mises does not refer to this tradition or its significance for the intellectual formation of his master, Böhm-Bawerk. However, Mises (1998, p. 697) did identify Schäffle as one of a handful of "eminent economists," including Vilfredo Pareto, Enrico Barone and

2.3 Carl Menger

This brings us to Menger's influence on the formation of Böhm-Bawerk's theoretical vision and how it compared to the influences of the latter's teachers, Schäffle and Knies. There is no denying that Menger's *Principles* had a fundamental effect on Böhm-Bawerk during his maturation as an economic theorist, and that its basic concepts pervaded all of his written work.[12] In particular he absorbed Menger's key insight that the central task of economic theory was to explain the exact causal processes that determine the prices really paid in the economy. This causal-realistic theory of price determination would be predicated on the unifying principle of marginal utility and comprehend all markets in the economy, including factor markets. Menger (1981, p. 49) clearly spelled out his proposed research program, which he never fully carried out, in a passage in the preface of the *Principles*:

> I have devoted special attention to the investigation of the causal connections between economic phenomena involving products and the corresponding agents of production, not only for the purpose of establishing a price theory based upon reality and placing all price phenomena (including interest, wages, ground rent, etc.) together under one unified point of view, but also because of the important insights we thereby gain into many other economic processes heretofore completely misunderstood.

The *Principles*, however, was only an introduction to a prospective multi-volume treatise on economic theory that Menger never completed because he became sidetracked by the *Methodenstreit* with the "younger" German historical school. Most of the book

N. G. Pierson, who had "touched upon the problem" of economic calculation under socialism. Of Knies, Mises (1984, p. 27) wrote that he was one of the few German professors in the second and third quarters of the nineteenth century who "wrote valuable contributions to economic theory" and whose book, along with those of Hermann and Mangoldt, "will be remembered in the history of economic thought." Summaries of Mangoldt's career and work can be found in Mai 1975, p. 147 and Blaug 1986, pp. 147-49.

[12] Böhm-Bawerk (1962, p. 107 fn. 8) implicitly expressed the precise scope of his intellectual debt to Menger in lauding him as "that genius … whose name it is impossible to extol too often or beyond his deserts whenever there is any discussion of the problems affecting the unshakable fundaments of economic science" (Böhm-Bawerk 1962, p. 107 fn. 8). In the same vein, Böhm-Bawerk (1962, pp.41) praised Menger's *Principles* "as a truly epoch-making work in its establishment of this specific concept [of what constitutes a good] and also of the supremely important basic concepts of economic science generally."

was, therefore, devoted to reformulating and integrating, on the basis of marginal utility, the theories of goods, economizing, and value inherited from the German subjective-value tradition. Menger provided only the rudiments of a theory of consumer prices and no theory of factor *pricing* or the money costs of production utilized in the economic calculations of entrepreneurs.[13]

The influence on Böhm-Bawerk of Menger's vision of a comprehensive and unified theory of the pricing process was reinforced by Schäffle's conception of the *Preiskampf*, the competitive bargaining process that operated to determine prices throughout all markets. Moreover, Böhm-Bawerk perceived that the role of marginal utility as the regulating principle in Menger's discussion of an individual economy, especially as it was elaborated into a theory of "indirect utility" or opportunity cost by Friedrich von Wieser, naturally lent itself to extension to Schäffle's competitive pricing process operating in a money exchange economy.[14]

Böhm-Bawerk was further inspired by Menger's insight that the concept of causality was fundamental to the definition of a good and all goods occupied a place in "the causal nexus of goods" (Menger 1976, p. 56). For Menger, goods' production and allocation were the objective manifestation of the causal chain that was anchored in subjective wants of individuals. Consumer goods were valued and produced because they were perceived as the direct cause of satisfaction of concrete human wants. Complementary goods of successively higher orders were valued as indirect causes of want satisfaction because their sequential combinations in a given production process brought into being the final, consumer good.

Menger thus recognized dual and opposite lines of causation in economic activity binding all goods together as both cause and effect. On the one hand, higher-order goods were the objective *cause* of the coming into being of lower-order goods and eventually of the satisfaction of concrete human wants. On the other hand, the subjective valuation of higher-order goods was the *effect* of their objective position in the

[13] Menger did, however, outline a brilliant solution to the problem of imputing *value* to the individual complementary factors of production in a Crusoe economy, a solution that would later be developed into the Austrian variant of the marginal productivity theory of factor pricing by Böhm-Bawerk (Salerno 1999, pp. 88-90, 98-99).

[14] See Hayek (1992, p. 112) on the limited but significant influence of Wieser's ideas on Böhm-Bawerk in the sphere of value theory.

production process that culminated in the emergence of the directly want-satisfying consumer good. There existed relations of substitution as well as complementarity in the causal nexus of goods because in the Mengerian individual economy, the various categories of concrete wants competed with one another for the satisfaction afforded by the available quantities of economic goods of all orders.[15] Schäffle's attempts at "organic" explanations of the *Preiskampf* must have exercised a parallel influence in alerting Böhm-Bawerk to the multiple and intersecting causal relationships binding together markets and prices within the capitalist economic process.

Despite Menger's admittedly enormous influence on him, the original stimulus for Böhm-Bawerk to formulate a general theory of the economy from the standpoint of distribution theory, and the theory of capital and interest in particular, came from Schäffle and Knies and only in a negative sense from Menger (Hennings 1997, pp. 54-66). Both of Böhm-Bawerk's German teachers in their own way attempted to refute the claims of socialism by working out a theory of capital and interest that accorded a central role to the time element. In addition, both – but especially Schäffle – used the theory as a point of departure to elaborate a much more comprehensive theory of the economic process. In contrast, in Menger's *Principles*, the theory of factor pricing in general, and interest theory in particular, represented a gaping lacuna in the application of marginal utility theory (Salerno 1999, pp. 98-99).

3 Reconstructing The Theory of Goods

The monograph *Rechte und Verhältnisse vom Standpunkte der volkswirthschaftlichen Güterlehre. Kritische Studie* appeared in 1881 and was Böhm-Bawerk's first publication. It was based upon the *Habilitation* thesis that he submitted to the University of Vienna near the end of 1879 (Hennings 1997, p. 10).[16] The work was translated

[15] For the overarching importance of the concept of causality in Menger's system, see Salerno 1999, pp. 81-83, 98.

[16] Menger was one of the readers of the thesis and apparently actively campaigned for its acceptance, which was only grudgingly given by its other reader, Lorenz von Stein (1815-1890). The thesis was officially accepted in early 1880 (Hennings, pp. 10-11). Von Stein, a conservative or corporate state socialist, was influenced by Louis Blanc and other French Utopian socialists (Mai 1975, p. 215).

into English as *Whether Legal Rights and Relationships Are Economic Goods* (Böhm-Bawerk 1962). However, a more accurate idea of the contents of the work is provided by the literal translation of the German title: *Rights and Relationships from the Standpoint of the Economic Theory of Goods*: *Critical Studies*.[17] For the work is in effect a critical treatise on the German theory of goods.

In his preface to the monograph, Böhm-Bawerk (1962, p. 30) contended that the "basic *economic doctrine of the theory of goods* ... was in need of correction in several respects, or at least of such revision as to make it truly comprehensive and universally valid." Such revision was required because goods theory embodied "concepts and truths fundamental to every economic train of thought." Böhm-Bawerk reemphasized the importance of the theory of goods in his introductory chapter, where he wrote that goods "constitute the primary material with which economic science makes it its business to deal." What Böhm-Bawerk (1962, pp. 32-33) found lacking in goods theory was a clear and unambiguous answer to the question of whether legal rights and contractual relationships were to be classified as "goods" from the point of view of economic science. His interest in addressing this issue stemmed from his research into the theory of capital and interest and his realization that such clarification was indispensable to the formulation of such a theory.[18]

Böhm-Bawerk (1962, pp. 39-41) argued that previous economists had successfully resolved two of the three fundamental problems posed by goods theory. First, the economic concept of goods as things that serve as tools or means for attaining human well-being had been more or less properly delimited from other concepts, especially the ethical concept, of goods. Second, the problem of elaborating the various criteria implied by the economic concept of a good – what Böhm-Bawerk calls "conditions precedent of goods-quality" – was resolved "pre-eminently through the work of German economists." Starting with the work of Ludwig H. von Jakob (1759-1827)[19] in 1805, the solution to the problem was progressively developed until it "attained a form that is characterized by formal completeness and final definitiveness" especially

[17] I am indebted to Guido Hülsmann for providing this translation.

[18] It is noteworthy that Schäffle also had addressed the status of rights and relationships in the theory of goods in 1864 in what Böhm-Bawerk (1962, p. 32) termed "a highly significant monograph."

[19] For an overview of the life and work of Jakob, an economist and Kantian philosopher, see Mai 1975, p. 119).

in the work of Menger. The third, and unresolved, problem was enumerating "the categories of economic good," that is, identifying the various kinds of concrete things that fulfilled the theoretical criteria of a good.

Before tackling the solution to this problem, Böhm-Bawerk (1962, pp. 41-42) spelled out the several preconditions of a good for an economizing individual, "adher[ing] essentially to Menger" but correcting him in "one minor respect." For a thing to attain the status of a good for an economizing individual, the following conditions must be simultaneously present: 1. a human need; 2. the thing must be objectively adapted to satisfying the need or want; 3. the individual must be cognizant of the usefulness of the thing to satisfy the want; 4. the individual must also possess the technical knowledge necessary to utilize the thing to satisfy his want; and 5. finally, he must possess power of disposal over the useful thing. Böhm-Bawerk's minor correction of Menger lay in his listing the fourth precondition separately from the third, differentiating general cognition of a thing's usefulness for the attainment of one's end from the practical knowledge of how to actually utilize it as a means to achieve his end.

As Böhm-Bawerk (1962, p. 42) recognized, all but the second precondition are "less inherent in the things themselves than in the economic subjects for whom they are or are not goods."[20] From this insight, Böhm-Bawerk (1962, pp. 42-45) logically deduced a series of propositions regarding goods that implicitly established economics on a praxeological foundation. Goods-quality is not a purely objective attribute of a thing, but a relationship that must exist between a thing and an economic subject. Goods-quality may be created or destroyed purely by a change in subjective relationships and in the absence of any change in objective conditions. A thing is never a good *per se*, but always a good for a particular economic subject – "just as every good must be good 'for something,' so also it must be good 'for somebody.'" Finally, there is a distinction between goods as concrete means to ends, which as such meet the criteria of an economic good, and goods as non-marginal and abstract ultimate ends, such as happiness, contentment, peace of mind and so on, which are beyond the purview

[20] In an article pruning the errant non-praxeological elements from the Austrian goods and value theories inherited from Menger and Böhm-Bawerk's, Mises (2003 p. 185) noted that the second and third preconditions should simply be replaced with, "the *opinion* of the economizing individuals that the thing is capable of satisfying their wants."

of economic science. This last in particular is a crucial insight because it opens the door to the praxeological conception of economics as a science of means.[21]

Up to this point, Böhm-Bawerk was recapitulating and refining what he believed to be the gist of goods theory handed down by his predecessors in the German subjective-value tradition. One of his great theoretical breakthroughs occurred as soon as he turned to his stated task of clarifying "the categories of economic goods." Noting that these categories must "find a place for all genuine contributions to human well being," Böhm-Bawerk (1962, pp. 49, 50) insisted that nonmaterial "personal services" be included alongside "material goods" as a category of good, a position that most contemporary economists, especially French and English, had finally come to accept but without adequately comprehending why. Focusing first on "corporeal goods," Böhm-Bawerk (1962, pp. 67-68) pointed out that the usefulness of such goods in satisfying human wants consisted of "the activation for the delivery of useful renditions of the forces of nature residing in them." Indeed it was impossible to conceive of the utilization of a good in any other way than either the intentional activation or reception of the useful renditions of services emanating from the good. The fact that the useful renditions of service are based on natural powers that inhere in a material good does not imply that the good itself is a purely objective phenomenon. Böhm-Bawerk employed the example of the production and consumption of a poem to illustrate that the good is inextricably bound up with the want-satisfaction process that traverses and links the objective and subjective realms. Wrote Böhm-Bawerk (1962, p. 69):

> Be it granted that the poet's soul must have originated thought and emotion, and be it further granted that only in another soul and through intellectual powers can those thoughts and emotions be reproduced, but the path from soul to soul leads through the physical world for one stretch of the journey and on that stretch the intellectual element must make use of the physical vehicle, that is to say, of the forces or powers of nature. The book is that physical material vehicle.

[21] As Mises (1998, p. 93) pointed out, "It is customary to call the end the ultimate good and the means goods. In applying this terminology, economists mainly used to think as technologists and not as praxeologists. They differentiated between free goods and economic goods... Only the economic goods are the substratum of action. They alone are dealt with in economics." For a recent critique of the central concepts of modern welfare economics, "collective goods" and "external benefits," based on Böhm-Bawerk's theory of goods, see Campan 1999.

In his mature work, Böhm-Bawerk conceived the time-consuming production process in a capitalist economy as a process that wound its course from "soul to soul" via the competitive bargaining process in factor and, eventually, consumer-goods markets and culminated by rendering a concrete service in satisfying specific human wants. Böhm-Bawerk (1962, p. 77) concluded, therefore, "the concrete renditions of service are means for the satisfaction of want in a more real sense than are goods themselves… [I]t is not goods but … the renditions of service that emanate from those goods which constitute the smallest independent units of our economy and that the former (i.e., goods) constitute only complexes of the latter, that goods are therefore a secondary category."[22] Böhm-Bawerk's theoretical innovation in identifying renditions of services as "the veritable basic element of our economy" followed naturally from Menger's praxeological emphasis on "individual concrete wants" in developing the theory of marginal utility.[23]

Having elucidated the fundamental position of renditions of service, Böhm-Bawerk had no trouble in establishing personal services or "the means to well-being which belong to the *subjective world of the personal ego*" as a category of good. He pointed out that in a world where slavery no longer existed neither the person himself providing the services nor the "talents, powers and qualities" that enable him to provide such services but only the renditions of service themselves can be considered as goods.

Armed with these two categories of goods, the renditions of service by material goods and by human beings respectively, Böhm-Bawerk (1962, pp. 59-66, 79-83) was easily able to show that legal claims to material goods and to partial utilization of such goods do not constitute separate categories of good. Rather, to the extent that they are enforceable – and only to such an extent – they are one of the preconditions

[22] Böhm-Bawerk's distinction between material goods and renditions of service forms the basis of the Fetter-Rothbard theory of rent: "In regard to a durable good … the price of the unit service is distinguishable from the price of the 'good as a whole.' It is obvious that *the rents are the fundamental prices*. The marginal utility analysis has taught us that men value goods in *units* and not as wholes; the *unit price* (or 'rent') is, then, the fundamental price on the market" (Rothbard 1993, 1:417-18).

[23] "The natural unit of means-of-satisfaction will be the one that corresponds to the means of satisfying one unit of our wants or to the attainment of one unit of our purposes… For the whole make-up of the human mind and spirit is such that it is inevitable, whenever man appraises his emotions, his needs and his purposes … that he begins by establishing a unit of those emotions, needs and purposes" (Böhm-Bawerk 1962, pp. 74, 76).

of a thing's goods-quality, viz., the power of disposal over the thing. A thing does not become a good until it becomes someone's "property." Outside a Crusoe economy this requires the recognition and enforcement of the individual's right to control the thing. Böhm-Bawerk (1962, pp. 58-59) summarized his argument as follows: *"[W]herever a good is to serve an economic purpose, there must, under all circumstances*, be present some factual possession, some physical controlling power adequate for the economic purpose concerned... Hence a legal right or the legalized power of disposal over a thing is nothing more nor less than a necessary reinforcement supplied by a politically organized state of the physical power which is needed by the owner of a good as a condition of its economic utilization."

The same argument applies to contractual "rights to partial utilization" of an object, as in lease or rental contracts, which are simply rights to "renditions of service as independent economic entities" (Böhm-Bawerk 1962, p. 81). To ascribe the status of an independent good to such contractual rights would be redundant. Böhm-Bawerk (1962, p. 82) used the example of hiring a taxi to drive home his point. For the taxi passenger, "it is impossible, therefore, to speak of his power of disposal over the rendition of service [from the taxi] as an independent good beside and in addition to the rendition of service itself."

Böhm-Bawerk made some of his most significant contributions to economic theory when he addressed the question of whether "rights to the future yield of goods" or, what we might broadly refer to today as "financial assets" constituted a separate category of goods. In the case of a "payments-claim" or the legal right to demand repayment of a debt, which Böhm-Bawerk (1962, pp. 83-85) considered to be theoretically the most important of this group of rights, the "true goods" are "the objects themselves that constitute the matter of the debt." These are the anticipated renditions of services that the creditor is entitled to claim at some definite time in the future. The payments-claim thus endows its owner with power of future disposal over a real thing. Hence it is not a good *per se* but merely one precondition of "future goods-quality" in the same way that a property right in a thing is one of the preconditions of "an already present goods-quality."

Although the resolution of this issue was apparently straightforward, Böhm-Bawerk recognized that futurity was an inherent element of economizing activity and raised profound problems that had not previously been addressed by the theory of goods. Thus he initiated a systematic transformation of German goods theory into a theory of action that was not completed until his student Mises published his treatise on *Nationalökonomie* in 1940, which was rewritten and published in English as *Human Action* in 1949. His first efforts in this direction yielded seminal analyses of the roles in economizing of time, foresight, intertemporal valuations, uncertainty, causality, and "wealth computation" or monetary calculation.[24]

Böhm-Bawerk (1962, p. 87) pointed out that "economic science is not concerned only with *today*," because human beings develop "economic foresight" as soon as they begin to strive after the "objective means" for ensuring future well-being. Once this has occurred, "the future has gained a sure and important place in our economizing," and we evaluate our anticipated wants and availability of goods against our existing wants and goods. Accordingly, "our economic behavior in the present" is "governed by the prospective presence of future needs just as if they were already upon us in the present." Thus had Böhm-Bawerk introduced the concept of an intertemporal scale of valuations.

As Böhm-Bawerk (1962, pp. 90-92) noted, however, "nothing that is future is for us *absolutely certain*." Thus when dealing with claims to future renditions of service – whether these be in the nature of a debt claim or the ownership of a durable good like a house – neither the actual disposal over these future goods nor, *a fortiori*, their value is assured. Rather our objective power to utilize them as well as their subjective value to us are subject to "probabilities of an infinite number of degrees of probability which will range from something bordering on complete certainty" to "mere doubtfulness" and on to "an almost disappearing possibility." Nonetheless, the very nature of economizing dictates that such uncertain future advantages are taken account of and valued in some manner. Anticipating the distinction between what Mises (1998, pp. 105-15) later called "class probability" and "case probability," Böhm-Bawerk did not believe that the expected values of uncertain future goods could be objectively calculated and summed up.[25] The circumstances determining the maturing of an individual's claim to a specific future good into actual disposal over useful renditions

[24] Of course, Menger had dealt with all of these topics but in a cursory and less methodical fashion (Salerno 1999, pp. 90-93).

[25] Mises's terms correspond to what are today called, much less felicitously, "risk" and "uncertainty."

of service in the anticipated economic situation were unique and incommensurable. According to Böhm-Bawerk (1962, p. 91-92), therefore,

> [W]e cannot differentiate "sure dollars" from "probable dollars" and again from "possible dollars" and … if we could, we should not arrive at a final uniform total, any more than we arrive at a sum resulting from adding apples, pears and plums. Consequently, we can do no more than transfer the gradation in the degree of probability from the area where it exists but cannot be expressed, *the degree of probability*, to an area where it does not exist but where it can be expressed, namely, the magnitude of the prospective advantage. That is to say we modify *the magnitude of the prospective advantage* or modify the estimation of value we place upon it.[26]

In other words, appraising the value of a claim to a future good involved an individual's qualitative and subjective understanding or forecast of the unfolding of the unique events relating to the good's coming into being and the transformation of this qualitative forecast into a quantitative uncertainty discount in objective and certain present dollars. Thus, for example, legal title to a house of given durability and serviceableness built near the San Andreas fault may be appraised at a lower value by an individual than title to a house of the same durability and serviceableness built elsewhere, because his power of disposal over its future renditions of service are less probable in the first case. Unfortunately, Böhm-Bawerk went astray by comparing this subjective process of appraising uncertainty discounts for future goods to the very different case of objectively calculating the expected value of a lottery ticket. While correctly perceiving that its "true" expected value never equaled the actual *ex post* value of any individual lottery ticket, Böhm-Bawerk (1962, p. 92) leaped to an erroneous inference: "Objectively considered, this manner of computing wealth (except for the case of complete certainty) *always* leads to a result that is wrong." In fact, the appraisement of a future good or of an individual's overall wealth, *while always fallible, is not always wrong*, because the calculation is always instrumental to economizing or action. If the act of production or exchange that the calculation informs

[26] Thus Böhm-Bawerk's novel approach to probability reflected implicit awareness of the gist of the criticism later leveled by Mises (1998, p. 107) against modern probability theory: "The problem of probable inference is much bigger than those problems which constitute the field of the calculus of probability. Only preoccupation with the mathematical treatment could result in the prejudice that probability always means frequency."

results in a surplus of utility gained over utility surrendered, then it is correct. But this was a minor flaw in Böhm-Bawerk's path-breaking analysis of the fundamental futurity and uncertainty that characterized all valuations and choices.

By clarifying the nature of future goods and the method of their evaluation in the present, Böhm-Bawerk (1962, pp. 100-107) was preparing the ground for his foundational explication of the nature and productivity of capital goods. He began by adopting Menger's conception of "orders of goods" and identifying as a class of future goods the present possession of goods of "more remote order" – the term he preferred to Menger's "higher order." This subclass of future goods was of "paramount importance" because "to it belongs the entire mass of goods which constitute the *capital* of our economy."

The theoretical construction of "a serial structure, or *succession of orders of goods*" embodies the idea of causality, which is intrinsic to the goods concept. For Böhm-Bawerk, then, his theory of capital is nothing more than the elaboration of the logical implications of German goods theory (1962, p. 100):

> All goods, by the very terms of the concept "good" itself have one feature in common. That feature is that they are capable of constituting a link in the chain of cause and effect – the causal chain ... between human needs and the satisfaction of those needs. Now this causal relation may be direct or remote; it may be immediate or it may function by way of one or more intermediate links of the chain. In the nature of things these intermediate links of the chains are themselves goods, and the transmission of the utility takes place in such manner that from goods of remote utility there are first produced other goods which are closer by one stage to the (final) stage of direct utilization; then through these goods there is effected either the direct satisfaction of the want, or the production of still another good which, in its turn, occupies a place that is one stage closer to that which represents the satisfaction of the human want.

Referring to Menger's two laws, Böhm-Bawerk (1962, p. 102) argued that the goods-quality and value of every good of remote order is conditioned by the goods-quality and magnitude of value, respectively, of the goods of successively less remote orders for whose production they serve. Ultimately every link in the causal chain of goods derives its economic significance "from *one and the same source, namely, the want*." In defending Menger's law of value that the total value of all goods of remoter orders are determined by and exactly equal to the value of the goods of the first order to whose production they contribute, Böhm-Bawerk was the first economist to state the law of opportunity costs as it applies in production.[27]

The objection that Böhm-Bawerk aimed to refute by enunciating what he later called "the law of cost" stemmed from a misinterpretation of the empirical fact that some of the goods of remoter order employed by a single producer, particularly the various kinds of labor, already possessed an established value or price. This being the case, the opponents of Menger's law argued, how could it be reasonably maintained that the value of the product determined the value of the labor and capital goods expended in its production rather than the other way around. Böhm-Bawerk responded that many goods of remoter order had "a multiplicity of ways of utilization" and, therefore, drew upon "a multiplicity of sources of value." He then proceeded to elaborate this insight regarding the existence of nonspecific factors of production into the doctrine of opportunity costs:

> If a good of remote order, such as human labor, because of the multiplicity of the possible avenues of application attains an estimation of value via a large number of channels, then its value with respect to one single object to which it has been applied and which is considered separately by itself, will appear to be something definitely established and firmly determinable. And in that event, since we are inclined to use goods of definite value for the production of other goods only if the product can attain at least equal or perhaps greater value, than it is easily possible that the labor, regarded from a biased viewpoint, can appear as *causing* the value of the product (Böhm-Bawerk 1962, p. 103-104, fn. 5).

It is indeed a tribute to both his creative genius and his intense single-mindedness that Böhm-Bawerk conceived the law of opportunity costs as a stepping-stone to the clarification of a problem in the foundations of capital theory.

Although the value of goods of remoter orders is a "derived value," it is also "prospective in nature" and "anticipates the facts." The reason for the "anticipatory" or

[27] As Hayek (1992, p. 112) noted, despite the fact that it has come to be called "Wieser's law," Böhm-Bawerk "developed the law of costs with utmost lucidity three years before Wieser, albeit in off-hand fashion and in an obscure part of his book."

forward-looking character of the value of remoter-order goods is precisely that they must be transformed through time-consuming processes into goods of progressively less remote orders before they can finally release their future utility. For Böhm-Bawerk (1962, pp. 95), however, the present value placed on goods of remoter order and on future goods in general is the result of an individual and uncertain process of "wealth computation." This process is "an operation replete with subjective interpretations and insinuations." This mental operation is designed to give the economizing individual more than a mere listing of "the things comprising [his] wealth"; rather it is designed to provide "some estimation of their significance, their economic importance … their *value*, in order that we may add them up and compare them with other accumulations of wealth (Böhm-Bawerk 1962, p. 86). The uncertain, subjective and fluctuating "capital values" that are summed up into an individual's wealth are thus distinct from his objective possession of presently existing, concrete goods of remoter orders that constitute "capital."[28] Böhm-Bawerk (1962, p. 105) characterized the relationship between capital value and capital in the following manner:

> All capital value is an *anticipation* of the value of the prospective consumptible end-product. Production, of which capital is the tool and the material (e.g., machines and raw materials) is the condition, the justification and the materialization of the value which has temporarily been ascribed to capital goods; it is the process by virtue of which the future value of a capital good is transmuted into the present worth of the matured consumptible end-product, the process which leads to capital's fulfillment and justification.

Although Böhm-Bawerk did not here address the issue of how monetary calculation of capital values guided entrepreneurs in allocating concrete capital goods, his clear distinction between the two concepts was a seminal contribution to economic science and was a crucial step on the road to the development of a complete theory of monetary calculation by Mises.

[28] Elsewhere Böhm-Bawerk (1962, p. 97) differentiated "the materials of wealth" from the "forms of wealth." The former, which include, in addition to concrete capital goods, both durable and stored consumer goods, "are patently identical with the genuine goods which in actual fact lend support to our life and our well-being." The latter are the appraised values of our diverse rights and relationships that bear some probability of the promise of future renditions of service and are "mere creatures of our subjective interpretations."

Having thus thoroughly analyzed the category of future goods and incorporated it into the theory of goods, Böhm-Bawerk was finally ready to pose the defining, but theretofore unasked, question of capital and interest theory that would shine new light on the avenue to its solution. Böhm-Bawerk (1962, p. 105) first restated his conclusion that production, which involved "transformation of capital goods into consumptible goods, is not a process of creating values." Rather value is attributed to capital goods in anticipation of their time-consuming, *physical* transmutation into objects directly yielding renditions of service in satisfying concrete human wants. Hence the "productivity of capital," which has no existence in the dimension of value, could not be the cause of the value phenomenon of interest. Thus, as Böhm-Bawerk (1962, p. 106) was first to perceive, the central question to be answered in explaining the phenomenon of interest is: "If the prospective value of the product has already been ascribed to the producing capital in advance, how is capital, in the course of production to produce a 'surplus value'?" Or more concisely: "Whence this phenomenon of capital outgrowing itself?" Not only would this simple query become forever associated with Böhm-Bawerk's name, but his tenacious and meticulous pursuit of its answer eventually yielded a brilliant vision of the dynamic capitalist economic process that has suffused the works of his doctrinal descendants down to the present day.

With his typical modesty Böhm-Bawerk (1962, p. 106) concluded that his momentous breakthrough in capital and interest theory, which was the fruit of his ingenious reconstruction of goods theory, was "merely a slight indication of the existence of a problem which, in my opinion, has received far too little attention on the part of economic science. I hope to be able to offer a solution at some future time in an independent work toward the preparation of which the present work constitutes a preliminary labor." These words were written in 1881, at the age of thirty. Before he turned forty he would offer to the world a solution that would propel him to the forefront of economic theorists.

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Austrian Trade Cycle Theory and Rationality[i]

Brian P. Simpson[ii]

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Abstract: In this paper I show that Austrian trade cycle theory is fully consistent with rational expectations. I also compare and contrast rational expectations with an alternative theory of rationality and show that Austrian trade cycle theory is consistent with this alternative theory of rationality. I achieve the above by first providing an exposition of Austrian trade cycle theory. I then proceed to show that one would have to associate omniscience with rationality to claim that Austrian trade cycle theory is inconsistent with rationality. I also show that because the central bank manipulates the money supply in an erratic manner, it is impossible to use Austrian trade cycle theory to predict exactly when the current cycle will end and the next cycle will begin. Further, I show that even if all businessmen and entrepreneurs had rational expectations, the trade cycle would still occur. I show that because of the nature of the monetary and banking system we have today, the trade cycle must necessarily occur, and that it is supporters of the current system who have irrational expectations.

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[ii] Associate Professor, National University, School of Business and Management, 11255 North Torrey Pines Road, La Jolla, CA 92037, bsimpson@nu.edu.

1 Introduction

Many criticisms of Austrian trade cycle theory (from now on ATCT) have been made. The most potentially damaging criticism is the claim that ATCT is not consistent with "rational expectations."[1] This attack on ATCT says that if the central bank regularly creates the trade cycle through a manipulation of the supply of money and credit, businessmen and entrepreneurs should be able to learn from these repeated episodes and not make the same mistakes over and over again. According to this argument, by learning from the repeated episodes of the trade cycle, businessmen and entrepreneurs should be able to prevent the central bank from continuously creating such a cycle by counteracting the effects of the central bank's actions. In fact, according to this argument, entrepreneurial individuals should be able to profit from the central bank's actions. At a minimum, businesses should be able to use ATCT to make themselves immune from the central bank's actions if, indeed, ATCT is correct. In essence, if ATCT is correct, businesses should be able to use it to anticipate the different phases of the cycle by predicting when they will occur. They should be able to profit from the cycle by using the theory to position themselves appropriately based on which phase of the cycle is approaching.

Although there have been many other arguments made against ATCT, most of them are not very significant. Many of them are not very strong criticisms against ATCT. Further, many of them have been addressed. For instance, it has been claimed that there is no historical evidence to support the theory and that the theory is too complex to be valid. It is outside the scope of this paper to address these arguments, as well as many other arguments. However, both of these arguments against ATCT, and many more, have been addressed.[2]

As I said, the rational expectations argument against ATCT is the most potentially damaging and, therefore, ATCT must be defended against this argument if it is

[1] For examples of authors who make such a criticism, see Tyler Cowen (1997, p. 77) and Richard E. Wagner (1999, p. 71).

[2] For the claim that historical evidence does not support the theory, see Robert A. Gordon (1961, p. 360). For the claim that the theory is too complex, see Leland B. Yeager (1986, p. 380). These and many other arguments against ATCT are addressed in Roger W. Garrison (1986, pp. 447-51). Walter Block (2001, p. 63) also provides references to a number of criticisms and rebuttals. He also provides rebuttal to a number of criticisms as well in that paper.

to remain as a valid explanation of the trade cycle. It is important that ATCT be consistent with rational expectations because rationality is a fundamental characteristic of human beings. If the theory cannot be defended against this argument, it would be proper to abandon it. Fortunately, ATCT can be defended and its abandonment is not necessary.

In this paper, I will show that ATCT is fully consistent with rational expectations, as that term is used by contemporary economists. I will also show that the concept of rationality that contemporary economists use is not a very good one, in that it does not get to the root of what it means to be rational. Because of this deficiency, I will present an alternative view of what rationality is and show that ATCT is also consistent with that.[3]

Some "Austrian" economists have addressed the rational-expectations criticism of ATCT; however, these economists do not provide a complete analysis of this criticism.[4] They do not focus on the role that changes in the rate of profit have on the actions of businessmen and entrepreneurs, they do not show how it is government officials and economists who support fiat money and fractional reserve banking that have irrational expectations, they do not expose the errors in contemporary economists' conception of rationality, and they do not offer a better alternative to the contemporary economists' conception of rationality. These are the major contributions I make in defending ATCT from the rational-expectations critique.

2 Austrian Trade Cycle Theory

To understand what I mean when I use the term ATCT, I will give a very brief description of the explanation of the trade cycle that this theory offers. My exposition of the theory essentially follows the presentations given by Ludwig von Mises, F.A. Hayek, Murray Rothbard, and George Reisman.[5]

[3] This paper is based on a portion of my dissertation. See Brian Simpson (2000, pp. 128-32).

[4] See Ludwig von Mises (1943, pp. 251-2), Gerald P. O'Driscoll Jr. (1977, pp. 102-8), Garrison, pp. 445-7, and Block, pp. 65-8 for examples.

[5] See Ludwig von Mises, (1966, pp. 550-71), F.A. Hayek, (1967, pp. 32-100), Murray Rothbard, (1962, vol. 2, pp. 850-879), and George Reisman, (1996, pp. 938-40). George Reisman (2007, 2002, and 1999) also

In its most basic form, ATCT says that the trade cycle results from a rapid increase in the money supply. As the money supply expands at a rapid rate, spending, business revenues, and profits in the economy increase. This provides businesses with an incentive to expand their investment activities. This creates the expansion phase of the cycle.

The additional revenue and profits created by the money injected into the economy are not the only factors providing businesses with an incentive to expand. There is also the fact that, as the money supply expands at a rapid rate, the rate of interest is prevented from rising initially, at least to as great of an extent as the rate of profit. The rate of profit rises immediately because of the additional revenue generated by the increase in the money supply and volume of spending. However, interest rates will not rise so rapidly (or may even fall) as the new money enters the economy. This is due to the way most of the new money enters the economy. Due to the fractional reserve nature of our banking system, most of the new money enters the economic system in the form of an additional supply of credit. This increased supply of credit initially puts downward pressure on interest rates (at least relative to the rate of profit) and provides businesses with an additional incentive to expand. This is the case because not only do businesses face an increase in the rate of profit they can earn on investments, they face an artificially low interest rate that decreases the cost of using debt to finance any new investments. The changes in interest rates and the rate of profit also have the effect of lengthening the structure of production.

The structure of production refers to the relative production of capital goods versus consumers' goods in the economy; it refers to how roundabout the methods of production are in the economy. The greater relative production of capital goods, the more roundabout the methods of productions in the economy. More roundabout methods of production ultimately lead to a greater absolute production of consumers' goods, even though the relative production of consumers' goods is less. A lower interest rate and a higher rate of profit lengthen the structure of production; that is, they cause an increase in the relative production of capital goods because more roundabout methods of production will become more profitable relative to less roundabout

provide some excellent recent applications of ATCT that showcases its power to explain the perpetual cycle of boom and bust.

methods of production due to the compounding effects involved. In other words, lower interest rates and high rates of profit increase the present discounted value of long-term investments relative to short-term investments and thus increase investment in the former relative to the latter.[6]

The contraction occurs when the expansion of the money supply ends (or even just slows sufficiently) so that spending, revenues, and profits decline (or increase at a less rapid rate) and businesses contract their activities. At this point, the economy enters a period of recession or depression. As a part of the contraction, the rate of interest briefly rises relative to the rate of profit and provides a further incentive for businesses to contract their activities, since this means the cost of financing investment activities has risen. Further, the structure of production shortens due to the changes in interest rates and the rate of profit.

What does this mean for the individual businessman? During the expansion businessmen and entrepreneurs will find it easier to sell their goods into a growing revenue stream. This makes it possible to operate with lower cash balances relative to their spending. This phenomenon is witnessed in the fact that the demand for money, as measured by the velocity of circulation of money, typically remains low, and often declines, during inflationary expansions. Further, the "easy" credit policy on the part of the central bank, and the low interest rates that are indicative of such a policy, also makes it possible for businesses to operate with lower cash balances. This is because with an "easy" monetary policy, businesses find it easy to raise needed funds in the loan market, so they do not need to hold onto as many funds to finance their spending. When the central bank has followed such a policy for a significant period of time, profit-seeking businessmen find it all too tempting to take advantage of the prevailing economic data. Eventually they make investments to expand their operations by hiring workers and/or expanding their facilities. The expansion might occur slowly at first, but as long as the inflationary policies of the central bank continue – and accelerate – the real profit opportunities become harder to pass up. Even if businessmen understand the opportunities may be short lived, the incentive to invest to try and take advantage of them become stronger the longer the central bank pursues an "easy" monetary policy.

[6] For more on the structure of production, see Hayek, pp. 37-68.

The expansion does not affect all industries at the same time and to the same extent. As was discussed above in connection with the structure of production, industries farther removed from final consumption tend to expand more than industries closer to final consumption. Further, industries that are particularly sensitive to changes in interest rates, such as the construction industry and stock market, are also susceptible to dramatic fluctuations in their scale of economic activity. The dramatic rise in housing prices for a number of years in the recent past (through 2006) in the United States and the subsequent fall in prices starting in 2007 is just the most recent example of the boom-bust cycle. The Federal Reserve's "easy" monetary policy from late 2000 to late 2003 fueled the dramatic run-up in housing prices through 2006. Its "tight" monetary policy from early 2004 to mid-2007 precipitated the housing crisis in the United States.[7]

Less recently, the tale of Cisco Systems, the maker of computer networking equipment, during the inflationary expansion of the latter 1990s and the recession of the early part of this millennium provides an excellent description of the details faced by firms during the boom-bust cycle. During the latter 1990s inflationary expansion, Cisco's revenues grew at an annual rate of 53-percent. This is unheard of for a multibillion-dollar company. Toward the end of the expansion, it doubled its payroll to 44,000 employees in just one-and-a-half years. The company had 500 recruiters just to sift through job applications. It acquired a company, on average, once every other week. New employees were shown charts projecting a 30-percent annual increase in the company's stock price. This turned out to be conservative, as the stock price doubled each year, on average, throughout the 1990s.

In the last weeks of 2000, things abruptly changed. Companies stopped buying from Cisco, as they realized they had massively over built their computer networking infrastructure. Revenue fell for the first time in company history: by mid-2001 revenue had fallen 33-percent from where it had been six months earlier. The company had to engage in its first-ever mass layoff in 2001.

If Cisco Systems was to survive, a number of things had to be changed. During the 1990s inflationary expansion, Cisco emphasized increased revenues. After the bust hit, it had to demand profits. During the expansion, Cisco had 22 groups, with

[7] See Reisman (2007) for a detailed analysis, based on ATCT, of the housing crisis.

more than 100 employees, creating customer-service policies. One group did nothing but track the other 21. When the bust hit, company management acted to cut these groups to one with fewer than 10 employees. During the expansion, Cisco raced to devour start-ups and build niche products. When the bust hit, the company focused on building fewer, more versatile products internally.[8]

While the story might be more dramatic for Cisco Systems than most companies, the basic tale is the same: one of increased business due to a dramatic inflation of the money supply and volume of spending. Once the inflation slows or stops, companies hit the wall, as Cisco did in late 2000 after the slowing of the inflation by the Federal Reserve starting in 1999. Revenues decline or fail to rise sufficiently, workers must be laid off, and investment plans that depended on the continuation of the inflation must be scrapped if the company is to have a chance to survive. Fearing the harmful effects of possible deflation, the central bank begins to inflate again, using the recession or credit crunch as an inflationary refueling period. This was exactly the situation faced in the United States in early 2008. At that time the Federal Reserve used the housing crisis as a rationalization to resume an "easy" monetary policy (as witnessed by its targeting of a lower Federal Funds Rate).

3 Austrian Trade Cycle Theory and "Rational Expectations"

As I state, the above boom-bust cycle is created by the central bank's manipulation of the supply of money and credit, with the help of the banking system. If this is so, why do businessmen and entrepreneurs repeatedly get fooled by the central bank's manipulation of money and credit? Why are they repeatedly duped into expanding, only to have to eventually rid themselves of the investments they engaged in during the expansion? Why don't they learn from their past mistakes and prevent the central bank from leading them into an artificial expansion? In fact, why aren't they able to profit from the central bank's repeated actions? This is the basic argument made by rational expectations theorists against ATCT. In order to understand why ATCT is consistent with rational expectations, one must first understand what exactly is meant by that term.

[8] See Scott Thurm (2003).

Rational expectations, as contemporary economists use the term, means that people's expectations of the future are not systematically wrong and that people use all available information when forming their expectations. It says people can learn about changes taking place in the economy and correct any mistakes they made in the past. This is the view expressed in the famous article by John Muth that eventually led to the development of the "rational expectations" approach in mainstream economics. Muth states it most clearly when he says that the assumption of rationality is dropped whenever systematic biases and incomplete or incorrect information are incorporated into one's analysis.[9] Even though this does not provide a very good understanding of what it means to form expectations rationally, ATCT does not imply that businessmen and entrepreneurs make systematic errors or that they do not correct their mistakes. Businessmen and entrepreneurs act fully within the limits of rational expectations, as that term is used by contemporary economists.

The first thing that can be said in defense of ATCT is that the same economists who use rational expectations theory to argue against ATCT also typically recognize that ATCT is not a very well known or widely accepted theory among economists. If this is true, it is hard to believe that many businessmen and entrepreneurs, who are taught trade cycle theory by economists, know about the theory. Therefore, how could they use a theory they most likely have never even heard of to protect themselves or profit from the cycle?[10] One cannot be said to be acting inconsistently with rational expectations if one does not have the knowledge necessary to correct one's actions. In fact, to the extent that other theories of the trade cycle that do not accurately explain the cycle are prevalent among economists, and thus among businessmen and entrepreneurs, if businessmen and entrepreneurs act on these theories, this would contribute to the errors they make in connection with the trade cycle.

Further, even if businessmen and entrepreneurs did have knowledge of ATCT, and thus would be in a position to use it to their advantage, one must remember that being rational does not imply being omniscient.[11] Businessmen and entrepreneurs do not have a crystal ball they can use to predict the future. They cannot know every move

[9] See John F. Muth (1961, pp. 330 and 333). For a similar view, see Thomas J. Sargent and Neil Wallace (1975, pp. 246-7).
[10] A similar point is made in Block, p. 65 and Garrison, p. 442.
[11] Also on this point, see Block, p. 67.

that a central bank, private banks, or the demand for money will make. They cannot predict the exact lag between a change in the money supply and a change in the volume of spending, or in which parts of the economy the new money will be spent first. This is true even if the central bank follows a policy of "inflation targeting" and, therefore, attempts to stabilize the general rate of price increases. First, one cannot know when or if the central bank will change its "inflation target." Second, even if the general rate of change in prices is stabilized, changes in the prices of individual goods could still fluctuate dramatically, providing an incentive for industries with favorable price changes to expand. Further, and more significantly, one cannot predict exactly when the prevailing economic data will change and cause the central bank to have to shift its policy from accelerating to slowing the inflation of the money supply (or vice versa) to maintain its target. In addition, even if the central bank is targeting a particular rate of price increase, at times it will be following an "easy" monetary policy to maintain its target. Even if businesses are aware of the policy of "inflation targeting" the "easy" monetary policy will still provide businesses with an impetus to expand. If businessmen and entrepreneurs are continuously faced with increases in revenues and profits, and interest rates that remain low relative to the rate of profit (regardless of what policy the central bank chooses to follow), sooner or later they will expand their business activities. Further, the longer and more rapid the increase in the money supply and spending, the more likely businesses will expand (and the greater that expansion will be).

ATCT does not imply that businessmen and entrepreneurs make systematic errors because the central bank does not manipulate the money supply to create a consistent pattern of expansions and contractions. For instance, the central bank does not create a contraction once every five years. If this were the case, businessmen and entrepreneurs could exploit this pattern and incorporate it into their expectations. Recessions do not occur at an unchanging frequency; however, they occur in an erratic manner because of the erratic manner in which the central bank manipulates the money supply. Therefore, no businessman or entrepreneur should be able to know what the central bank is going to do to the money supply tomorrow, next week, next year, or in the next decade. Uncertainty in both the duration and magnitude of the changes in the supply of money and credit is what helps to generate the cycle (or make a particular cycle more severe).

The trade cycle, in a fundamental sense, does not stem from the errors of entrepreneurs and businessmen; it stems from the nature of the monetary and banking system we have today. It occurs due to the nature of fiat money and fractional reserve banking.[12] Fiat money gives the central bank the ability to easily manipulate the money supply (specifically, the amount of standard money or the monetary base). It gives them the power to increase the money supply at a rapid rate, thus creating an expansion, and then decrease it or slow its increase, thus creating a contraction. Further, as stated earlier, the fractional reserve nature of the banking system creates the effects in the loan market which provide further incentives to businessmen and entrepreneurs to expand or contract their activities. The fractional reserve nature of the banking system also makes possible potentially large and rapid swings in the money supply due to the creation and destruction of fiduciary media.

Under such a system, the actions of businessmen and entrepreneurs cannot be expected *not* to create the trade cycle. This is the case because if the money supply is being increased at a rapid rate, the incentives to expand are in place and it will only be a matter of time before businesses begin to expand. They may not expand if the increase in money and spending is short-lived or at a very low rate, but the longer and more rapid the increase, the higher the profits are that can be earned, the lower interest rates will be relative to the rate of profit, and thus the more likely it is that businesses will expand their activities. In other words, the incentives to expand their activities in response to rapid increases in the money supply exist whether businessmen and entrepreneurs know about and believe in ATCT or not; whether they can use the theory to their advantage or not; and whether they know how the money supply is changing and affecting the economy or not. Those incentives are in place due to the nature of our fiat money monetary system and fractional reserve banking system. If the increase in the money supply continues long enough, and at a rapid enough rate, the movement in the rate of profit and interest rates creates a strong incentive to expand, and eventually, in order to attempt to profit from the prevailing economic data, businesses will expand.[13]

[12] One does not actually need both fiat money and fractional reserve banking at the same time to create the trade cycle; both are sufficient by themselves to create the cycle. However, the two together have the potential to create much wider swings in the cycle. Further, fractional reserve banking provides a much stronger influence in creating the trade cycle than does fiat money.

[13] See Block, p. 66 and Garrison, p. 446 on this point also.

This brings me to the actual role of expectations in the trade cycle. As I have said, businessmen and entrepreneurs are not omniscient, and it is difficult for them to know exactly how an increase in the money supply will affect the demand for their products from year-to-year. However, when the increase is fairly slow and constant, businessmen and entrepreneurs can easily take it into account and it will not cause them to expand. They will simply adjust their prices, borrowing, and spending accordingly. Here, because the increase in money, spending, and credit is slow and steady, businessmen's expectations tend to accurately reflect the changes in these parameters, and the actions they take based on these expectations tend to be in line with what is actually occurring in the long run, so no cyclical expansion and contraction take place.

It is only when the increase in demand for their products, due to an increase in the money supply, is greater than expected, that the incentive to expand will be present. It may be that businesses do not expand immediately when spending for their products is greater than expected. They may adjust their prices initially to adapt to the changing conditions. However, if spending for their products repeatedly outstrips their expectations, and the rate of profit continuously remains high relative to interest rates, sooner or later businessmen and entrepreneurs will expand in response to these incentives. In essence, when businessmen and entrepreneurs *expect* to be able to profit from the increase in money and spending, they will expand their activities.[14] Hence, one can see that expectations (whether "rational" or "adaptive") can easily be incorporated into ATCT. However, such expectations will not prevent the trade cycle from occurring.

Some businessmen and entrepreneurs may even realize that the expansion is only temporary and that the relatively high profits and low interest rates will come to an end. However, this might not stop them from making investments based on the prevailing distorted data. To the extent that they think they can divest at the right time or that any losses they might incur due to the eventual contraction will be more than offset by the gains from the expansion, they will have a strong incentive to engage in such investments. Businessmen and entrepreneurs cannot escape the prevailing economic data. All they can attempt to do is profit from it, and, again, the longer

[14] For more on this, see Reisman (1996, pp. 588, 938-40, and passim).

and more extreme the expansion, the greater the incentive for businessmen and entrepreneurs to make such investments.

Businessmen and entrepreneurs may make errors during the trade cycle due to uncertainties associated with the size and duration of the expansion, or due to the readily available supply of money and credit during the expansion; however, these errors are not systematic, and businessmen and entrepreneurs cannot, ultimately, be blamed for such errors or for the existence of the trade cycle. Responsibility for the trade cycle, and the errors businessmen and entrepreneurs make in connection with it, must ultimately be placed where it properly belongs: on the institutions of fiat money and fractional reserve banking, and the economists and government officials who support such institutions. It is economists and government officials that have created the system within which businessmen must act. Businessmen are merely reacting to the incentives provided by a system that is fundamentally flawed. It is flawed because it creates an environment where the trade cycle is inevitable.

If anyone is making systematic errors, it is the government officials and economists who support the institutions of fiat money and fractional reserve banking. They repeatedly commit the error of supporting a monetary and banking system based on these institutions, despite the flaws that are inherent in the system, and in spite of the fact that these flaws have been recognized by Austrian economists and other economists for more than a century. If contemporary economists and politicians acted in accordance with rational expectations, when faced with the repeated episodes of boom and bust that such a system creates, they would learn from their mistakes and correct their errors. That is, they would take the necessary actions to abandon the current system and replace it with its opposite, the only system that renders monetary induced trade cycles virtually impossible: a 100% reserve gold based monetary and banking system.

I am not going to discuss the virtues of a 100% reserve gold based monetary and banking system. That would fall outside the scope of this paper and would take at least another paper to address. If one wants to read about the virtues of gold and 100% reserves, see the relevant readings in von Mises, Rothbard, or Reisman.[15]

[15] These include Ludwig von Mises (1981, pp. 456-459, and 480), Rothbard in Leland B. Yeager (1962, pp. 94-136), and Reisman (1996, pp. 951-63).

4 Austrian Trade Cycle Theory and a Better Understanding of Rationality

It is important, at this point, to discuss an alternative theory of rationality. Contemporary economists' concept of rationality is the source of much confusion in economics, including the source of much of the confusion regarding the validity of ATCT.

The arguments I have made up until this point in defense of ATCT are based on the definition of rational expectations as used by contemporary economists. However, this definition is not a very good one because it does not get to the most important characteristic of rationality. A good definition must be based on the most important, or essential, characteristic(s) of a concept. Aristotle was the first philosopher to recognize the importance of defining terms based on essential characteristics.[16] With respect to man, for instance, Aristotle identified man's defining characteristic as his rational faculty. What Aristotle was referring to when he spoke of the rational faculty was man's reasoning mind.[17] Reason is the tool that identifies and integrates the material provided by man's senses.[18] It allows him to think at the conceptual level (i.e., in terms of concepts, principles, and ideas). It is the faculty that separates man from the lower animals.

Based on the nature of man's rational faculty, to be rational means to use reason or, equivalently, to base one's thoughts and actions on the facts of reality and logical analyses of those facts. Likewise, to act on emotions or on ideas not based on facts and logic is to act contrary to reason and rationality. If one is rational one will not make systematic errors, but not making systematic errors is just an effect of acting rationally; it is not rationality itself. Therefore, to define rationality based on the absence of systematic error (which is what contemporary economists do) is to take an effect, or non-essential characteristic, of rationality and make that the essence of rationality.

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[16] To see Aristotle's statements regarding definitions, see Richard McKeon (1947, pp. 76-77).

[17] On Aristotle's definition of man, see W.D. Ross (1928, pp. 130, 980, 1095, and passim).

[18] On this definition of reason, see Ayn Rand (1964, p. 22). For more on the Aristotelian method of definition and this view of rationality, see Ayn Rand in Harry Binswanger (1986, pp. 117-21, 404-5, and 407-10) and the references provided there.

As long as businessmen and entrepreneurs use reason or act based on facts and logic, they are acting rationally. Further, as long as they form their expectations based on reason, their expectations are rational. In many cases, it can be rational to base one's expectations on past experience alone (if that is the only information one has available or is the only information that one believes to be relevant). Therefore, so-called adaptive expectations can be rational. Further, a person can make mistakes and still be rational. The focus of the concept rationality is on the process by which one attempts to gain knowledge, not on the outcome of that process. Of course, if one is rational, he will take the necessary steps to correct any mistakes he might make.

Some may think that differences between definitions are just semantic differences, that definitions are essentially arbitrary statements of what a concept is, and that differences in definitions do not play a very significant role in intellectual life or in economics. However, such a belief is grossly mistaken. Definitions are not arbitrary. The definition of a concept helps to distinguish one concept from all other concepts, and it determines what concretes in reality we identify with a particular concept. A definition can help or hinder one's conceptual understanding of what something is. Good definitions help us achieve a clearer understanding of what something is. Poor definitions lead to confusion and false conclusions.[19]

If definitions were truly arbitrary, one could literally define something to be anything one wanted. For instance, a horse could be defined as a doughnut shaped flotation device. If such a method of definition were taken seriously, it would lead to confusion and false conclusions on a massive scale. Fortunately, those who claim that definitions are arbitrary usually do not act consistently on that belief. However, to be in a position where we must rely on the inconsistencies of people is, indeed, to be in a very precarious position.

A proper understanding of rationality takes the focus away from whether or not a person is making errors and places the focus on the process that one uses to attempt to gain knowledge. To put the focus on the absence of error is to associate

[19] The false conclusion that ATCT is not consistent with rational expectations is just one example of the false conclusions to which bad definitions lead. For more on the cognitive function of definitions, see Leonard Peikoff (1991, pp. 96-105). Also, for another good economic example of the confusion and false conclusions to which a bad definition leads, see Reisman (1996, pp. 920-2). There he shows the misunderstandings created by contemporary economists' definition of inflation as rising prices.

omniscience with rationality. It is this confusion that leads some economists to say that ATCT does not incorporate "rational expectations." By putting the focus on the process of using reason, or acting based on facts and logic, one can eliminate this confusion and the inappropriate distinction between various types of expectations (such as adaptive expectations and rational expectations). One can also understand that being rational does not guarantee that one will not make errors. Finally, one can say that in the context of a fiat money, fractional reserve monetary and banking system, businessmen and entrepreneurs are acting as rationally as possible given the fundamentally flawed nature of the system within which they must act.

5 Conclusion

As one can see, ATCT is perfectly consistent with rational expectations, as contemporary economists use that term, and it is also consistent with a better understanding of rationality. Businessmen and entrepreneurs do not need to make systematic errors in order for ATCT to be able to explain the trade cycle. However, one must always keep in mind that being rational does not imply omniscience. Businessmen and entrepreneurs cannot see the future and know exactly how long an expansion will last. As long as businessmen and entrepreneurs are acting based on facts and logic, they are acting rationally, even when they do make errors. Furthermore, businessmen do not create the economic system within which they act and, therefore, cannot escape the incentives that such a system creates. Namely, they cannot escape the incentives created by a fiat money, fractional reserve monetary and banking system. Such a system is a breeding ground for periodic economic disasters. The rational thing to do is to get rid of this system and replace it with a stable system – a 100% reserve gold based monetary system – within which more rapid rates of economic progress can occur.

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Monetary Reform and Deflation – A Critique of Mises, Rothbard, Huerta de Soto and Sennholz[i]

Philipp Bagus[ii]

JEL Classification: E50, P11, P21, P31

Abstract: In this paper I will analyze the reform plans proposed by Ludwig von Mises, Murray N. Rothbard, Jesús Huerta de Soto, and Hans Sennholz. Though their contributions to monetary reform are significant, their fear of deflation leads them to consider monetary reforms that are theoretically inconsistent and ethically problematic.

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[ii] Associate Professor of Economics at the University Rey Juan Carlos in Madrid and Visiting Scholar at the University of Economics, Prague, philipp.bagus@urjc.es.

1 Introduction

Austrian economists generally agree that the actual monetary system is, to say the least, imperfect, leading to redistributive inflation and business cycles. Therefore, many Austrian economists, as does Huerta de Soto in his recent treatise *Money, Bank Credit, and Economic Cycles*, propose monetary reform plans to eliminate those characteristics of the monetary system. Many of them agree that the desirable aim of a monetary reform is a 100% gold standard, i.e., a system where all bank notes and demand deposits are completely covered by gold. Even though there are disagreements about how this reform should be reached, these proposals have one characteristic in common: an attempt to avoid deflation.[1,2] In this paper I will analyze the reform plans proposed by Ludwig von Mises, Murray N. Rothbard, Jesús Huerta de Soto, and Hans Sennholz. Though their contributions to monetary reform are significant, their fear of deflation leads them to consider monetary reforms that are theoretically inconsistent and ethically problematic.

2 Ludwig von Mises

Mises' plan for monetary reform can be found in "Monetary Reconstruction" in the 1953 English edition of his theoretical monetary treatise *The Theory of Money and Credit*.[3] Here Mises proposes the reestablishing of the classical gold standard, which he praises throughout his writings (Mises 1998, 468-473 or Mises 1980, 480-481). Notably, Mises advocates a return to the gold standard in which gold is actually used as money. Mises' primary reason for advocating the return to the classical gold stan-

[1] In this essay, deflation always means monetary deflation.

[2] Barnett and Block (2004) maintain that Mises and Rothbard opposed any change in the extant stock of money (inflation and deflation), apparently whether it is commodity money or not. Hence, Barnett's and Block's view supports the point made here.

[3] Earlier versions and variations of his proposal are his 1919 essay "Der Wiedereintritt Deutsch-Österreichs in das Deutsche Reich und die Währungsfrage" in *Schriften des Vereins für Sozialpolitik* 158. Leipzig: Duncker & Humblot and his 1923 essay "Die geldtheoretische Seite des Stabilisierungsproblems" in *Schriften des Vereins für Sozialpolitik*. 164: 2. Munich & Leipzig: Duncker & Humblot and his essay "Noninflationary Proposal for Postwar Monetary Reconstruction" written in 1944 and published in Ebeling (2000) (ed.) *Selected Writings of Ludwig von Mises: The Political Economy of International Reform and Reconstruction*, Vol. 3. Indianapolis: Liberty Fund. Pp. 71-118.

dard is that "it makes the determination of the monetary unit's purchasing power independent of the measures of governments" (Mises 1980, 480).

But how should this return to the classical gold standard be accomplished? Mises proposes a three-step reform for the U.S.[4] First, the issuing of any further fiduciary media, i.e., bank notes or bank deposits not backed completely by gold, will be forbidden. This implies a rigid 100 percent reserve for all *future* bank notes and deposits. Second, and at the same time, a free market for gold is to be established. People are free to buy, sell, hold, import, export, lend, or borrow gold, while the government must restrict itself from intervening in the gold market. Third, once the market has established a somewhat stable price for gold, this market rate will be declared the new legal parity. The unconditional convertibility of dollars into gold and vice versa will be secured by a state-run "Conversion Agency."

Two main critiques against Mises' proposal should be made here. First, even though Mises' proposal implies the cancelation of interventions into the monetary realm, it involves other interventions and is centrally planned. Second, his plan tries to avoid deflation without any theoretically consistent justification. First, let us consider the critique that his reform is a managed reform, containing several interventions. In fact, Mises' proposal contains new interventions besides the abolition of already existent interventions. Mises assumes without any demonstration that additional interventions would be necessary for the sake of liberalization. In fact, Mises' centrally planned monetary reform seems to be in contradiction to his other writings where he points out the deficiencies of central planning.[5] Even more surprising is that in *The Theory of Money and Credit*, only a few pages before he presents his reform plan, Mises criticizes central planning in regard to money:

> Money is the commonly used medium of exchange. It is a market phenomenon. Its sphere is that of business transacted by individuals or groups of individuals within a society based on private property ownership of the means of production and the division of labor… The goal of their [governments and po-

[4] See Mises (1980, 490-495). In his 1944 article Mises (2000, 104-106) has four steps. The additional step in this earlier plan, which preceeds the three discussed here, consists in balancing the national budget without engaging in further inflation.

[5] See for instance, Mises (1962) for his endorsement of classical liberalism and Mises (1996) for his critique of interventionism.

> litical parties] policies is to substitute "planning" for the alleged planlessness of the market economy. The term *planning* as they use it means, of course, central planning by authorities, enforced by police power. It implies the nullification of each citizen's right to plan his own life. (1980, 478)

After his criticism of economic central planning, is it not a contradiction on his part to propose a centrally planned and conducted reform? Can an economist propose the correct government interventions to achieve the ideal economic system? Considering his opposition to government intervention in the market, why does he not call for a simple but immediate retreat of the state from the monetary sphere?[6] Did he think that this would result in chaos, even though he did not think the abolition of other government interventions would lead to chaos? Or did the usually uncompromising Mises just want to make his proposal more appealing? In light of these questions his monetary proposal is puzzling to those who are familiar with his work. There is a likely explanation for this inconsistency; however, for the moment, let us turn to the details of his plan.

Mises' plan explains how the government should install a gold standard. Ironically, we find these details only a few pages following his critique of central planning. Here, Mises fails to see that even with the advice of such a brilliant economist of his own caliber, a central agency, while it can trigger a reform,[7] lacks the information required to manage an unambiguous and perfectly orchestrated reform. More precisely, the central agency lacks the information that the individuals have about their specific circumstances and their valuations. This information would be necessary to find a monetary unit or a new parity consistent with valuations of market participants and, thus, to coordinate the transition toward the new monetary system.

Not surprisingly, Mises offers some rather arbitrary features and peculiar details in his plan. The first ambiguity of his plan consists in the time frame that runs from the installment of gold in a free market to the announcement of the new legal parity.

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[6] A note on semantics: I do not understand the abolition of interventions as an intervention, as one might suggest. This procedure is not another intervention but rather a cessation of further intervention.

[7] For instance, Dulbecco and Renard (2003) show that by decentralization the Chinese government triggered the economic reforms of China. I would like to thank an anonymous referee to bring this paper to my attention.

As Mises states:

> Once the market price has attained some stability, the time will have come to decree this market rate as the new legal parity of the dollar and to secure its unconditional convertibility at this parity. (1980, 492)

But what does "some stability" mean? This "stability" is of course arbitrary and not operational. Markets are never in equilibrium, if that is what Mises meant by "stability." Moreover, it leaves room for discretionary decisions of the central agency, namely deciding when "some stability" is reached. In public choice terms we might expect decision makers to be biased in a certain direction. Therefore, it does not even seem to be correct to speak of a market price of gold. The material value of a paper dollar in terms of an ounce of gold is close to zero. The paper dollar only gains value because people are expecting a new legal parity that effectively converts the dollar in a gold substitute. This promulgation of the new legal parity is an intervention, and as such, it is vulnerable to the whims of the central agency. Market participants will try to anticipate this intervention, guessing what the new parity will be.[8] As a result, a free market price of gold is simply not possible in Mises' proposal.[9]

There are other ambiguities in Mises' plan. For instance, in his earlier 1944 plan Mises states that,

> [f]or the interval preceding the promulgation of the dollar's new gold parity, the heights of the ad hoc gold deposit required for every additional dollar should be fixed in accordance with the market price (in terms of dollar's) plus a margin of ten percent. (2000, 106)

Why should it be ten percent and not nine or eleven? Herein lies the problem. In planning an intervention thoroughly, one needs to plan the details.[10] And in planning

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[8] Another problem is the stabilization of the exchange rate of gold and the US dollar that is implied in setting a new legal parity not backed by 100% reserves. Stabilization or fixation of exchange rates can incite speculative attacks. In an attack, in the worst case a speculator does not lose, but can win when the exchange rate depreciates. See on this Yeager (1976, 248-49). A spectacular example of such an attack was the 1992 attack of George Soros on the fixed exchange rate of the British pound.

[9] In the final phase of Mises' reform, of course, gold has become money and there are many free market prices of goods and services in terms of gold.

[10] An exception might be interventions leading to a transition. For instance, the decentralization in the Chinese economic reform triggered a transition process. See Dulbecco and Renard (2003).

the details of interventions one is in ambiguous territory. This planning of details occurs again, when Mises goes on to advise the regulation of "the issue of additional fractional coins by the government" (Mises 2000, 106). There he claims it unnecessary to have those coins covered 100 percent by gold, thereby, allowing for a small inflation and a seignorage for the government.

Interestingly Mises calls for another intervention within one year after the gold standard is installed:

> Moreover, the Treasury is bound to withdraw from circulation, against the new gold coins, and to destroy, within a period of one year after the promulgation of the new legal gold parity of the dollar, all notes of five, ten, and perhaps also twenty dollars. (1980, 494)

Of course, the one year period and the "perhaps" is arbitrary. However, the intention that Mises pursues with this intervention is farsighted and in the long tradition in the U.S. of opposing the banks' issuing of small-denominated notes.[11] Mises intends this intervention to encourage the circulation of gold coins, thereby, making it more difficult for the government to nationalize gold and introduce fiat paper money. However, the use of government intervention to circulate gold coins seems counterproductive to the larger goal of installing a monetary system resistant to government intervention. This is so because what is essential with respect to a lasting and sound monetary system is that the public no longer believes that government intervention into monetary affairs is necessary. By using government force to install a gold standard, the illusion that the government needs to plan, possesses the capacity to plan, and has the right to impose this plan in order to improve monetary affairs is reinforced.

Moreover, as Herbener points out, the conversion agency that Mises proposes to unconditionally convert gold into dollars and vice versa is a government agency and thereby, provides a governmental foothold into the monetary system. The Federal Reserve System (Fed), which Mises leaves in its place, could also function as such a foothold to expand government power into the monetary system especially in times

[11] See, for instance, Rothbard on the Jacksonians being anxious to eliminate small-denominated notes (2002, 105).

of "crisis" (Herbener 2002a, 14).[12] The continuing existence of government intervention into the monetary system in the form of the banking regulations of the Federal Reserve System or the business of the Conversion Agency must also be problematic from Mises own point of view, as he claims that government interventions are not stable. They lead to consequences that the interventionists do not want. Therefore, interventionists are faced with two options: either abolish the intervention or intervene further in order to combat the unintended consequences.[13]

Mises likely regarded it as necessary to deviate from the path of straight liberalization to overcome resistance and opposition against a monetary reform. Therefore, he argues for a rather long-term transition process involving the government and a newly created Conversion Agency. However, he fails to answer the important question that economists dealing with transition can seek an answer for: "If the reform agents deviate from a clear-cut reform path in the short-run, what are the mechanisms that can keep them committed to the reform process in the long-term?"[14]

Now let us turn to the second main critique of Mises' proposal and the question why Mises does not immediately call for monetary freedom but for a state managed reform. Jeffrey Herbener offers an answer, suggesting that Mises wants to avoid a deflation (2002b, 90 and 2002a, 14). Indeed, Mises is rather deflation phobic.[15] Not only does he wish to avoid monetary deflation, but price deflation in certain cases as well, as inferred by a statement he makes while discussing the proposal of introducing an international paper money:

> If all nations were to agree upon an international currency consisting of international paper money issued by a world bank or of national paper money unconditionally redeemable in deposits with a world bank, *it would be necessary to provide for future increases in the amount of this international paper money or of these deposits*. If such an expansion of the quantity of the circulating medium were to be prevented for all time, the increasing demand for money, arising from economic progress and the intensification of trade and commerce, would result

[12] See also Salerno (1982) who criticizes monetary reform plans which leave space for governmental institutions therefore serving as a foothold for the government in the monetary system.
[13] See Mises (1996, 8-9).
[14] I owe this point to a comment by an anonymous referee.
[15] For a critique of Mises general view on deflation, see Bagus (2003, 24-26).

> in a permanent tendency towards falling prices. The system would have a deflationary effect. (2000, 83, italics added)

Mises does criticize proposals for an international paper money because of the difficulty of distributing the "necessary ... future increases" of this money. His reasoning, however, does suggest that these increases are necessary to prevent prices from falling. His monetary reform plan also prevents prices from falling by freezing the amount of fiduciary media. This might be perceived as a strategy of reform sequencing. In the environment of price controls (minimum wage), resulting price deflation may result in unemployment etc. That may be then deliberately misinterpreted as a result of the "monetary freedom." This in turn could damage any (if only marginal) gains of "monetary freedom."

It is possible that similar considerations influenced Mises' argumentation. However, the problem with Mises' approach is that he does not explain that his plan is conditioned by strategic considerations. By not clarifying this, he gives the impression that falling prices are a danger for the economy. Yet, falling prices *per se* are not an economic problem for the economy as a whole.[16] Entrepreneurs can make profits even when prices fall. What is important is not the general movement of the price level but the price differential between buying and selling prices. When selling prices fall and buying prices fall even faster, the price differential increases, allowing entrepreneurs to make even higher monetary profits. Of course, there might be entrepreneurs that commit errors and do not bid prices down sufficiently, buying at prices at which they run into losses. However, why would this kind of error (of bidding too much for factors of production) necessarily be higher in times of falling prices than in times of rising prices or in times of generally stable prices? In times of inflation, buying prices might actually rise faster than selling prices.

Moreover, the inefficient entrepreneur who continuously buys at prices that are too high will eventually be driven out of the market. His assets then would be taken over by entrepreneurs who abstained from buying, waiting for this opportunity to come. This procedure, of course, is the normal market process, independent of the question whether there exists a general tendency towards rising or falling prices.

[16] On this point for instance, see Hülsmann (2003, 51-52) and Salerno (2003, 83-85).

In *Human Action*, Mises gives us another indication why he does not allow for deflation in his monetary reform stating that "[d]eflation and credit contraction no less than inflation and credit expansion are elements disarranging the smooth course of economic activities, and sources of disturbance" (1998, 564). However, Mises fails to see that with his freezing of existing fiduciary media, he might also actually trigger a recession "disarranging the smooth course of economic activities." This is so because there might be a credit driven boom underway when Mises' reform is introduced. In a credit expansion there is a relative reduction of the interest rate that is not caused by an increase in real savings.[17] The reduction of the interest rate boosts the value of capital goods, making projects, particularly in the higher, more interest dependent stages of production, look more profitable than they would have been otherwise. When owners of the factors of production do not increase their savings sufficiently, but spend their income on consumption goods, this makes consumer goods prices rise relative to capital goods. It becomes obvious that the investments in the higher stages of production must be abandoned. Factors of production will be shifted back to the lower stages of production. However, the boom can go on if further credit is extended to entrepreneurs in the higher stages of production, who keep buying factors of production at rising prices. Thereby, the relative increase in prices of consumer goods is delayed. With Mises' reform, credit expansion is suddenly stopped. There are no further injections of credit. Hence, consumer goods prices will increase relative to prices in higher stages of production. This implies a relative increase of accounting profits in stages of production close to consumption and a relative increase in the interest rate, finally leading to accounting losses in companies relatively more distant from consumption.[18] Thus, with Mises' reform, existing malinvestments will be purged. Yet, this will not happen as quickly as it would with a credit contraction.

Later on in his essay on monetary reconstruction, it becomes even clearer why Mises wants to prevent deflation. He points out that "the effects of a deflation … would not heal the wounds inflicted by the inflation of the two last decades. They would merely open new sources" (1980, 498). He is right that the individuals who

[17] This is not necessarily so, since entrepreneurs might have anticipated the effects of the credit expansion and bid them into the interest rate, as Hülsmann (1998) has pointed out.

[18] For the microeconomic details of the boom and bust in the Austrian Business Cycle Theory, see Huerta de Soto (2006, 347-384).

lost in terms of relative wealth during the inflation are not necessarily the ones who would profit from a deflation. He is also correct that there will be a redistribution of wealth by the deflation. However, he fails to prove his point that this redistribution opens new wounds, or that this particular result of redistribution would be bad. Every liberalization from government intervention into the economy brings about a redistribution from those who are currently profiting from the intervention to those who are suffering from it. Of course, the liberalization of the monetary system also leads to a redistribution and restructuring of the production (possibly even a massive one). But it is hard to see that this redistribution and restructuring of the production according to free market choices of consumers would be something inherently bad that must be avoided. It is possible that Mises wanted to prevent the restructuring of the production according to choices of consumers, because he wanted to make his reform plan more appealing.

The passages Mises writes following the discussion of his reform plan indicate that his deflation phobia is not based on *a priori* reasoning but rather on his historical understanding of past deflations. He critiques the deflationary path the United Kingdom chose after the Napoleonic wars claiming that the British "stirred social unrest" (1980, 498). He is, of course, right. If a massive intervention into the market economy were to be eliminated, social uproar on the part of those who profited from the prior intervention would occur. For example, the abolition of slavery in an economy whose social and productive structures rest on the institution of slavery might lead to "social unrest" by slave owners. There might also be an outcry on the part of those who were suppressed by the intervention if they do not get any compensation.

Mises provides another historical example that explains his animosity toward deflation. He claims that the United Kingdom repeated the "error" of a deliberate deflation after World War I: "As the labor unions would not tolerate an adjustment of wage rates to the increased gold value and purchasing power of the pound, a crisis of British foreign trade resulted" (1980, 498). It is true that unions can settle for wage rates higher than the market rate if they are given the legal privilege to do that. However, when the unions have the power to lift wages over market clearing rates, they can do that irrespective of what the general tendency of prices is. They can do that when prices are generally stable, falling, or rising. They can do that when prices are continuously falling at a slow rate or when there is just one big price drop. This is why the "stubborn" union argument against deflation fails. Mises goes on with his historical interpretation, stating that "[…] in the opinion of the masses, conditions gave an apparent justification to the Keynesian fallacies" (1980, 499). His interpretation might be true and explains his aversion to deflation. However, here Mises speaks as an economic historian about a unique historical case and not as an theoretical economist. He, thus, does not offer theoretical reasons why deflation would be harmful, but rather argues that in this specific historical case aided by the prevailing public opinion, deflation gave rise to a justification of Keynesian fallacies. Yet, he cannot and does not prove that deflation necessarily leads to the implementation of Keynesian fallacies. He fails, therefore, to make a case against deflation based on economic theory.

In summary, Mises develops an interventionist plan for monetary reform. While he favors the cancellation of some interventions, he supports the introduction of others. It seems that he resorts to the state to manage a monetary reform because he fears the opposition to straight liberalization and the effects of the deflation that can occur when the monetary sphere is completely liberalized.

3 Murray N. Rothbard

The role of deflation in Rothbard's plans for monetary reform towards a 100 percent gold standard changes over the years. In 1962, he speaks of two possible ways to establish a 100 percent gold standard, one involving deflation:

> [W]e have essentially two alternatives, polar routes toward 100 percent gold: either to force a deflation of the supply of dollars down to the currently valued gold stock, or to "raise the price of gold" (to lower the definition of the dollar's weight) to make the total stock of gold dollars 100 percent equal to the total supply of dollars in the society. Or we can choose some combination of the two routes. (1991, 66)

Here Rothbard unnecessarily restricts the options that can lead to a 100 percent gold standard. For example, the government could force the supply of dollars down to a level even lower than $35 per ounce, for example to $20 per ounce which was the earlier definition of the dollar in the U.S. Rothbard offers no particular reason that would speak against such a measure.[19] Moreover, a reform involving a complete and immediate privatization of monetary affairs, i.e., the abstention of further intervention into the monetary system, might also evolve into a 100 percent gold standard.

Continuing on, Rothbard states that,

> ... we have built deflation into an absurd ogre, and have overlooked the healthy consequences of a deflationary purgation of the malinvestments of the boom, as well as the overdue aid that fixed income groups, hit by decades of inflationary erosion, would at last obtain from a considerable fall in prices. A sharp deflation would also help to break up the powerful aggregations of monopoly unionism, which are potentially so destructive of the market economy. At any rate, while the deflation would be nominally sharp, to the extent that people would wish to save much of their present cash holdings, they would increase voluntary savings by purchasing bank debentures in lieu of their deposits, thereby fostering "economic growth" and mitigating the rigors of the deflation. (1991, 67)

Rothbard makes four arguments in favor of deflation as a means of returning to a stable monetary standard: 1) purgation of malinvestments, 2) redistribution in favor of fixed income groups, 3) a possible break of union power, and 4) an increase in voluntary savings. Surprisingly, in spite of these arguments Rothbard does not commit himself to the deflationary course back to the legal parity of dollar with 1/35 ounce of gold. His reason is simply because there is "no particular reason to be devoted to the $35 figure at present time" (Rothbard 1991, 67).

In 1983, in *The Mystery of Banking*, Rothbard dismisses the first way to establish a 100 percent gold standard involving deflation stating that "[t]he old definition of the dollar as 1/35 gold ounce is outdated and irrelevant to the current world" (1983, 263).[20] Now he endorses the second way and proposes the following plan: "In short,

[19] One might argue that Rothbard thought deflation of a certain amount would become too disruptive. However, in this article he does not make that argument explicitly, but on the contrary names arguments in favor of price deflation without elaborating on the "rigors" of price deflation.

[20] Another place where his proposal to redefine the dollar to back all notes and deposits by gold can be found in "Aurophobia: or, Free Banking on What Standard?" in The Review of Austrian Economics, Vol. 6, No. 1 (1992), pp. 97-106. In *The Case Against the Fed* (1994), Rothbard basically upholds his

the new dollar price of gold (or the weight of the dollar), is to be defined so that there will be enough gold dollars to redeem every Federal Reserve note and demand deposit, one for one" (Rothbard 1983, 264). His plan is to hand over the gold that was nationalized in 1933 from the Fed to holders of Federal Reserve Notes and to the banks. With the new definition of the dollar all existing banks would have 100 percent gold reserves for the deposits. He seems to consider it as an advantage of his reform plan that "each bank will have 100 percent reserve of gold, so that a law holding fractional reserve banking as fraud and enforcing 100 percent reserves would not entail any deflation or contraction of the money supply"(Rothbard 1983, 265). He acknowledges the argument that banks receive part of the nationalized hoard as an undeserved gift, allowing them to back demand deposits. Furthermore, he agrees that banks should be held responsible for fraud, but only after the reform has taken place. He justifies this view by pointing out that with his plan "we have the advantage of starting from Point Zero, of letting bygones be bygones, and of insuring against a wracking deflation that would lead to a severe recession and numerous bankruptcies… [O]ne wonders whether a policy equally sound and free market oriented, which can avoid such a virtual if short-lived economic holocaust might not be a more sensible solution" (Rothbard 1983, 268).

Rothbard's plan is surprising in the sense that it contradicts or omits the economic and ethical theories and insights which he himself developed. Let us first turn to the economic insights he neglects. As mentioned earlier, in 1962 Rothbard names four advantages of deflation. Moreover, in his 1963 *America's Great Depression*, he clarifies in detail the advantages of deflation in the form of a bank credit contraction

1983 plan with the only difference being not to outlaw fractional reserve banking, calling it a "second best" solution. It should be noted that he would only support fractional reserve banking if the FED were outlawed, as well as governmental deposit insurance and lender-of-last-resort function and governmental bailouts. And then only because he judges that "any problem of inflationary credit or counterfeiting would be minimal … it would suffice as an excellent solution for the time being, that is, until people are ready to press on to full 100 percent banking." (1994, 150-151) In his 1995 *Take Money Back* (http://www.mises.org/rothbard/moneyback.asp) (parts of which were published in September and October 1995 issues of the Freeman), Rothbard, again, calls for redefining the dollar, *but he* acknowledges that his reform entails an "undeserved" gift for banks. Interestingly, he mentions the possibility of letting the banks collapse without explicitly endorsing this possibility. The question remains why Rothbard, throughout his lifetime, remained vague and indecisive in his plans for monetary reform although he held clear-cut positions on nearly every other issue.

in a recession.[21] He gives several reasons why the bank credit contraction speeds up the readjustment and recovery in a recession. First, falling prices tend historically to encourage greater savings and

> the accounting illusion of the boom is reversed: what seems like losses and capital consumption may actually mean profits for the firm, since assets now cost much less to be replaced. This overstatement of losses, however, restricts consumption and encourages saving; a man may merely think he is replacing capital, when he is actually making an added investment in the business. (Rothbard 2000, 17-18)

Since it is a lack of savings in relation to consumption that has led to the recession, the recovery is quickened. Continuing on, Rothbard names another beneficial effect of the credit contraction.[22] The credit contraction leads to less money in the hands of entrepreneurs, mainly those who are located in the higher stages of production expanded during the artificial boom. Accordingly, the demand for factors of production falls, lowering the factor prices and income. Hence, the price differentials between buying and selling prices increase.

Also, it is hard to understand why Rothbard considers the likelihood of recession and "numerous bankruptcies" as a reason to avoid a reform plan that involves deflation. He himself makes it clear that if a company is forced into bankruptcy because there is a falling price level and its debt burden becomes too heavy, the bankruptcy only involves transfers of ownership between the legal claimants of companies. This is so because in case of bankruptcy there is a redistribution from equity holders to creditors.[23] Production must not necessarily be disturbed by this redistribution.

In addition to Rothbard's own argument, it must be added that there are not necessarily more bankruptcies in times of a falling price level as compared to times of rising prices. Only entrepreneurs who do not anticipate the falling prices and buy at prices that are too high will incur losses.[24] When, in addition to this, they are

[21] See Rothbard (2000, 14-19).
[22] See Rothbard (2000, 18).
[23] See Rothbard (2000, 51).
[24] It should be noted that the underlying monetary policy and its effects on the credit markets make the anticipation of price movements more difficult. Entrepreneurs cannot only suffer losses because they do not anticipate a price deflation but also if they retreat from an overheated market too early.

in debt, their real debt increases and they face the risk of bankruptcy. These entrepreneurs commit errors in their anticipation of the future state of the market or rely on government intervention to bail them out (for example on the continuation of government interventions into the monetary system or, more specifically, on further credit expansion). Bankruptcies are normal for a market economy. And what does "numerous bankruptcies" mean? Would a certain number or percentage of bankruptcies be unacceptable, requiring the help of the government? Again, a high number of bankruptcies does not mean that production is necessarily hampered. Assets are taken over by the new owners, for example the creditors, who have an interest that production continues and is immediately adjusted towards consumer wants.

Let us now have a look at Rothbard's ethical theory elaborated in his book *The Ethics of Liberty* (1982), written just before his 1983 proposal for monetary reform. Applying Rothbard's theory of ethics to his proposal, we must conclude that his plan for monetary reform fails to match his ethical positions. He claims that fractional reserve banking is fraudulent because banks issue more money titles than they have received money proper and promise to redeem the money title into money proper on demand. As the promise cannot be fulfilled, this constitutes fraud and fraud is implicit theft.[25] And what is to be done in the case of theft? According to Rothbard, justice demands that the

> criminal must pay *double* the extent of theft: once, for restitution of the amount stolen, and once again for the loss of that he had deprived another… [F]or proportionate punishment to be levied we would also have to add *more* than double so as to compensate the victim in some way for the uncertain and fearful aspects of his particular ordeal. (Rothbard 1998, 88-89)

Therefore, according to Rothbard's reasoning, if banks and bank equity owners are not able to pay that amount, the bank assets and their personal assets would be turned over to the victims: the depositors. If this would not be sufficient, bank owners would have to work for the remainder of what they could not pay (86).[26]

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[25] See Rothbard (1991, 50-51).

[26] See Rothbard (1998, 86): "The ideal situation, then, puts the criminal frankly into a state of enslavement to his victim, the criminal continuing in that condition of just slavery until he has redressed the grievance of the man he has wronged." Another cause for punishment of banks could be made by

Strangely enough, in outright contradiction to his theory, Rothbard does not recommend that. On the contrary, he calls for a transfer of the nationalized gold to the fractional reserve banks.[27] That gold was stolen from the bank depositors who are its just owners and should be handed back to them. Inconsistently, Rothbard claims the elimination of taxpayer bailouts as an advantage of his reform (Rothbard 1994, 150); however, from the point of view of his ethical theory, his proposal entails a last giant bailout of the criminal banks. Rothbard also claims that his plan would "have the advantage of starting from Point Zero, of letting bygones be bygones"(Rothbard 1983, 268). Rothbard's "Point Zero" is, however, the result of a governmental intervention that prevents punishment of the banks. Would it not rather be a real "Point Zero" to let an unsound banking system collapse by abstaining from further interventions into the monetary system, instead of maintaining a status quo that results from privileges? Moreover, one wonders, why Rothbard upholds his plea for letting bygones be bygones, since in his ethical theory there is not anything like a statute of limitations. Justice is not a question of time.[28] Therefore, the amnesty for banks that Rothbard's reform establishes is inconsistent with his writings on ethics.

With great insight, Rothbard analyzes the economic consequences of deflation, showing that it is not something inherently bad or that it must be prevented. Applying his ethical theory to fractional reserve banking would certainly wipe out the existing banking system and lead to a deflation entailing the consequences that Rothbard analyzed favorably. He fails to endorse a deflation that is in line with both his economic and ethical theories, but rather passes over his economic insights and contradicts his ethical theory calling for a managed reform. The question as why he does this is hard to answer and rather puzzling.

pointing to their relationship to the state, which is from Rothbard's point of view "a coercive criminal organization" (172). Fractional reserve banks, by inflating the money supply and buying government bonds, help to finance the criminal activities of the state directly and indirectly. Hence, fractional reserve banks are guilty not only of defrauding customers but also of operating in symbiosis with a criminal organization. Also, a case could be made for punishing bank employers who – knowingly or not – collaborated within this criminal symbiosis. For the question of a "libertarian Nuremberg Trial," see Block's discussion of this in the Rothbardian tradition (2004 and 2006).

[27] While this transfer is in contradiction to Rothbard's ethical theory, it is an interesting idea to overcome the threat of resistance against monetary reform posed by the major benefiters of the current system – the financial sector.

[28] Rothbard (1982, 42): "... the theory must hold true for all men, whatever their location in time or place."

4 Jesús Huerta de Soto

In his recent treatise *Money, Bank Credit, and Economic Cycles*, Huerta de Soto elaborates a sophisticated plan of monetary reform in the Rothbardian tradition (Huerta de Soto 2006, 715-812). His ideal monetary system involves three components: complete freedom of choice in currency, complete banking freedom, and the fulfillment of traditional legal rules (a 100 % reserve requirement on demand deposit contracts). In order to achieve this ideal, he proposes a twofold strategy. On the one hand, he argues that it is important to educate the public about the benefits of the ideal monetary system. On the other hand, a short-term policy of a gradual progress towards that system must be adopted. Huerta de Soto divides his reform in five stages. In the first stage the central bank is still legally "dependent" on the government. It centrally plans the whole monetary sphere. In the second stage the central bank becomes legally "independent" and a monetary growth rule of approximately 4%-6% is installed.

In the following third stage, a 100 percent reserve requirement for banks is set with a monetary growth rule of 2 percent. This 100 percent rule is achieved in a curious way. First, bank assets above the bank's equity are transformed into mutual funds. Then during a certain period of time, depositors get the option to change their deposits into shares of this mutual fund. "Each depositor to select this option would receive a number of shares strictly proportional to the sum of his deposits with respect to the total deposits at each bank" (Huerta de Soto 2006, 792). The 100 percent reserve requirement is then made by just printing the paper money necessary to back all remaining deposits and giving it to the banks.[29] No further issuing of fiduciary media will be permitted. But would that not involve a gift to the banks? Huerta de Soto acknowledges this argument by criticizing Rothbard:

> In general we agree with the transition program formulated by Rothbard. However we object to the gift he plans for banks, a contribution which would

[29] At this point we are faced with a curious question: Would anyone stick with his deposits and not transform them into shares of the mutual fund? Before the reform, the deposits were "backed" or "supported" by the assets the banking system was holding (loans, etc.). These assets form now part of the mutual fund and are substituted by paper. Thus, it seems unlikely that many depositors would stick with their deposits.

> allow them to keep the assets they have historically expropriated from society. In our opinion, it would be perfectly justifiable to use these assets toward the other ends we discuss in the text. (2006, 795-796, fn 100)

What are these ends? The ends are the replacement of outstanding treasury bonds and the partial or total liquidation of other state liabilities, like social security pension, etc. That means that the holders of treasury bonds and other state liabilities receive the mutual funds left over by the reform at the prevailing market rate. In other words, the shares of the mutual funds that do not correspond to the banks' equity and are not claimed by depositors, replace treasury bonds at the prevailing market price.[30] Any remaining shares would also replace other state liabilities. The banks' holdings of treasury bonds are simply canceled.[31]

At the fourth stage, the central bank is abolished and complete banking freedom subject to traditional legal principles prevails. The price of gold is redefined, similar to Rothbard's plan, in order to make all paper money redeemable in gold. A 100 percent gold standard is in place.

At the fifth stage, the gold standard would spread to the world. Here Huerta de Soto calls for an international agreement of a single gold standard. This requires the creation of fixed exchanges rates between all currencies in prior stages. This would allow us to "uniformly assess the entire world supply of fiduciary media and to redistribute among the economic agents and private banks of the different countries the stocks of gold held by the world's central banks. This redistribution would be carried out in exact proportion to the sum of deposits and bills in each." (Huerta de Soto, 2006, 802). At the fifth stage the complete freedom in monetary affairs would also allow for the emergence of new monies.

While Huerta de Soto's reform is unmatched in details and strategically interesting, there are some problems with it. First of all, his reform is a managed reform which does not leave room for free market developments. For example, in arguing for his gold standard reform, Huerta de Soto writes that,

[30] Before this replacement depositors have the option to switch their deposits into shares of mutual funds.

[31] Here, we face a problem. According to Huerta de Soto, treasury bonds should be included as part of the mutual funds because these bonds are assets as well. However, if the treasury bonds are canceled, former depositors, now mutual fund owners, lose a portion of their assets, that according to Huerta de Soto should belong to them.

> [i]t is impossible to take a leap in the dark and establish an artificial monetary standard which has not emerged through an evolutionary process. Hence the new form of money should consist of the substance humanity has historically considered money par excellence: gold. (2006, 799)

It is true that gold was money for a long time. But in many countries silver was also the dominant currency in the retail economy. Moreover, other currencies existed prior to gold. One cannot know *a priori* which money would prevail in a free competition today. It might be gold, it might be gold and silver, or it might be another money. Why should it not be left to free decisions of individuals which monies are used from the beginning of the reform onward?

Of course, with an interventionist reform we are left with arbitrariness. For example, how long should these stages last, and how long should depositors have the option to switch to mutual fund shares, or why is it five stages? And why should money growth be 4 percent – 6 percent and later 2 percent; and why should this monetary growth be used to finance state activities or buy gold?

Here we come to some strategic problems. On first sight, one of the main advantages of Huerta de Soto's proposal for an ideal monetary reform is it moderateness. But this can also be a disadvantage. The long-term objectives can be forgotten. At every stage there is the danger that steps will be taken in the wrong direction. The reform is easily reversible, as the influence of the state in the monetary sphere is only very slowly displaced. As William Lloyd Garrison expresses this, "[g]radualism in theory is perpetuity in practice." Another example of gradualism is Huerta de Soto's comments about the Soviet Union. Why does he argue that due to its huge gold reserves, the Soviet Union could change its monetary system immediately to a pure gold standard, while other countries would have to wait?[32] Why could other countries not go immediately to a pure gold standard? Huerta de Soto gives no convincing argument why other countries have to wait to get rid of recessions. It is possible that he thinks it is not possible to convince people of directly going to a pure gold standard, but how can we convince people to go there, if we advocate a fiat paper money system with 4-6 percent growth in the first place? Another related strategic problem with his plan is that the state's planning of the reform could foster the belief in the state's ability to improve monetary affairs.

[32] See Huerta de Soto (2006, p. 805).

A point that could make the introduction of his reform very difficult is that Huerta de Soto argues for the introduction of a gold standard on a world wide scale in order to "prevent the transition from having any unnecessary, real effects".[33] Yet, first mover countries would have an advantage of adopting a pure gold standard. They would receive the gold at still relatively low prices, while countries which adopt such a standard later would have to pay higher prices. These "real effects" are not something that must be prevented. Furthermore, countries probably would not agree to fixed exchange rates that Huerta de Soto's plan suggests because this would imply a redistribution of gold. They would not agree upon the exact rate of exchange.

So where do all these detailed interventions stem from? As with Mises' and Rothbard's plan, the details and interventions Huerta de Soto's plan seem to be based on a fear of deflation. Indeed, Huerta de Soto points out that his reform like Rothbard's is not deflationary.[34] He seems to imply that deflation in a monetary reform should be prevented.[35] Unfortunately, Huerta de Soto does not see the advantages of deflation as a fast purge of malinvestments and unsound banks, as possibly increasing savings, and as increasing pressures to abolish regulations.

Another critique against Huerta de Soto's reform is that it defends the status quo irrespectively of how this status quo was arrived at. He himself sees it as a weak point in Rothbard that banks receive a gift in the privatization of nationalized gold.[36] That implies Huerta de Soto employs, at least partially, an ethical point of view in his argumentation for a monetary reform. He also writes about the "aggregate wealth the banking system has expropriated"(Huerta de Soto, 2006, 794). So, why is he against a gift to the banks but in favor of an amnesty for their expropriation? Should depositors not be compensated and all bank assets turned over to depositors? Moreover, should not the nationalized gold be given back directly to the population? And why are financiers of the government (holders of treasury bonds) being rewarded with shares in the mutual fund?

[33] See Huerta de Soto (2006, p. 802).
[34] See Huerta de Soto (2006, 796 fn. 100).
[35] This seems also be implied in his view of the British deflations after the Napoleonic Wars and after WW I. See Huerta de Soto (2006, 447-448). There he speaks of "unnecessary pressure" for the economic system.
[36] See Huerta de Soto (2006, 797, fn. 100).

In sum, Huerta de Soto's proposal is a sophisticated elaboration on Rothbard's plan. Its strategic advantages must be recognized and his ideal monetary system might be a desirable goal. Yet, the way he proposes to get there is too time consuming, too interventionist, involves unjustified conservation of the status quo, and has arbitrary distributional effects. All these effects result from his attempt to avoid deflation and make the reform more appealing.[37]

5 Hans Sennholz

Even though Hans Sennholz does not expose a detailed monetary reform, he certainly argued in his work for severe changes in the monetary system. Sennholz[38] in *Age of Inflation* (1979)[39] and later in *Money and Freedom* (1985) offers one of the most radical and most libertarian proposals for changes in the monetary system: "We seek no reform law, no restoration law, no conversion or parity, no government cooperation: merely freedom"(Sennholz, 1985, 77). What is to be done specifically to "remove government from all monetary affairs" (Sennholz 1979, 149)? Sennholz offers three specific points (1979, 149-50): First, all legal tender must be repealed. Second, the central bank must be abolished,[40] and third, the compulsory monopoly of the mint is to be eliminated.

Sennholz' laissez-faire approach is far more consistent than it is in the aforementioned reform plans offered by other Austrian economists. He does not want to impose any result of his reform but merely remove government interventions: "Government need not establish the gold standard by any conscious or deliberate act," because people may choose it again (1979, 158). Because Sennholz does not mention time at this point, it seems that he calls for an immediate removal of government from the monetary sphere. He rightly states that in today's ideological climate, the

[37] Confronted with my critique, Huerta de Soto acknowledged most of the points and made clear that his proposal was not intended to be the theoretical best reform.

[38] In his Phd thesis, *How can Europe survive* (1955, 296-99), written under Mises, he still embraced Mises' reform plan.

[39] Some of the relevant parts of *Age of Inflation* appeared before as "In Search of Monetary Stability" in The Freeman, February 1977, pp. 80-90.

[40] He does not touch the interesting question who should get the nationalized gold, now controlled by the central bank.

change he proposes is out of political reality. He does not explain how to make his proposal feasible. But that is for Sennholz – at least at this point of his discussion – not the important question. He is not willing to compromise economic principles and indicates that this might actually be an advantage in the effectiveness of the plan:

> We need not here enter a discussion of who is more practical and effective: he who uncompromisingly seeks to draw his conclusions and reveal irrefutable truths, or he who permits his deliberations to be colored by that which is more popular. (1979, 150)

It is curious that Sennholz does not mention deflation in respect to his plan. This might actually be the reason why his initial proposal is more radical and free market than the aforementioned plans. However, the immediate removal of government from monetary affairs and especially the abolishment of the central bank will probably involve a deflation. When the prestige of the central bank and state regulations vanish, people may immediately make a run on their banks. In a fractional reserve banking system without a central bank, this in turn may purge the whole system involving the deflation of the fiduciary media. Even if there are no initial bank runs when the central bank is dissolved, confidence, which is essential for a fractional reserve banking system, is likely to be shaken during the next recession. This recession has probably already been induced by the abstention from further credit expansion. A bank run might occur at this time, and this purge would involve a substantial credit contraction, likely followed by declining prices.

Interestingly enough, only a few pages later, Sennholz takes a huge step back from an unconditional immediate liberalization of the monetary sphere and, somewhat, revises his plan. His "revised plan" entails four objectives (Sennholz, 1979, 166-67).[41] The first and second objectives consist in the freedom to trade, hold, and use gold. The third object is the freedom to mint coins. However, the Federal Reserve System, stays in place (166), which is an outright contradiction to Sennholz' very own statement that government intervention in the monetary sphere be ended. He predicts

[41] This version of Sennholz' plan is very similar to Henry Hazlitt's plan which can be found in Hazlitt's *The Inflation Crisis, And How To Resolve It* (1978), pp. 175-190 and in his (1975) essay "To Restore World Monetary Order." Hazlitt, as Sennholz, seems to shy away from a complete abstention from government intervention into the monetary realm, because he dreads deflation (1978, 190 and 1975, 74). Like Sennholz, Hazlitt does not elaborate why deflation must be avoided.

that a "parallel standard" with both fiat paper and a gold standard would prevail.[42] As gold outcompetes fiat money, Sennholz predicts that to save the dollar the U.S. government might decide to make its money convertible to gold as well.

Where in these few pages does Sennholz shift from total abstention from government intervention into the monetary sphere to a "parallel standard" stem from?[43] As with the other economists mentioned earlier, it might have been the fear of deflation. As Sennholz states: "Prices and wages would have to be drastically cut, which no modern society could withstand in an orderly fashion." Why could a modern society not withstand this? Sennholz gives no explanation for that. He just assumes it as self-evident. But why can union power not be broken? This could be done at the same time governmental monetary interventions are ended. If the power of unions were not broken, there would be an immense pressure to break the rigidities that state interventions impose on the price system after the reform.

A severe problem of a "parallel standard" that Sennholz proposes is that it would not really be free competition between the government money and gold. Government could and very likely would subsidize its own currency via its taxation power. Sennholz himself states that the FDIC could stay in place.[44] Government subsidies could give the government money an advantage that might prevent its currency from being outcompeted by gold.

Moreover, as Joseph Salerno (1982, 12) vividly points out:

> [...] there looms the distinct possibility that the political authority may use the occasional, but highly visible, financial crises and bank failures which follow the inflationary booms as a pretext for regulation of the banks "in the public interest." Having thus regained its first crucial foothold, the government would be well on its way to reimposing its monopoly over money.

In sum, Sennholz proposes changes of the monetary system very close to a free market solution. Perhaps frightened by the possibility of an unpopular deflation, he dilutes his plan, neglecting the advantages a deflation could have.

[42] For a brilliant critique of monetary reforms proposing a parallel private gold standard see Salerno (1982, 10-14).
[43] A "parallel standard" does not correspond to a free market but rather to a "mixed economy."
[44] See Sennholz (1985, 81).

6 Conclusions

Mises, Rothbard, Huerta de Soto, and Sennholz offer plans of monetary reform that entail numerous state interventions into the economy, inconsistencies, arbitrariness, and tactical ambiguities. Their proposals contradict their own ethical and political principles, and seek to engineer an improved institution of money. All of these problems seem to stem from the authors' attempts to preserve the status quo and to avoid alleged chaos, their reliance on a problematic economic theory of deflation, or the attempt to gain acceptability by avoiding a deflation. Yet, a good reform must fulfill three complementary criteria. Monetary reform must be based on a sound economic theory. Monetary reform should be ethically just, and it should leave the maximum space possible for an entrepreneurial process to determine the exact results. A reform that fulfills these criteria, would probably also bring about deflation. However, deflation is not something inherently bad. Rather, it can be seen as a corrective process that is part of creating a stronger financial market. Because of this inherent importance of deflation in the return to a sound monetary system future research should be directed to more in-depth analysis of deflation.

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Postmodernism and Its Discontents: Whither Constitutionalism After God and Reason?

Nikolai Wenzel[i]

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Abstract: Modern institutions rely on philosophical appeals – specifically the ideas of the Enlightenment Project (Modernity). Truth exists, along with natural rights, and we are to use the human faculty of reason to discover them and conduct our affairs accordingly. Institutions follow. After three centuries of dominance, the modern project is now facing serious challenges from two sources. First, the post-modern alternative rejects the notion of a knowable truth in favor of radical relativism; reason has serious limitations, and there is no absolute appeal. Second, a pre-modern claim, in the form of a fundamentalist religious revival, has been calling for a return to Covenant; an appeal to Scripture and tradition is increasingly challenging modern claims. An attack on modern philosophy, and the replacement of modern mental models with pre- or post-modern alternatives, will necessarily have deep constitutional implications – for the way we organize our affairs, but also for the liberties that modern institutions are meant to protect. In sum, whither constitutionalism after God and Reason?

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[i] Department of Economics, Hillsdale College, Hillsdale, Michigan, USA, nwenzel@hillsdale.edu.
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Introduction

We may very well be coming to the end of an intellectual era. At the very least, new forces are challenging the shared philosophical foundations and mental models that have characterized Western Civilization for the past three centuries. Even if it is not facing its twilight, the Enlightenment Project (Modernism) is undergoing radical shifts.

On the one-hand, *Post*-modernism is emerging as a serious challenger to the modern project. More than a mere academic parlor-game, more than a technical and obscure fad for the salons of Europe, more than a fancy for a select few high priests at departments of cultural studies and English at scattered US universities, the Postmodern contender has been throwing its weight around. The effects of the radically relativist philosophy are evident in Western thinking, conscious and unconscious, from the unspoken mental models of popular culture to the explicitly articulated models of high culture.[1]

On the other hand, parallel to the *post*-modern rejection of modernity's bold claims, there is emerging a *pre*-modern religious radicalization in the West. Whereas mainstream religion has been dwindling over the past century in the West, there has been a significant migration towards more fundamentalist churches, especially in the US (where religious scholars speak of a Fourth Great American Awakening).[2] Like Postmodernism, this shift towards religious fundamentalism makes claims against the modern worldview, and is proposing to supplant at least a portion of the modern appeal to reason with a pre-modern appeal to the presumptive authority of tradition. But, as we will see, the pre-modern backlash is mostly relevant for explaining the rise of Postmodernism.

The transformation is clearly not complete, and the Modern has not been supplanted, nor is it certain that it will ever be. But, increasingly, post- and pre-moder-

[1] The new metaphysics, epistemology, and ethics that are emerging are the subjects of much vaster studies. I will thus focus this paper on a general postmodern worldview, which includes elements of all three of these fields of philosophy. Beyond institutions, the likely implications for all of civilization could be staggering, from the arts and sciences, to politics and education, to social norms, and beyond. For philosophical details, see Pippin (1999), Harvey (1989) or Yack (1986).

[2] The international phenomenon of radical Islam falls under this category, but it is complex enough to be the subject for another paper; see Wenzel (2008).

nism are coming to represent challenges to the prevailing modern worldview, with new mental models, and new heuristics for engaging and understanding the world, the individual's place in it – and the ensuing institutions, formal and informal.

This paper examines the possible consequences of shifts in philosophy on the modern constitutional project, from post- and pre-modern tensions. Section one starts with the philosophical foundations of the modern project, and Section two examines the postmodern challenger to Modernism. Section three looks at the pre-modern backlash to help explain the postmodern phenomenon. Section four offers a case study on postmodernism and constitutionalism, that of the proposed EU Constitution. The final section concludes.

But, first, a methodological disclaimer.

Disclaimer

It is always with some trepidation that I, a political economist and not a trained philosopher, venture into the realm of philosophy. I am, after all, reminded of Buchanan's (1975, xvi) warning that "I have read some, but by no means all of the primary and secondary works [in political philosophy]. To have done so would have required that I become a professional political philosopher at the cost of abandoning my own disciplinary base. As an economist, I am a specialist in contract." I am also called to methodological humility by Rothbard's (1995) lament that "it is no crime to be ignorant of economics, which is, after all, a specialized discipline... But it is totally irresponsible to have a loud and vociferous opinion on economic subjects while remaining in this state of ignorance." I sincerely hope I am not engaging in this very behavior vis-à-vis philosophy.

And, yet, as an economist, I must study philosophy to make sense of human action, and I am convinced there are strong gains from trade to be reaped in the interaction between political economy and philosophy. After all, F.A. Hayek – himself an economist – reminds us that the "facts of the social sciences" are the opinions and beliefs that people hold (Hayek 1979[1952], 47 and 64 and the eponymous essay in Hayek 1948, 57-66); individuals build up an understanding of the world based on their "views and concepts" thereof (Hayek 1979[1952], 40). Philosophy is thus supremely relevant – nay, crucial – to understanding the process of economic choice, especially for such fundamental, value-laden decisions as constitutional political economy and the institutions adopted to deliver the desired political goods. I will thus ask readers trained in philosophy to bear with me and forgive my rough-around-the edges, practical approach – while also begging the indulgence of more technical economists whose comparative advantage leads them to a specialization that includes infrequent examination of the philosophical foundations of economic choice.

1 Philosophical Foundations of Modernity and Contemporary Challenges

So, why does all of this philosophical stuff matter for constitutionalism? Simply put, modern institutions rely on philosophical claims. They are a manifestation of the overall modern worldview regarding the proper organization of human affairs.

Starting roughly in the 17th century, Modernism[3] substituted the pre-modern appeal to faith with an appeal to reason – human reason to find a knowable truth. Without lapsing into details, the implications for political theory and everyday life ring familiar, as they are still with us today: the modern nation-state, with legitimacy derived from the people rather than the monarch's divine right; the supreme authority of reason (over tradition or faith); natural rights and the states instituted for the explicit purpose of protecting them; free markets; and the mastery of nature through science and technology (Pippin 1999, 4-5). Harvey (1989, 12) explains how the purpose of the modern project was

> to use the accumulation of knowledge generated by many individuals working freely and creatively for the pursuit of human emancipation and the enrichment of daily life. The scientific domination of nature promised freedom from scarcity, want, and the arbitrariness of natural calamity. The development of rational forms of social organization and rational modes of thought promised liberation from the irrationalities of myth, religious superstition, release from

[3] Out of simplicity, I am lumping together two very different – and often antithetical – strains of Modernity, *videlicet* the Scottish/British/American and the French/German/Continental. See below for details.

> the arbitrary use of power as well as from the dark side of our human natures. Only through such a project could the universal, eternal, and the immutable qualities of all humanity be revealed.

Habermas (1983, 9) adds that the early Moderns had "the extravagant expectation that the arts and sciences would promote not only the control of natural forces but also understanding of the world and of the self, moral progress, the justice of institutions and even the happiness of human beings." Modernism was a hopeful, excited project, an optimistic unleashing of the human spirit and previously untapped human creativity, after an earlier stifling by the bonds of tradition and faith – an "enthusiastic alternative to a static and contemplative system" (Kors 1998).

Modernism offered a new epistemological appeal, detached from earlier religious confines and the presumptive authority of tradition. Kors (1998), in a deliberate simplification and distillation of Aristotle's *Metaphysics*, explains the pre-modern epistemology as follows:

> Europe in the seventeenth century still had a traditionalist and subsistence culture. For that culture, past inheritances had a presumptive authority because they had stood the test of time and been successful parts of what had permitted mankind to survive... In the educated world, that intellectual inheritance was a fusion of Aristotelian (and other Greek) philosophy and of Christian theology; it was known as "scholasticism" or, more precisely, as Aristotelian scholasticism. Its means of teaching and persuasion was the *disputatio* (disputation), based upon (in order of importance) intellectual authorities, logical deduction from these authorities, and the appearances of the world. This system dominated the universities and schools of Europe. Thinkers believed that it brought coherence to the world, explaining the nature of all things... By distinguishing among all beings in terms of the degrees of their "perfections," scholasticism created a "great chain of being" that permitted us to know contemplatively the value of all things. The science of final causes (teleology) permitted us to know contemplatively the purposes of things, and to grasp how, under God's design, all things strove for God's created order. The seventeenth century marked a momentous assault upon all aspects of the Aristotelian scholastic synthesis.

Kors (1998, 11) further explains that "supernatural authority was based on Scripture, as correctly understood by appropriate authorities. Natural authorities were based on the presumptive authority of the past (what had stood the test of time) – above all, the Greeks." In the next step, "the authority of ancient authors and texts was integrated into Christian theology and intellectual life, especially when the thought of those ancient authorities helped to explicate the truths of the Christian faith." The pre-modern system was not, then, devoid of reason. Rather, reason was used in a process "by which one derived what follows logically from things known by authority."

Harvey (1989, 13) explains that the subsequent shift to Modernity was "a secular movement that sought the demystification and desacralization of knowledge and social organization in order to liberate human beings from their chains." Even as it broke from the earlier religious monopoly, Modernity did not shed transcendent foundations entirely. Rather, the Enlightenment can be described as a felicitous marriage between God and Reason, with its most vivid expression in Jefferson's Declaration of Independence: "We hold these truths to be self-evident, that all Men are created equal, that they are endowed by their Creator with certain unalienable rights, that among these are Life, Liberty and the Pursuit of Happiness." Truth and rights exist exogenously, and we must endogenously use the human faculty of disciplined reason to discern them. Modern institutions, especially constitutions, follow. Again in the words of Jefferson, "to secure these rights, governments are instituted among Men." Although the ultimate political good to be secured was different, the same broad principle applied in the French tradition of the state as expression of Rousseau's general will, later picked up and refined in Hegel's philosophy of the state.

Constitutions originate in human reason and effort, but they rely on meta-appeals. Philosophy underlies institutions, both consciously and unconsciously. As Pippin (1999, 43) explains, "if the principles appealed to in political life are to be justified, they must be justified as much more than the way we go about things; the principles must be binding 'for any rational agent'."

For all the prevalence of the modern project, and its firm grip on our collective mental models, two powerful challengers are emerging. The first is postmodernism, the second a pre-modern appeal to religious fundamentalism. Both of these philosophical challenges are significant because they make claims on our mental models, our way of engaging the world (generally, see Harrison and Huntington 2000, North 1990, and Pejovich 2003). Instead of struggling with each new situation we face, reinventing the proverbial wheel on a case-by-case basis, we employ heuristics (meta-skills of understanding and action). Philosophical systems constitute the very foundations that shape our conscious and subconscious understanding of, and approaches to, the world. A change in the prevalent worldview – our predominant sense of who we are, what truth is and how it is to be known, what is right, and how human society ought to be organized – will necessarily have implications for the way we lead our lives. A questioning of Modernity's philosophical foundations thus implies, *ipso facto*, a questioning of modern constitutional arrangements.

For the sake of clarity, the following table summarizes the basics of each philosophical current; section two offers details on postmodernism, and section three on fundamentalism.

	Modernism	**Postmodernism**	**Pre-Modernism**
Summary	Reason	Radical relativism	Fundamentalism
Philosophical Appeal	Reason to discover natural rights	Competing and contingent narratives	Presumptive authority of the past
Purpose of Government	Protect natural rights	Imperialistic attempt to impose narratives	Fulfill natural order

In closing, I should note immediately that, out of simplicity, I am conflating two very different (and often contradictory) schools of Enlightenment thought, *videlicet* the Scottish and Continental Enlightenments. This is admittedly a dangerous conflation – if far too common (even such serious thinkers as Bauman 1989, Giddens 1990, and Gellner 1992 conflate the two enlightenments); but it bears important consequences for understanding postmodernism, a point to which I return below.

2 The Postmodern Challenger

2.1 Postmodernism – A Primer

Postmodernism emerged from the horror and destruction of World War II in Europe, but its roots extend back to the 19th century.[4] The philosophy stands in stark contrast to Modernism. As explained above, Modernism substituted the pre-modern appeal to faith with an appeal to reason – human reason to find a knowable truth. It was a hopeful, excited project, an optimistic unleashing of the human spirit.

But the modern project was not without its doubters. As early as the 19th century, the very premises of Modernism began to be called into question. What began as doubts about the limitations of reason (initially brushed aside by Modernism's confident optimism) evolved into a fuller critique. Modernism was seen to be spiritually weakening at best and downright destructive at worst. Pippin (1999, xii) describes "the widespread nineteenth century suspicions (at least on the European continent) that ... the two greatest accomplishments of world civilization, modern natural science and technology, and a progressive, liberal democratic culture, were ... slowly and inexorably enervating and spiritually destroying that very culture." In many ways, such early grumblings foreshadowed much of the 20th century's ugliness.

The horrors of World War II galvanized the theoretical concerns. Pippin (1999, 7) explains that

> the great self-confidence and progressivism characteristic of the modern enterprise and especially what seemed its nineteenth-century fruition, all looked even more difficult to accept after the historical horrors of the twentieth century. The fact that "art, intellectual pursuits, the development of the natural sciences, many branches of scholarship flourished in close spatial, temporal proximity

[4] The focus of this paper is the effect of postmodernism on constitutionalism, rather than a detailed explanation of postmodern theory. Terms such as simulacra, *différance*, the Other and (k)nots are thus eschewed, as are such technical subtleties as described by Connor (2004: 4): "How one capitalized or hyphenated – 'post-modern,' 'Post-Modern,' 'postmodern,' or 'Postmodern' – seemed to many to matter a great deal, along with whether one chose to refer to 'Postmodernism,' 'postmodernity,' or simply 'the postmodern'." Such details are beyond the present scope, and the interested reader is invited to visit the literature for greater depth that goes beyond the limited scope of this review (see, *e.g.*, Lyotard 1981, Habermas 1983, Huyssens 1984, Harvey 1989, Bauman 1992, 1995 and 1997, Bertens 1995, Natoli 1997, Sim 2001 or Connor 2004).

> to massacre and the death camps" has raised for many doubts about not only modernity's self-assurances, but about all of Western culture, has raised the issue: "Why did humanistic traditions and models of conduct prove so fragile a barrier against political bestiality."

Harvey (1989, 13) echoes this thought, explaining that "whether or not the Enlightenment project was doomed from the start to plunge us into a Kafkaesque world, whether or not it was bound to lead to Auschwitz and Hiroshima, and whether it has any power left to inform and inspire contemporary thought and action, are crucial questions."

According to the alternative school of *Post*-modernism, the modern project, "laudable though it may have been at one time, has in its turn come to oppress humankind, and to force it into certain set ways of action" (Sim 2001, vii). Where some saw aberrations or challenges within the modern project, Postmodernism saw necessary and logical consequences: colonialism; fascism/communism and industrially planned genocide; the destruction of the natural environment in the name of unfettered progress and technology; the North's "exploitation" of the South; the horrors of modern warfare, compounded by the methodical application of the very science and technology initially meant to liberate us; and the spiritual poverty and alienation of mass consumerism. Harvey (1989, 13) explains that "there are those – and this is… the core of post-modernist philosophical thought – who insist that we should, in the name of human emancipation, abandon the Enlightenment project entirely." The postmodern rejection of the modern project is thus both (a) theoretical and methodological, and (b) applied and political.

On the theoretical and methodological side, we see a "rejection of many, if not most, of the cultural certainties in which life in the West has been structured over the last couple of centuries" (Sim 2001, vii). Specifically, Postmodernism attacks the very core of the modern project, questioning the existence of the truth and the ability of human reason to find it. As a radical alternative, Postmodernism holds that all knowledge is a product of environment, and that we should thus speak of contingent "narratives" rather than absolute truths. Naturally, different people will have different narratives, as they have different cultural, intellectual, economic and sociological backgrounds. So, instead of a modern contest between absolutes, we see a postmodern comparison of narratives, where none has a legitimate right to exclude any other. Everything is contingent on context and background, and there is no "inside track" to truth (see Natoli 1997).

On the applied and political side, Postmodernism rejects any claim of absolute truth as the attempt to impose one worldview over others. In the vocabulary of Postmodernism, such claims are referred to as attempts to impose a "master voice" or "meta-narrative." "Postmodern politics then becomes a continuous negotiating of various compromises as to what meanings and values are to be represented in the social order and to what degree. Outcomes here are relative to time and place and the already established dispositions of power" (Natoli 1997, 18). There follows a suspicion of certainty, a predilection for dialogue and process over decisive result, and the replacement of absolute "meaning" with relative "interpretation." Pippin (1999, 41) explains that "for many so-called postmodernists, modernism represents the last game played by Western bourgeois high culture, an elitist code designed only to preserve and celebrate the … point of view of an exhausted but still immensely powerful middle class." Postmodernism thus challenges the main tenets of modern political economy. The modern nation-state becomes an instrument of centralized repression of minority voices; the supreme authority of reason ends up being but the "voice" of those in power attempting to impose their views as "the master voice" over all other narratives; natural rights are not universal values, but a Western concept, imposed on the rest of the world by "cultural imperialism" or simply brute force; free markets are seen as the freezing of one particular institutional arrangement that benefits those who have the power to expand their wealth; and the mastery of nature through science and technology becomes an excuse for "ecocide" in the empty name of progress.

2.2 A Sidebar Note: Post-"Modernism"… But Which "Modernism"?

As indicated above, "modernity" is often used as a catch-all for parallel, if antithetical, philosophical movements. Most strikingly, Giddens (1990, 172) asserts that "totalitarianism and modernity are not just contingently, but inherently, connected." Perhaps… but which modernity? Totalitarianism as a consequence of the Continental Enlightenment, certainly; of the British Enlightenment, unequivocally not. The

British (Locke, Hume, Ferguson, etc.) emphasized humility, reason grounded in faith (and vice-versa), and a healthy acceptance of human nature, whereas the Continentals (Rousseau, Hegel, Comte, etc.) lapsed into a hubristic cult of reason, leading to social engineering, a complete negation of the individual in favor of some putative "common" good – and, bluntly, Auschwitz and the Gulag. For details on the two Enlightenments, see Hayek 1948, 1967, 1978 and 1979[1952], Boettke 2000, and Himmelfarb 2004.

As much as I shudder to conflate the two lines of thought, I must resign myself to the fact that they are indeed conflated in the popular – and intellectual – mind. The postmodern reaction – if it is indeed a reaction to Auschwitz, the Gulag, the growth of the state at the expense of individual autonomy, the destruction of the environment through ill-defined property rights, and the industrialization of war, all of which are necessary and inevitable consequences of the Continental Enlightenment – makes perfect sense. In other words, Postmodernism is indeed "the highest form of Modernity," if only of the Continental type.[5] However, if we return to the humility of the Scottish Enlightenment, grounded in self-inquiry, honest doubt and a foundation of "faith within reason," then there is room to question the vast shortcomings of (prevalent/conflated/Continental) Modernity, without lapsing into the nihilism and linguistic obscurantism of Postmodernism. As in so many other cases, Hayek (1967, 120) captures the problem neatly: "it was Rousseau and not Hume who fired the enthusiasm of the successive revolutions which created modern government on the Continent and guided the decline of the ideals of the older liberalism and the approach to totalitarian democracy in the whole world."

Although it is a necessary sidebar note, this is ultimately a problem best left for another forum.

2.3 Constitutional Implications of Radical Relativism

Constitutionalism, if it is to be successful, must rely on an acceptance of some notion of principles over expediency. Elster (2000) writes of a *sine qua non* for successful constitutionalism: a polity's willingness to be bound. Without that willingness, that

[5] To use the phrase from an anonymous reviewer.

deferral of immediate power in the name of long-term constitutional order, there can be no binding, and thus no constitutionalism. Whether a constitution is ultimately a contract (Buchanan 1975, Brennan and Buchanan 2000) or a coordinating mechanism (Hardin 1999, Wenzel 2007b), constitutionalism requires an acceptance that rules, long-term stability and constitutional principle, must all prevail over the temptations of in-period politics. If the validity of an appeal to principle is discarded – as it is by postmodern claims – constitutionalism will be weakened, or destroyed.

Constitutionalism rests not only on an appeal to principle over expediency,[6] but also on dynamic sacrifice in the name of stability and rights. If Postmodernism prevails, constitutionalism is apt to whither away into a set of by-laws, with the good increasingly defined by those who have the votes. Or the guns. In the recent words of a popular news magazine, constitutionalism may increasingly become "politics by other means." This is already the case in most European countries, whose Kelsen-style constitutional councils many consider to be essentially third chambers of the legislature (see, *e.g.* Stone 1992 and Provine 1992). Their nomination, by the executive and legislature, is temporary rather than lifelong, and they are often approached by legislative political factions that fear they might lose through traditional parliamentary channels. Generally, see Kelsen (1942).

On the US side, we are starting to see much the same thing. In response to a recent Supreme Court ruling on takings,[7] a leading member of the US Congress declared that "it is a decision of the Supreme Court ... so this is almost as if God had spoken." Asked if she agreed with the decision, the Representative asserted "the Supreme Court has decided ... that that was appropriate, and so I would support that."[8] No mention of rights or principle. No mention of abuse of human power against natural rights. Note the subtle but troubling difference between such a postmodern hagiographic claim and

[6] See Buchanan's (1981) enjoiner that "what is now needed is widespread adoption of a genuine 'constitutional attitude,' a proclivity or tendency to examine issues from a constitutional perspective, as opposed to the pragmatic, short-run utilitarian perspective that seems to characterize modern academic scholarship as well as day-to-day political discussion and action."

[7] *Kelo v. City of New London* (2005). This decision vastly broadened the definition of "public interest," allowing local governments much more latitude in claiming eminent domain to seize and redistribute private property for the purpose of increasing tax bases. An outrageous violation of natural rights, individualism and the spirit of the Declaration of Independence and Constitution ... and a quintessential example of expediency over principle.

[8] US Representative (now Speaker of the House) Nancy Pelosi, press conference, 6/30/05.

the alternative (modern) explanation that we accept to be bound by the Court's bad and immoral decision in the name of stability and constitutionalism (while continuing to fight it). The state and procedure have been raised to a quasi-religious status. This is not surprising, as the emergent postmodern worldview denies the very existence of truth. All is narrative and competing at that. Might makes right. Neuhaus (1986) observes that in *Roe v. Wade* (the US Supreme Court decision legalizing abortion), "for the first time in American jurisprudence, the Supreme Court explicitly excluded philosophy, ethics, and religion as factors in deliberation…" Regardless of one's views on *Roe*, it seems rather uncontroversial that the debate did have philosophical bases and ramifications. The Court backhandedly recognized this, explains Neuhaus: "Knowing that such a decision should nonetheless have the appearance of moral justification, the court searched for some covering 'value' and came up with the value of privacy. Much of the course of public reasoning in America can be read from the fact that our highest appeal is no longer to Providence but to privacy."[9]

3 A Return to Covenant? The Pre-Modern Challenge

The literature points to a decline in mainstream religion (Repstad 1996, Roof and Aagedal 1996, Iannaccone 1998, Greeley 1996), with a parallel rise in fundamentalism (Roof and McKinney 1987, Johnson 1986, Neuhaus 1986, Iannaccone 1998, Greeley 1996). Johnson (1986) explains that

> What seems to have happened is that as the mainline churches began to decline they sought the protection of ecumenicalism … and the common platform of ever more extreme forms of liberalism. This move provoked an angry conservative response from their disenfranchised rank-and-file that took the form of a new … variety of ecumenicalism… This popular ecumenicalism is based upon a common reassertion of traditional moral values and of belief in the salient articles of Christianity not as symbols but as plain historical fact.

[9] This explanation has a distinct pre-modern (rather than modern) flavor – but speaks elegantly about postmodern trends.

On the American side, some authors even speak of a Fourth Great Awakening (see Johnson 1986) or a "neocon reformation."[10]

Before the Enlightenment revolution, religion formed the bulk of Western mental models, as appeals were made to faith, Scripture, tradition and the authority derived from them. The Modern project tempered and modified this exclusivity, but did not entirely reject an appeal to religion. Rather, the Enlightenment project blended the two, grounding appeals to human reason within a sense of the eternal and human use of that very reason to discover natural law and live according to it. The current trend in religious fundamentalism is different, and does not fit comfortably within the modern tradition. Rather, it would increasingly supplant Scripture and the presumptive authority of tradition for secular debate and reason. Neuhaus (1986) writes that "intellectually, what is now called neoconservatism not only represents disillusionment with earlier liberal policies but in many cases stands as a challenge to reigning assumptions of the secular Enlightenment." He continues, explaining that the

> movement is sometimes called "traditionalist" or the "back-to-basics movement." But that is to define it much too narrowly, in terms that register specific "issues" on the political screen of today and tomorrow. The movement is in large part a mood, the protest in large part an uneasiness – about the public loss of transcendence, about a perceived moral vacuum at the heart of our public life, about the absence of a sense of interest-surpassing content...

To be sure, fundamentalism is not, *per se*, a postmodern phenomenon – quite the contrary, it rejects Modernism's secularism and Postmodernism's rejection of truth; in fact, fundamentalism could best be described as pre-modern, as it returns to an appeal to faith and authority over reason. But fundamentalism is, in many ways, a reaction to Postmodernism, and thus bears mention in this review – not for the details of fundamentalism, which are best left to other essays, but to demonstrate how fundamentalism emerged, in large part, as a reaction to the radical relativism of Postmodernism.

On this point, generally, see Stark and Bainbridge (1985) and Berger (1999). Although the verdict is not entirely clear, it strikes me that the rise in fundamentalism

[10] This trend includes not only traditional religious groups, but also others concerned with the overall decline in American values and morality (Neuhaus 1986).

represents the reverse of the postmodern medal. Just as Postmodernism questioned, then rejected, the Modern project after the upheavals of the 19th century and the horrors of the 20th began to cast doubt on the strength and viability of modern claims, the rise in religious fundamentalism can be seen as a reaction to both Modernism and Postmodernism. If the horrors of the 20th century are seen as fundamental failures (and inevitable) of Modernism, a pre-modern rejection makes just as much sense as a post-modern one. The direction of the counter-claim is just that – a question of direction. In fact, Neuhaus (1986) writes that the current rise in fundamentalism goes beyond traditional religious forces, to incorporate many who are troubled by a perceived decline in values. It may thus make sense to label the current fundamentalist trend as an anti-postmodern backlash (as the two are not only mirror opposite responses to the same perceived problem, but also exhibit a stunning chronological overlap). Just as the Modern project was borne largely of a religious reformation and followed by a counter-reformation, the current intellectual landscape can be divided into three competing forces, three heuristics, three overarching mental models: prevailing but struggling Modernism; the postmodern "Reformation" of radical relativism; and the pre-modern "Counter-Reformation" of tradition, faith, and scriptural literalism. See Wenzel (2008).

Interestingly, this pre-modern phenomenon is not confined to any one religion. Just as Christianity was inextricably associated with the pre-modern view, it also fed many modern staples, such as the inherent dignity of the individual or limited government. The same can be said of the other major religions, which can be made to fit within pre-modern, modern or post-modern epistemologies (again, see Wenzel 2008).

4 A European Case Study

As an illustrative case study, the EU Constitution can be seen as the result of the emergence of postmodern thought from the university to the statehouse (Petroni 2003 and 2004, and Wenzel 2007a). Likewise, many aspects of the current transatlantic divide can be explained as an intellectual clash between a postmodern Europe (with its insistence on listening to competing narratives, diplomacy over force, and shying away from what it sees as "simplistic" absolutes in international relations) and a modern US (with its rhetoric of "axis of evil," and efforts at bringing human rights to the world). Standard Public Choice stories and geopolitical/economic realities go some way in explaining these phenomena – whether one views the EU as a coordination game, or as the unintended consequence of a supra-national bureaucracy (see, *e.g*. Langlois 1992 and 1994, Anderson 1984 and Kagan 2002). But, for all their descriptive powers, these two traditional stories of institutional change do not sufficiently explain the overall thrust of the European Constitution.

4.1 The EU Constitution – a Bizarre Document

Beyond length and lack of clarity, the EU Constitution is bizarre at best; in fact, Pini (2003) has gone so far as to describe it as "a constitutionalist's delusion," "a political aberration," and "not a constitution – not theoretically, not practically." As the 126-page behemoth reads more like a spending bill than a constitution, I simplify the analysis into three salient representative themes: citizenship, rights, and strategic obfuscation.

4.1.1 Citizenship and Identity

In the American model, government derives its legitimacy up from the people. There is no such sense in the European case, where the constitution comes first, then citizenship derives from the document. The oddity continues with a tautological definition of identity: the constitution is based on a sense of "Europeanness" that is itself derived from the constitution. European identity – rather than natural law in the American tradition, or the popular will in the continental Rousseau-Hegelian tradition – has become the philosophical foundation (see, generally, Petroni 2004). Similarly, delegates to the Constitutional Convention agonized over the proper wording and substance for the philosophical foundations of Europe. Although some delegates pushed for inclusion of a reference to Europe's Christian heritage, that wording was deemed too controversial, and was replaced by a milder acknowledgement of Europe's "Graeco-Roman and Enlightenment tradition" (de Jasay 2003a and 2003b).

4.1.2 Rights

The fundamental purpose of a constitution is to establish the basic parameters of sound government and protect rights – to "impose significant constraints on government, whatever form it takes (majority rule or otherwise)" (Barry 1990; see also Hayek 1960, Pini 2003, and European Constitutional Group 2004). The European constitution does neither. By its sheer size, it cannot be said to set up basic parameters. Instead, it attempts to set up the detailed mechanics of European federalism. Furthermore, Pini (2003) worries that the constitution, instead of limiting state power and protecting rights, is not sufficiently abstract and removed from the foibles of in-period politics (as a good constitution should be), and that it "adds rules, as always" (see also European Constitutional Group 2004). The length and detail of the document underscore the radically different philosophies of the American and European documents. The former sets forth the limits of state action, establishing "islands of regulation in a sea of liberty." Its European cousin, conversely, establishes "islands of liberty in a sea of regulation" (see Barnett 1991 and 2004). Just as citizenship is granted from the top down, so are rights. Petroni (2003) explains that there are no individual rights under the EU constitution: rights are those given by the constitution to the people. In this top-down spirit, the EU constitution places greater emphasis on (so-called) positive than negative rights – along with the governmental responsibilities in "guaranteeing" them.

4.1.3 Muddle, obscurity and subterfuge

The mere length of the EU Constitution makes it a delight for sadistic law professors. The text of the US Constitution is comparatively simple and straightforward, yet has generated volumes of controversy and interpretation. So one can only imagine the seeds of confusion, conflict and interpretation strewn in the long and complex European text. A plausible story has been told that the lawyers and judges co-opted the original European project (see Petroni 2003 and Wenzel 2007a for details). By making things more legalistically complicated, these high priests of constitutional interpretation stand to gain.

But the story does not end there. Howe (2004) explains the institutional mission creep and jurisprudence of European legal interpretation. The European Commission (the EU's executive arm) has been "using powers for one purpose to serve a quite different ... purpose." The EU Constitution's "general provisions ... will encourage the Commission and the ECJ [European Court of Justice] to interpret EU powers even more broadly than they do at present." Furthermore, the Court has not been an innocent bystander in this process. In addition to expanding its own powers and Union powers through creative interpretations and through the principle of *acquis communautaire*,[11] the Court has been manipulating jurisdiction. Howe (2004) explains how the Court "interprets the legal texts which it enforces largely by reference to their 'objects and purposes.' This means ... that identically worded provisions in two different treaties can be interpreted to have very different effects." In a telling example, Petroni (2004) describes how the Constitution clearly defines "human health" as a function specifically reserved for the member-states and shielded from EU jurisdiction. Simultaneously, the Constitution enumerates "public health" as a European Union function – but does not define a distinction between "human health" and "public health"!

Robinson (2004) explains that such "constitutional muddle" is intentional, and has served the purposes of European centralizers. Unable to obtain their political goals immediately, they have resorted to legalistic obfuscation and unclear constitutional verbiage to achieve their aims through "subterfuge," "confus[ing] the citizens of various member states [in Europe's] 'Journey to an Unknown Destination'." Again, the lawyers, judges and Convention delegates remain the high priests in the interpretation of an intentionally confusing document; the incentives are clear. Such self-serving interpretation would seem to parallel the political sleight of hand we are now witnessing in the constitution's imminent ratification. Having failed to convince the people, and having failed by referendum, politicians of EU member countries are now adopting the constitution via the back door of parliamentary majority.

[11] Basically, once an EU-level power, always an EU-level power, even in different but "similar" cases – as defined, of course, by the Court.

4.2 A Postmodern Explanation

4.2.1 Citizenship and Identity

In a postmodern context, which eschews one "overarching story" in favor of competing narratives, Europe is the new galvanizing factor. Rather than the modern nation-state, postmodern Europe is an umbrella that gives voice to regional and personal interests; "one of the main points of postmodernism … is that 'the most particular is the most universal.' So when it comes to 'identity' the trick for the constitutional experts writing the constitution was to express that by being very much themselves, they would be more European" (Prado 2004). The European umbrella, along with the constitutional refusal to derive legitimacy from the people or nation-states, is a reflection of "[Postmodernism's] 'anything goes' pluralism and its delirious celebration of difference." (Sim 2001, 28)

4.2.2 Rights

In a Postmodern worldview, natural rights are viewed with a great deal of suspicion, as culturally contingent impositions. Far better to emphasize positive "rights" (which are much more fluid and subject to interpretation). The same goes for the safe, descriptive allusion to the "Graeco-Roman and Enlightenment heritage" over any appeal to Christianity and its tendency to impose a "meta-narrative." Naturally, a more traditional explanation would point to a pragmatic catering to Europe's large Moslem minorities or Turkey's possible entry into the EU. But, again, the traditional story makes more sense with an added ideological/philosophical explanation.

4.2.3 Textual Obscurity

The lack of clarity in the European Constitution goes beyond mere lawyers' games and is better understood as postmodern interpretation over clear meaning. Prado (2004) explains that

> [a] Constitution is, like every text, made out of language. Thus, given the metaphoric nature of language … a Constitution written in the 21st century is very open to a postmodern … analysis… Plus, given the fact that many governments will ask their citizens to approve the Constitution via referendum, the openness to interpretation of every text (a main issue in postmodernism) will play a big role. Every government will have to 'interpret' the Constitution in a certain way to make it palatable to its own citizenry. That's postmodern practice – "meaning" is never "closed".

Again, the referendum is now moot, but the intent remains. Postmodernism sheds a whole new light on the EU Constitution's textual obscurity and the European Court's interpretation of a treaty's purpose over its text.

4.3 Other European Preferences

Space considerations prevent more detail, but other aspects of European policy are also made clear within a postmodern understanding. Europe's quasi-religious preoccupation with environmental protection over economic growth, along with its adoption of the precautionary principle over rational, mathematical risk assessment, reflects the postmodern concern with scientific apprentices turning against their modern sorcerers. Europe's lack of military power and reluctance to use force can be understood as a (postmodern) state of "perpetual peace" through diplomacy, in contrast to the (very modern) Hobbesian world of military force in which the US continues to live (Kagan 2002). Europe's predilection for diplomatic and bureaucratic process and dialogue – over results – can be understood as a postmodern consideration of competing narratives rather than imposition of one narrative as the "meta-narrative." And the list goes on.

As for the actual document, a critical mass of its voters has rejected the proposed Constitution of 2003. But we have not heard the last from the European constitutionalists and centralizers. We are already witnessing a new constitutional incarnation, if in the form of a treaty to be ratified by compliant legislatures rather than fickle voters. In the meantime, the draft Constitution offers great insight into the prevailing *Weltanschauung* in Europe. From the university to the statehouse, ideology has emerged. For details on the EU Constitution as Postmodern document, see Wenzel 2007a.

Possible Futures and Concluding Thoughts

A change in worldview, a change in the heuristics employed to make epistemological and ethical decisions (consciously or not), means a change in the intellectual foundations and underlying claims of institutions. As heuristics and philosophical appeals change, we may see a postmodern rejection of constitutionalism in favor of increasingly unfettered rule of the "popular will" (constitutions are, after all, claims of principle over majoritarian power). Alternatively, we may see a move towards pre-modern religious elements (with a commensurate decline in attention to real meta-issues). We are already seeing elements of both.

As explained above, the fundamentalist backlash is mostly useful for understanding Postmodernism.[12] Postmodernism, on the other hand, already goes a long way towards explaining current intellectual movements. It also presents great leverage for understanding certain institutional changes. Beyond the European case study presented above, Postmodernism also helps to understand the current trend of extra-constitutional amendment of the US constitution. If Postmodernism has not overtaken prevailing US mental models completely, this does not mean that the ideology has been quarantined in Europe or resides exclusively at isolated departments in scattered American universities. Postmodernism is not just a cute way of interpreting literature, to the delight of sadistic faculty and the terror of students. Postmodernism is slowly creeping into the American worldview, as it already has in Europe. The intel-

[12] Woodberry and Smith (1998) explain that, although fundamentalists have great public visibility and "impressive mobilization of activists, [their] political impact has been minimal. Many of [their] victories have been symbolic, such as influencing the working of the [US] Republican party platform... Most scholars now believe that [fundamentalism as a political force] will not disappear but will not become a dominant influence in politics either." Furthermore, fundamentalist activists "have little power to determine how their movements will be framed in the national media or to influence which people and statements will be highlighted to represent their causes." The worries from the ideal-type pre-modern revolution would thus appear to be exaggerated. Conversely, the first three religious awakenings in America were strong factors in sociopolitical changes of great historical weight: the US Revolution, the Civil War, and 20th Century Progressivism (see Johnson 1986). So the verdict is still open. And, again, this holds in the West; see Wenzel (2008) for more detailed speculation on Islam.

lectual landscape and subconscious heuristics are changing, as Postmodernism gains ground. Huyssens (1984) asserts that

> What appears on one level as the latest fad, advertising pitch and hollow spectacle is part of a slowly emerging cultural transformation in Western societies, a change in sensibility for which the term "post-modern" is actually, at least for now, wholly adequate. The nature and depth of that transformation are debatable, but transformation it is. I don't want to be misunderstood as claiming that there is a wholesale paradigm shift of the cultural, social and economic orders; any such claim clearly would be overblown. But in an important sector of our culture there is a noticeable shift in sensibility, practices and discourse formations which distinguishes a post-modern set of assumptions, experiences and propositions from that of a preceding period.

It is, naturally, impossible to predict exactly what will happen to constitutionalism in the face of such tectonic shifts in the intellectual landscape. It is, however, certain that there will be effects (some are already visible). Simply put, ideas have consequences. Institutions, generally, have philosophical foundations; they represent the political implementation of the prevailing worldview about the proper arrangements of human affairs. Modern institutions, specifically, rest on the Enlightenment Project's premises, including a clear vision of Man in the Universe, the use of reason to discover natural rights, and the use of constitutions (and other institutions) to protect those rights.

Either way, the intellectual landscape is undergoing radical changes. There will be changes in the institutions that govern human affairs. That much is certain. The pre-modern, religious fundamentalist challenge to modern institutions appears to be currently limited. Postmodernism, on the other hand, is already gnawing at the very core of our mental models and institutions.

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