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MORE THAN QUIBBLES: PROBLEMS WITH THE THEORY AND HISTORY OF FRACTIONAL RESERVE FREE BANKING

ROBERT P. MURPHY*

JEL CLASSIFICATION: B53, E32, E42, E58, G21

ABSTRACT: The extensive debate over fractional reserve free banking (FRFB) has spanned decades and includes volleys from many contributors. Consequently, relative newcomers to the controversy often wish to extend the conversation on several fronts. In this spirit, Bagus and Howden (2010) is a 27-page paper detailing numerous objections to FRFB, which they modestly entitled, “Fractional Reserve Free Banking: Some Quibbles.” The present paper continues in this tradition, elaborating on some of the key critiques of FRFB raised by others earlier in the debate. In particular, I critically explore two key claims of the FRFB camp: that holders of banknotes implicitly lend funds to the issuing bank, and that the historical periods of relatively free banking illustrate the stability of the system.

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I. INTRODUCTION

The debate over fractional reserve banking predates the Austrian School. David Hume favorably cites the bank of Amsterdam (Hume 1987 [1742], II.III.4), while Adam Smith explains this famous case of 100 percent reserve banking in *The Wealth of Nations*.¹ The early 19th century British Currency School was so influential that it achieved a legislative insistence on 100 percent reserves in the issuance of banknotes (though not demand deposits) in the famous Peel's Act of 1844. (Salerno 2012, p. 98)

Besides some economists in the Austrian tradition, the Chicago School is also known for a streak favoring 100 percent reserves (e.g. Fisher 1935), and in the wake of the financial crisis some prominent Real Business Cycle economists are reconsidering the proposal (Prescott and Wessel 2016). Yet the present paper falls squarely within the Austrian School, critiquing the practice of fractional reserve banking from the perspective of Mises-Hayek business cycle theory. Some representative works in this vein include Mises ([1912] 2009), Hayek ([1925] 1984), Rothbard ([1962] 2001), and Huerta de Soto (2006).

The foil for this paper's perspective is the framework of "fractional reserve free banking" (FRFB) advanced for example in Selgin (1988), Selgin and White (1996), and Horwitz (2001). The free bankers endorse the Mises-Hayek theory of business cycles, but they deny that fractional reserve banking per se is the problem. Instead, the advocates of FRFB blame various types of government interference with money and banking.

As with Bagus and Howden (2010), the present paper joins this long-standing yet vigorous debate, seeking to address several of the

¹ "The bank of Amsterdam professes to lend out no part of what is deposited with it, but, for every guilder for which it gives credit in its books, to keep in its repositories the value of a guilder either in money or bullion. That it keeps in its repositories all the money or bullion for which there are receipts in force, for which it is at all times liable to be called upon, and which, in reality, is continually going from it and returning to it again, cannot well be doubted.... At Amsterdam... no point of faith is better established than that for every guilder, circulated as bank money, there is a correspondent guilder in gold or silver to be found in the treasure of the bank" (Smith [1776] 1904, IV.3.27). In fairness to proponents of fractional reserve free banking, I concede that some later writers have described the bank of Amsterdam as a forerunner of modern central banks.

key controversies. Although Bagus and Howden modestly label their contribution as a collection of “quibbles,” in fact their discussion of money demand and credit expansion highlights a devastating flaw in the FRFB position. In this paper, I elaborate on this problem,² showing that the FRFB claims are demonstrably incompatible with the Misesian approach to money and banking. Beyond that, I show that Selgin’s two highlighted examples of the *best* historical cases of FRFB (namely, Scotland and Canada) are, if anything, poster children for the Rothbardian warnings against fractional reserve banking.

In Section II, this paper establishes that Mises and Hayek both believed that fractional reserve banking per se is instrumental to the business cycle. Section III extends the Bagus-Howden approach to demonstrating the problem with the FRFB claim that fiduciary media need not disrupt the loan market. Section IV critically analyzes the historical examples of FRFB nominated by Selgin. Section V concludes.

II. MISES (AND HAYEK) THOUGHT FRB *PER SE* WAS DISRUPTIVE

Setting aside the potential legal and conceptual problems with fractional reserve banking in order to focus on the economics, one of the key areas of dispute is whether FRB necessarily leads to an unsustainable boom as described first by Mises ([1912] 2009) and elaborated by his disciple Hayek (e.g. [1931] 1967). It is significant that both of these developers of what is sometimes called “the Mises-Hayek theory of the business cycle” thought that FRB was a central element of the story. To be sure, Mises and Hayek may have been *mistaken*, but it is worth documenting their position because in the debate over FRB, one often hears (especially in informal venues) casual claims that only dogmatic Rothbardians could find fault with fractional reserve banking per se.

We find an unambiguous statement of Mises’s position in *Human Action*. Mises defines “fiduciary media” as bank-issued claims to

² Selgin himself responded to Bagus and Howden (Selgin 2012), and then they responded in turn (Bagus and Howden 2011 and 2012). I will note in the text when these subsequent exchanges touched on the issues I want to revisit, but in my opinion their further discussion did not flesh out the points I make in this paper.

money, payable upon demand, that are *not* covered by base money in the vault, and then declares:

The notion of “normal” credit expansion is absurd. **Issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle.** Of course, if the additional amount issued is not large, neither are the inevitable effects of the expansion. (Mises [1949] 1998, 439, n. 17; bold added.)

Regarding Hayek, even the FRFB writers admit that his understanding of commercial bank behavior is inconsistent with their claims. For example, Larry White (1999, 761) writes that Hayek ([1925] 1984, 29) “suggested in one of his earliest writings a radical solution to the problem of swings in the volume of commercial bank credit: impose a 100 percent marginal reserve requirement on all bank liabilities....”

Mises too at some points in his career called for an explicit prohibition on additional issuance of fiduciary media,³ though he also wrote (for example in *Human Action*) in favor of “free banking” as *the best practical way to restrain the issuance of fiduciary media*. (Salerno 2012, 96–97) Readers should therefore not misinterpret Mises’s praise for laissez-faire in banking as an endorsement of the modern “free banking” claim that fractional reserve banking, at least under certain conditions, promotes economic stability.

To appreciate the specific problem of fiduciary media in the eyes of Mises, it is very instructive to consider *where* he placed the business cycle discussion in *Human Action*. One might have classified the periodic boom-bust cycles plaguing market economies as a result

³ In the early 1950s Mises wrote an essay (included in later editions of his *The Theory of Money and Credit* [1912] 2009) titled, “The Return to Sound Money.” In the portion pertaining to the United States Mises explicitly says,

No bank must be permitted to expand the total amount of its deposits subject to cheque or the balance of such deposits of any individual customer... otherwise than by receiving cash deposits in legal tender bank-notes from the public or by receiving a cheque payable by another domestic bank subject to the same limitations. This means a rigid 100 per cent reserve for all future deposits, i.e. all deposits not already in existence on the first day of reform. (448)

of political intervention, which would mean placing the discussion (as Rothbard did in *Man, Economy, and State*⁴) in the same section of the book that handled minimum wage laws and taxation. Yet Mises rejects this plausible approach, and his explanation illuminates his broader views on fractional reserve banking:

It is beyond doubt that credit expansion is one of the primary issues of interventionism. Nevertheless the right place for the analysis of the problems involved is not in the theory of interventionism but in that of the pure market economy. **For the problem we have to deal with is essentially the relation between the supply of money and the rate of interest, a problem of which the consequences of credit expansion are only a particular instance.**

Everything that has been asserted with regard to credit expansion is equally valid with regard to the effects of any increase in the supply of money proper as far as this additional supply reaches the loan market at an early stage of its inflow into the market system. If the additional quantity of money increases the quantity of money offered for loans at a time when commodity prices and wage rates have not yet been completely adjusted to the change in the money relation, the effects are no different from those of a credit expansion. In analyzing the problem of credit expansion, catallactics completes the structure of the theory of money and of interest....

What differentiates credit expansion from an increase in the supply of money as it can appear in an economy employing only commodity money and no fiduciary media at all is conditioned by divergences in the quantity of the increase and in the temporal sequence of its effects on the various parts of the market. Even a rapid increase in the production of the precious metals can never have the range which credit expansion can attain. The gold standard was an efficacious check upon credit expansion, as it forced the banks not to exceed certain limits in their expansionist ventures. The gold standard's own inflationary potentialities were kept within limits by the vicissitudes of gold mining. Moreover, **only a part of the additional gold immediately increased the supply offered on the loan market. The greater part acted first upon commodity prices and wage rates and affected the loan market only at a later stage of the inflationary process.** (Mises [1949] 1998, 571–72; bold added.)

⁴ Specifically, in his own treatise Rothbard ([1962] 2009) discusses the business cycle in Chapter 12, which is titled, "The Economics of Violent Intervention in the Market." (The discussion of inflation and the business cycle is contained in section 11 of the chapter, starting on p. 989.)

The above excerpt from Mises is extraordinarily important in understanding what role *he thought* the commercial banks played in a typical boom-bust cycle. Yet to correctly parse it, we should first remind ourselves what Mises means precisely by the phrase “credit expansion” (since he is contrasting it with “an increase in the supply of money proper”). Earlier in the book, Mises does not yet explain the trade cycle but defines the terminology that he will later need. He explains:

The term *credit expansion* has often been misinterpreted. It is important to realize that commodity credit cannot be expanded. The only vehicle of credit expansion is circulation credit. But the granting of circulation credit does not always mean credit expansion. If the amount of fiduciary media previously issued has consummated all its effects upon the market, if prices, wage rates, and interest rates have been adjusted to the total supply of money proper plus fiduciary media (supply of money in the broader sense), granting of circulation credit without a further increase in the quantity of fiduciary media is no longer credit expansion. **Credit expansion is present only if credit is granted by the issue of an additional amount of fiduciary media, not if banks lend anew fiduciary media paid back to them by the old debtors.** (Mises [1949] 1998, 431; italics in original, bold added.)

Putting together all three of the block quotations from *Human Action* that we have provided above, we can summarize Mises’s position as follows: The unsustainable boom occurs when a newly created (or mined) quantity of money enters the loan market and distorts interest rates, before other prices in the economy have had time to adjust. In principle, this process could occur even in the case of commodity money with 100 percent reserve banking.

However, *in practice* Mises believes such a theoretical possibility can be safely neglected, because (a) the quantity of new gold (or other commodity money) entering the economy will likely be relatively small over any short period and (b) *whatever* the stock of new commodity money entering the economy as a whole, typically only a small fraction of it would be channeled into the loan market upfront.

Thus, even though in principle Mises’s theory of the boom-bust cycle is fundamentally about new quantities of money hitting the loan market early on, in practice the explanation revolves around *newly-created fiduciary media* being lent into the market. That is why

Mises described his explanation as the “circulation credit theory of the trade cycle.” When we understand how Mises thought (in principle) newly mined gold could conceivably set in motion the boom-bust cycle, it becomes crystal clear that he thought *any amount* of newly-issued fiduciary media—i.e., a credit expansion—would do the same. (Remember, our earlier quotation shows Mises claiming that “[i]ssuance of additional fiduciary media, **no matter what its quantity may be**, always sets in motion” the processes that cause the unsustainable boom.) Thus there are no caveats or other conditions to consider, on this narrow question. Mises thought fractional reserve banking per se would set in motion the business cycle.

III. EXCHANGING MONEY PROPER FOR A MONEY SUBSTITUTE IS NOT LENDING FUNDS TO THE BANK

In contrast to the view of Mises and Hayek, the modern free bankers deny that FRB per se causes a deviation of market and natural interest rates. In a free market with no central bank or government-provided deposit insurance, profit-maximizing commercial banks will—so the free bankers claim—only issue fiduciary media in the case when the public increases its demand to hold bank money, and this is precisely the scenario in which we should *want* them to do so. The free bankers argue that an insistence on 100 percent bank reserves in the face of a sudden increase in the public’s demand to hold bank-issued money will lead to a period of monetary disequilibrium (in the sense of Yeager 1997).

With this approach, the free bankers apparently turn the 100%-reserve critique on its head. Selgin and White (1996) argue:

We aspire to be consistent Wicksellians, and so regard both price inflation and deflation as regrettable processes *insofar as they are brought about by arbitrary changes in the nominal quantity of money, or by uncompensated changes in its velocity, and not by changes in the real availability of final goods or the cost of production of money*. It is therefore an attractive feature of free banking with fractional reserves that the nominal quantity of bank-issued money tends to adjust so as to offset changes in the velocity of money. Free banking thus works against short-run monetary disequilibrium and its business cycle consequences. (Selgin and White 1996, 101–02; italics in original.)

Selgin (1988) makes the point in greater detail. He first recognizes that the balance between money supply and demand is conceptually distinct from equality between the market and natural rates of interest, but he claims that under a regime of free banking the two will be synchronized:

As used here “monetary equilibrium” will mean the state of affairs that prevails when there is neither an excess demand for money nor an excess supply of it at the existing level of prices. When a change in the (nominal) supply of money is demand accommodating—that is, when it corrects what would otherwise be a short-run excess demand or excess supply—the change will be called “warranted” because it maintains monetary equilibrium.

This view of monetary equilibrium is appropriate so long as matters are considered from the perspective of the market for money balances. But it is also possible to define monetary equilibrium in terms of conditions in the market for bank credit or loanable funds. **Though these two views of monetary equilibrium differ, they do not conflict.** One defines equilibrium in terms of a stock, the other in terms of the flow from which the stock is derived. **When a change in the demand for (inside) money warrants a change in its supply (in order to prevent excess demand or excess supply in the short run), the adjustment must occur by means of a change in the amount of funds lent by the banking system.**

An important question, one particularly controversial among monetary economists in the middle of this century, arises at this point. **Are adjustments in the supply of loanable funds, meant to preserve monetary equilibrium, also consistent with the equality of voluntary savings and investment? The answer is yes, they are.** The aggregate demand to hold balances of inside money is a reflection of the public’s willingness to supply loanable funds through the banks whose liabilities are held. To hold inside money is to engage in voluntary saving.

As George Clayton notes, whoever elects to hold bank liabilities received in exchange for goods or services “is abstaining from the consumption of goods and services to which he is entitled. Such saving by holding money embraces not merely the hoarding of money for fairly long periods by particular individuals but also the collective effect of the holding of money for quite short periods by a succession of individuals.” (Selgin 1988, 54–55, bold added.)

Steve Horwitz echoes these sentiments, arguing that “demanding bank liabilities is an act of savings” (1996, 299, qtd. in Bagus and Howden 2010, 40). Horwitz explicitly combines the bank function of credit intermediary with fractional reserves when he writes:

Savers supply real loanable funds based on their endowments and intertemporal preferences. **Banks serve as intermediaries to redirect savings to investors via money creation.** Depositors give banks custody of their funds, and banks create loans based on these deposits. The creation (supply) of money corresponds to a supply of funds for investment use by firms. (Horwitz 1992, 135, qtd. in Bagus and Howden 2010, 39; bold added.)

More generally, the FRFB writers see nothing special about demand deposits, that would make them qualitatively different from other forms of credit instruments. The FRFB writers can ask rhetorically: If Rothbardians do not object to a man lending \$1,000 to the bank by buying a 12-month CD, then why do they object to a man effectively lending \$1,000 to the bank by keeping it in his checking account for a year? Yes, it is true that if the bank lends out some of the funds and then the man tries to withdraw his money, there could be a problem. But by the same token, there could be a problem if the bank lends out the \$1,000 from the CD sale to fund a project that will not be repaid for (say) two years. According to the FRFB writers, all this shows is that commercial banks need to pay attention to maturity matching. It is not fraudulent and it does not cause the business cycle if banks sell (say) 12-month CDs and lend the funds out for 2-year projects (hoping to roll over the CDs when they mature).⁵ So by the same token, there is nothing especially risky or distortionary if we look at one end of the spectrum, where savers lend their funds to the bank for a loan that matures in “zero” time even though the bank uses those funds to invest in longer maturity projects. According to the FRFB writers, that is one way to appreciate the benignity of demand deposits or checking accounts: consider them as buying CDs that mature instantly and that the saver continuously rolls over.

⁵ In the text above, I am paraphrasing a line of argument from the FRFB camp, which presupposes that the typical Rothbardian does *not* object to maturity mismatching per se. However, some Rothbardians *do* argue that maturity mismatching is the fundamental problem, of which fractional reserve banking on demand deposits is only the most prominent example. See Block and Barnett (2017) for such a claim, and see Bagus, Howden, and de Soto (2018) for a critical response, which contains citations to the volleys of the running debate. Of course, for those in the 100 percent reserve camp who *agree* with Block and Barnett, this particular line of argument from the FRFB would fall flat.

As we have seen, it is essential for the FRFB position that people adding “inside money” (i.e. bank-issued claims to money payable upon demand) to their cash balances are engaged in an act of saving and furthermore are lending their savings to the bank. There is much controversy on this point. Some critics of FRFB (e.g. Hoppe 1994, 72) have denied that the accumulation of cash balances *is* a form of saving. However, I agree with Hülsmann (1996, 34) that the accumulation of cash is a form of (gross) saving. What I deny is that this act of saving, if performed using the vehicle of a banknote or demand deposit, represents an implicit loan to the commercial bank. Thus my position is compatible with Selgin’s (2012) response to Bagus and Howden on money balances and saving (p. 139); savings can take the form of an accumulation of bank notes. But admitting this does *not* mean that accumulating bank notes is the same thing as *lending funds to the bank that issued them*. The following thought experiment will illustrate the distinction.

Imagine a young boy who receives a weekly allowance of \$10 for his household chores. Each week his parents give the boy a crisp \$10 bill, which he promptly stores under his mattress. After eight weeks, the boy buys an \$80 video game. Does anyone want to deny that he “saved up for” the purchase? Both plain language and—I would argue—economic definitions must conclude that the boy consumed less than his income for the eight-week period, and engaged in saving. He invested in the accumulation of a very liquid financial asset, namely fiat money.

Things would not change if the boy (week after week) exchanged his fiat dollars for instantly demandable notes issued by a reputable bank. The accumulation of these banknotes would still represent saving and investment on the part of the boy. But they would *not* constitute a loan to the bank, any more than a man who checks his coat at a restaurant (and receives a claim-ticket) is lending his garment to the establishment. Even though a Martian observer might *think* the man was engaged in a credit transaction, our understanding of the true situation informs us that the coat-checking process is not a loan.

If our hypothetical boy converts actual money (“money in the narrower sense” in Mises’s terminology, or “outside money” in Selgin’s) into a banknote or demand deposit (“money in the broader sense” for Mises or “inside money” for Selgin), he has not altered

his ability to command goods and services immediately in the market. Therefore there is no *additional* credit transaction, besides the accumulation of money per se. The boy's saving translates into the "investment" of an accumulation of dollars in his cash balances. If he converts the fiat currency into banknotes, then his prior acts of saving "correspond to" the banknotes now in his possession. It was not his decision *to convert the fiat dollars into banknotes* that represents saving; *that* decision merely altered the form in which he holds his savings. There is no "excess saving" on the part of the boy that could accommodate the creation of additional banknotes that the commercial bank then lends out, with the boy's \$80 in fiat dollar deposits serving as the reserves.

Our analysis here exactly mirrors that of Mises. In *The Theory of Money and Credit* he begins a section titled "The Granting of Circulation Credit" in this way:

According to the prevailing opinion, a bank which grants a loan in its own notes plays the part of a credit negotiator between the borrowers and those in whose hands the notes happen to be at any time. Thus in the last resort bank credit is not granted by the banks but by the holders of the notes. (Mises [1912] 2009, 271)

Those familiar with Mises's rhetorical style can guess that things do not bode well for the FRFB camp. After some historical references, Mises continues the above train of thought by declaring:

Now this view by no means describes the essence of the matter. **A person who accepts and holds notes, grants no credit**; he exchanges no present good for a future good. The immediately-convertible note of a solvent bank is employable everywhere as a fiduciary medium instead of money in commercial transactions, and nobody draws a distinction between the money and the notes which he holds as cash. The note is a present good just as much as the money. (Mises [1912] 2009, 272, bold added.)

Now to be sure, just because Ludwig von Mises rejected a particular view, does not suffice to demonstrate its error. Yet when it comes to arguments over FRFB within the camp of economists *who all endorse the Mises-Hayek theory of business cycles*, it is crucial to study Mises's own view of fiduciary media and the connection to an unsustainable boom.

Contrary to the FRFB writers, Mises does *not* think that banknotes are simply a credit instrument with zero maturity. On the contrary, they are a form of quasi-money because of their special nature. Indeed a few pages earlier (p. 267) Mises explains that other types of claims are eventually redeemed; you cannot eat a claim on bread. And this is why a “person who has a thousand loaves of bread at his immediate disposal will not dare to issue more than a thousand tickets” entitling the holder to a loaf of bread. But things are different with instantly convertible claims *to money*, because these claims (so long as their redemption is not doubted) perform the services of money proper. That is why issuers of these claims can dare to create more tickets than they can redeem.

Early in *The Theory of Money and Credit* (pp. 50–54), Mises weighs the pros and cons of including fiduciary media in the category of “money” itself. After all, a perfectly secure and instantly redeemable claim to money is itself a commonly accepted medium of exchange. But Mises decides instead to use the term “money-substitute” since he thinks it necessary to distinguish between “money in the narrower sense” and “money in the broader sense” in order to explain his circulation credit theory of the trade cycle.

I have stressed these aspects of *The Theory of Money and Credit*—and earlier in the paper, I dwelled on the exposition in *Human Action*—to show that the thesis of Salerno (2012) has firm roots. It is true that Mises has kind things to say about free banking in *Human Action*, and his section on “The Case Against the Issue of Fiduciary Media” (pp. 322–25) in *TMC* is ambivalent. My modest point in this paper is that the entire Misesian framework of money and banking *denies the alleged ability of fractional reserve banking to enhance equilibration in the loanable funds market*.

Bagus and Howden (2010, 43) proceed along similar lines as the present critique when they imagine an individual who originally holds some gold coins under his mattress, but then—perhaps because of crime—decides to deposit them with a bank in exchange for notes. Bagus and Howden argue that the individual’s newfound willingness to hold banknotes should not be a signal to the bank to issue more loans to the community, because there is no act of net saving here.

However, in fairness Selgin could respond⁶ that in this case, the commercial bank would *not* find it profitable to issue more notes than the ones that would be held by the man (who first deposited his gold coins). It is only when the community wants to increase its *total* money holdings broadly defined (at given prices), Selgin would argue, that the profit-maximizing fractional reserve banks would find it in their interest to issue new loans (or engage in credit expansion, in Mises's terminology).

Yet we can tweak the thought experiment to shore up Bagus and Howden's critique. Suppose we have a gold-using community that is at an initial monetary equilibrium (in Yeager's 1997 sense) and a loanable funds market equilibrium where the market and natural interest rates coincide (in Wicksell's [1898] 1962 sense). Now suppose every single person in the community becomes more fearful for the future, and desires to increase his or her real cash balances by 10 percent. Under 100 percent reserves, the only way this can happen is through additional mining and/or falling prices (quoted in gold). Yet with FRFB, this sluggish adjustment can be neatly sidestepped: Each individual goes to the bank and takes out a loan, in the form of newly printed banknotes (claims on gold), which he or she then adds to cash balances. The community achieves its desired increase in cash holdings without "wasting" real resources digging up more gold, and without the discoordination of disequilibrium sticky prices.

The only odd thing about this scenario is that when asked to explain how this maintenance of "monetary equilibrium" can avoid disrupting the loan market, Selgin et al. would have to say, "Each individual in the community lent himself the extra money he is now holding."

⁶ It is awkward that Selgin had a chance to respond to Bagus and Howden on this point and chose not to; I am therefore reduced to suggesting what he *could* have said (but did not). Also, an anonymous referee disagrees with my attempt to speak on behalf of Selgin; the referee believes Bagus and Howden's example works as is. In any event, my own thought experiment in the text above perhaps makes the point even more forcefully.

IV. THE ALLEGED HISTORICAL SUCCESS OF FRFB

Besides the theoretical arguments, the proponents of FRFB claim that history vindicates their position. For example, Selgin (2000) argues:

Episodes of systemwide bank failures and serious bank over- and under-expansion have been less common than is often supposed. **The episodes that have occurred can generally be shown to have resulted not from any problem inherent in fractional reserve banking but from central bank misconduct or misguided government regulation or both....** Where fractional reserve banks have operated free of both significant legal restrictions and the disturbing influence of central banks, as **in nineteenth-century Scotland, Canada, and Sweden** (to name just a few cases that have been studied), **serious banking and monetary crises have been rare or nonexistent.** (Selgin 2000, 98; bold added.)

In blog posts, Selgin has held up Canada and Scotland as epitomizing the success of his vision of money and banking. For example in a 2018 post Selgin begins:

As all dedicated *Alt-M* readers know, **I am a big fan of the Canadian banking and monetary system** that flourished between Canada's Confederation in 1867 and the outbreak of the First World War. Besides thinking it was a darn good system, **I also regard it as the best example, together with Scottish banking during the first half of the 19th century, of a "free" (that is, largely unregulated) banking system.** (Selgin 2018; bold added.)

In the above quotation, Selgin's phrase "I am a big fan of the Canadian monetary and banking system" is hyperlinked to his earlier 2015 post praising the Canadian system, saying it was "famously sound and famously stable." This claim is in turn linked to an endnote where Selgin informs the reader, "For a very good review of the features and performance of the Canadian system in its heyday, see" R.M. Breckenridge (1895), *The Canadian Banking System: 1817–1890*, which is a nearly 500-page book on the subject.

Thus we have Selgin himself singling out the two apparently best examples of his brand of FRFB in action: Scotland and Canada, during the appropriately defined years. And yet, as we will see, both examples hardly seem exemplary, and if anything *confirm* the warnings of the Austrian critics of fractional reserve banking.

Free to Refuse: Scotland During the Free Banking Period

We can quickly deal with the case of Scotland by quoting from Murray Rothbard's (1988) review of Larry White's (1984) book on free banking in Britain. Rothbard observes:

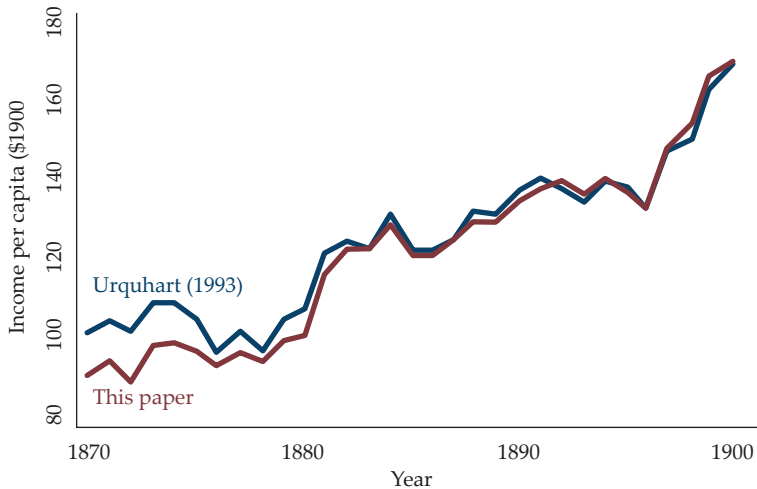
From the beginning, there is one embarrassing and evident fact that Professor White has to cope with: that **"free" Scottish banks suspended specie payment when England did, in 1797, and, like England, maintained that suspension until 1821. Free banks are not supposed to be able to, or want to, suspend specie payment**, thereby violating the property rights of their depositors and noteholders, while they themselves are permitted to continue in business... (Rothbard 1988, 230–31; bold added.)

The fact that the Scottish banks suspended specie redemption *for more than two decades* and were not forced to close their doors, proves that they were clearly not following the textbook exposition of a "free bank," which is allowed to maintain fractional reserves but of course is still subject to standard legal rules concerning contract enforcement. As Rothbard goes on to note, the fact that Scottish specie reserves fell to "a range of less than 1 to 3 percent in the first half of the nineteenth century" hardly clinches the case for fractional reserve banking. It is not surprising that "free banks" in Scotland let their reserves dwindle so low, when they were "free" to turn their customers away who demanded specie redemption.

Don't Blame Canada: Economic Volatility During the "Famously Stable" Era

As we established earlier, besides the celebrated case of Scotland, Selgin also held up Canada during the period 1867–1914 as the best example of FRFB in action, saying its banking system was "famously sound and famously stable." In this subsection I will offer some evidence to the contrary, relying (in part) on Selgin's own cited source.

First we can get a sense of Canadian stability by looking at a recent update (using a new method to calculate the GNP deflator) of estimates of GNP per capita. The following figure is taken from Hinton and Geloso (2018), contrasting the standard series by Urquhart (1993) with their slightly revised version:

Figure 1. GNP per capita using different deflators

Source: Figure 3 from Geloso and Hinton (2018), where “This paper” refers to Geloso and Hinton.

Note that the period covered in the figure (1870–1900) is a subset of the period Selgin identified. And yet, as the figure indicates, the Canadian economy exhibited nothing like smooth steady growth. Depending on which deflator we choose, per capita GNP had a sharp or modest boom-bust cycle from 1872–78, at which point it soared, rising some *30 percent* in a mere four years (1880–84). Then in a single year (from 1884–85), real per capita output fell a little more than 6 percent. (To get some perspective, during the Great Recession—which of course is the worst economic calamity to hit the world since the Great Depression—the biggest year/year drop in U.S. real GDP per capita was 4.9 percent, which occurred in the second quarter of 2009.⁷)

After the trough in 1886, there was another expansion through 1891, followed by another multiyear contraction. Then from 1896–1900 we see the beginnings of yet another massive boom, with real output per capita again rising about 30 percent in four years.

⁷ Data for U.S. real GDP per capita available at: <https://fred.stlouisfed.org/series/A939RX0Q048SBEA#0>.

Now in fairness to Selgin, 19th century economic data are notoriously prone to exaggerate the volatility in real output during business cycles, because of imperfect adjustment of the relevant price deflators. (This is why I used a chart taken from a very recent paper, which itself quibbled with the standard reference in the literature.) Yet even if Selgin and other FRFB advocates want to claim that the wild swings in Canadian output were mostly nominal, *that still contradicts their claim of stability*. Under the classical gold standard, nominal prices rose during booms and crashed during busts, but that was (at least partly) due to fractional reserve banking, where the bankers fed the boom by inflating through credit expansion and then starved the bust by deflating through credit contraction. The figure above—whether we take it at face value or even if we generously suppose it is partially mistaking nominal swings for real ones—is exactly what Murray Rothbard would suppose a FRFB economy would look like. It is *not* how the FRFB writers describe their vision.

Ironically, even if we turn to the very source Selgin cited—namely, R.M. Breckenridge’s (1895) large book on the Canadian economy—we find decent support for the claim that FRFB fosters the standard Mises-Hayek business cycle.

For example, in the Table of Contents, this is how Breckenridge lays out the topics in Chapter VIII:

Figure 2. Excerpt from Table of Contents of Breckenridge (1895)

CHAPTER VIII.—BANKING UNDER THE CONFEDERATION, 1867-89	
§43.—The Expansion between 1867 and 1873.....	264
§44.—Depression, 1874-1879	272
§45.—Bank Failures and Losses, 1874-1879.....	279
§46.—The Bank Act Revision of 1880.....	288
§47.—Dominion Note Legislation, 1872-1880.....	295
§48.—1880-1889.....	297
§49.—Bank Failures, 1883-1889 ..	305

Notice that the material in Chapter VIII covers the Canadian banking system for the first 22 years after Confederation—all of this falls under the period that Selgin singled out as epitomizing a sound, stable, fractional reserve free banking system in operation.

Now surely one does not have to be a fuddy duddy Rothbardian to say that the subject headings for Chapter VIII are inauspicious at best for the FRFB camp. We see a six-year “expansion” followed by a five-year “depression,” and a section devoted to the bank losses during the depression. The 100 percent reservists can now add Selgin’s recommended text as further evidence that FRFB fosters the Mises-Hayek boom-bust cycle.

Now to be fair to Selgin, Breckenridge *is* a fan of the Canadian banking system that he is describing. For example, here is how Breckenridge concludes his discussion of bank failures through 1889:

Here ends, for the present, the account of bank failures in Canada. If any conclusion may be drawn from the study, it is that **the disasters have been due to faults of practice, rather than defects in the system.** It is clear that legislation, scientifically framed, has not prevented poor management, bad management, or fraud. No one, probably, ever expected it would. It is clear also that it has not saved shareholders from loss. A careful estimate shows that, by reductions of capital, liquidations, failures, and contributions on the double liability, shareholders have sunk at least \$23,000,000 in Canadian banking since the first of July, 1867. **This sum, more than 37 per cent. of the present paid-up banking capital, is independent of the losses provided for out of profits,** or met by reduction of rests [sic]. **The security of a group of banks, however, must be judged, not by the losses of their proprietors, but by those of their creditors.** We may see now how well the Canadian system has minimized the creditors’ risks. **Out of 56 chartered banks, some time in operation in Canada since the first of July, 1867, just 38 survive.** Ten of those gone before have failed. But the **total loss of principal inflicted during twenty-seven years on noteholder, depositor, government, or creditor whomsoever, has not exceeded \$2,000,000, or less than one per cent.** of the total liabilities of Canadian banks on the 30th day of last June. (Breckenridge 1895, 314; bold added.)

And so we can see the sense in which Selgin could think the Canadian free banking system was vindicated. After all, the restaurants on a busy downtown strip (say) might be characterized by a high turnover, yet so long as entrepreneurs enter the field with eyes wide open, this could be a healthy example of cutthroat competition and Schumpeterian innovation. A high percentage of restaurant failures in a certain area would not necessarily prove that the market was failing consumers.

However, there are serious problems with such an attempt to rehabilitate the Canadian experience. First of all, in our hypothetical

restaurant analogy, we surely would not say, "The disasters have been the fault of the restaurants' management, not the system." When you have to use the word "disaster"—as Selgin's own preferred authority on the Canadian experience did—it is hard to maintain the claimed badges of stability and soundness.

Furthermore, Selgin is moving the goalposts if he thinks loss of customer deposits is the criterion for a desirable banking system. The claim—from Mises and Hayek through Rothbard up to writers such as Salerno in the present day—has always been that credit expansion sets in motion an unsustainable boom. Breckenridge's historical account confirms that claim beautifully. To put the matter another way: By Selgin's criterion, we could just as well "prove" that the *United States* banking system from 2000–10 was perfectly stable and sound. After all, no bank customers lost *any* deposits in standard checking accounts, and there were no banking panics of the kind witnessed during the 1930s.

As a final note, Breckenridge's figure of a mere \$2,000,000 in creditor losses is misleading. As Breckenridge explains earlier in the book, troubled banks had suspended note redemption, and in the consolidation process some depositors had to sell their notes at a loss, even though those notes would *eventually* be redeemed at par. This affected the public's mood—imagine that!—when the bank charters came up for renewal:

The expiry of all bank charters had been set for the 1st of July, 1881. In accord with the policy adopted a decade before, Ministry and Parliament took up... the question of what changes to make in the system at the time of the first decennial renewal of charters.

They were anticipated both by the public and the banks. **Among the people, much dissatisfaction had been caused by the bank suspensions of the preceding year. The notes of only one of the failed banks were finally redeemed at less than their nominal value, but at that time liquidation in several cases was still incomplete. To change the notes of failed banks into convertible paper, the holder had to submit to a discount, and the brokers who took the risk exacted ample pay for it. Many of those holding notes at the times of suspension had only the option between this loss and physical want.** They were forced to realize at the time when the credit of their debtors was at the lowest ebb. They could not even wait until the fears of the first week were quieted, much less till the day of final payment....

The bankers understood the popular discontent with the security of the currency. They saw their own interest, and the country's interest, no doubt, in calming it. For them, their privilege of circulation provided an easy, convenient, and useful means of profit; to the country, it gave an elastic currency, increased sources of discount, and through the system of branches promoted by it, widespread and accessible banking facilities. (Breckenridge 1895, 289–90; bold added.)

Whatever one might say about the block quotation above, it hardly sounds like a description of a smoothly operating free market, bereft of political favoritism, and where customer satisfaction is Job #1. On the contrary, it sounds exactly like the negative picture painted by a Rothbardian critic of fractional reserve banking.

Our brief sketches of Scotland and Canada have shown that the two examples held up by Selgin were plagued by decades-long specie suspension on the one hand, and depression coupled with bank failures on the other. It leads the critic of FRFB to doubt the accuracy of Selgin's assurances that all major problems with banking in history were the fault of anything *but* fiduciary media.

V. CONCLUSION

The intra-Austrian debate over fractional reserve banking is long and contentious. In the present paper, I have focused on the specific issue of whether fiduciary media per se set in motion the boom-bust cycle. I have shown that even the very definitions Mises chose in his monetary theory underscore this elemental fact. Furthermore, the FRFB attempts to reconcile credit expansion with loan market equilibrium fall apart when subjected to simple thought experiments. Finally, I have shown that Selgin's two favorite examples of the alleged stability of FRFB—Scotland and Canada—are in fact textbook illustrations of the dangers of fractional reserve banking.

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THE MENGER-MISES THEORY OF THE ORIGIN OF MONEY—CONJECTURE OR ECONOMIC LAW?

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JEL CLASSIFICATION: B13, B40, B53, E40, E42

ABSTRACT: In recent years some economists have begun to doubt the scientific standing of the standard Austrian theory of the origin of money. They seem to think that it is only one possible solution to the problem of accounting for money's value. Of these economists, Gary North (North 2012b) has presented the most cogent counter-interpretation to how we should understand the theory of the origin of money as elaborated by Carl Menger and Ludwig von Mises. Unlike the rest of economic theory, the origin of money and Mises's regression theorem do not partake of the character of a scientific law deduced from the basic principles of the science, but is rather, and is presented as such in the writings of Menger and Mises, what North terms "conjectural history." In this essay we will respond to North's challenge and to the economists who agree with him.

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1. INTRODUCTION

In his essay (North 2012b) for the 2012 volume in commemoration of the centennial of the publication of Mises's *Theory of Money and Credit* (Hülsmann 2012b), Gary North poses a challenge to our understanding of monetary theory. Carl Menger and Ludwig von Mises, North argues, did not really integrate their theory of the origin of money into the rest of economic science. Rather, this part of the theory of money exists in the netherworld of conjectural history: it is plausible, given what money is today, that it came about the way Menger and Mises speculate, but it is by no means certain. It is simply the most convincing account to scholars in the Austrian tradition, but other accounts are possible, and given the lack of historical evidence, there is in the final analysis no way of settling the issue.

This argument is worthy of response, especially given the authority of the source, and the fact that other monetary theorists seem to agree with Dr. North in demoting the regression theorem (White et al. 2014) from the realm of pure theory. In other publications Dr. North has lucidly explained and discussed the Misesian theory of money (see North 1993, 2012a), so it might well be that he has discovered serious objections to the regression theorem and the origin of money as stated by Mises and Menger. We do not believe, however, that North's position can be sustained and that we have to demote the regression theorem to a matter of historical conjecture. In the following we will attempt to show why.

We will proceed by first restating North's thesis: the origin of money and the regression theorem are best understood as a historical hypothesis concerning how money could have come about. We will then examine in more detail how Menger and Mises themselves conceived of the status of the theory of the origin of money in the corpus of economic laws. Finally, we will answer North's challenge by showing the impossibility of any other origin of the value of money than the one Mises provides and argue for the logical nature of the temporal regression by which he proves it.

2. DR. NORTH'S CHALLENGE—THE ORIGIN OF MONEY AS A HISTORICAL CONJECTURE

Carl Menger began his *The Origins of Money* by rejecting the theory that money owes its existence to law or convention. Such

a law would surely have been remembered, there would be some material evidence for it—but there is no evidence, so therefore it is highly unlikely that this is how money originated (Menger 2009, 17). Gary North contends that the same is true of Menger's own theory. Menger understands money as evolving in a process of selection from the most marketable goods to a few and finally one good that comes to be used as the most common medium of exchange. This process takes place over time as first a limited number recognizes the value of acquiring more marketable goods in exchange for less marketable and the other members of society subsequently learn from the success of these entrepreneurs. (Menger 2009, 35–37) But there is no evidence for this, or, rather, Menger provides no evidence. Writes North:

[W]e expect some historical documentation. There is none. This creates a tactical problem. A defender of the fiat dictate theory of money's origin can invoke the same argument against Menger as he had invoked against the critic's ideological peers. Each side declares that the origin of money was rooted in a particular institutional arrangement. What seems reasonable to one commentator does not seem reasonable to the other. (North 2012b, 170)

Menger is caught in a dilemma. He has rejected the conventional or state theory of money because of the lack of historical evidence to support it, but Menger himself provides a history of the origin of money unsupported by factual evidence. Mises's explanation of the value of money based on the objective exchange value the monetary commodity had based on its non-monetary use before being adopted as money (Mises 1981, 130–31) runs into the same problem: there is no historical evidence for this process (North 2012b, 171). As another critic of Mises's regression theorem wrote: "there is no unbroken sequence of uninterrupted economic causation from that far away hypothetical day to the present, in the course of which that original quantity of value has exerted its influence." (Anderson 1917, 102) The history simply cannot be proven.¹

¹ Absence of evidence does not necessarily count as evidence against a given theory. There might be good reasons why we should expect no evidence and nevertheless hold to the theory. On the other hand, Menger was right to cite the absence of evidence against the state theory of money, since it is the type of historical conjecture that needs historical evidence to appear plausible. Our point

The origin of money, then, cannot be explained with the same apodictic certainty that Mises saw in the basic laws of economics. “[W]ith respect to the transition from value-in-use to value-in-exchange, the most we can say is that this transition was probable.” (North 2012b, 171). There is, in the very nature of the case, no evidence for the transition, since societies practicing barter were too primitive to leave any detailed inscriptions or records behind. The records we have from ancient civilizations are precisely from societies that already had highly developed monetary arrangements (North 2012b, 172). This is why we have to resort to conjectural history in order to understand how these arrangements came about.

Menger and Mises therefore resorted to what we may call a sort of conjectural history or developmentalism, following Nisbet (1969). Since there are no facts to investigate, they simply offered “a theory of how it could have happened, and more than this, how it must have happened, given the goal of individuals to improve their circumstances. Yet they stopped short of identifying their account as inherent in human action in the way that higher prices reduce the quantity demanded” (North 2012b, 174–75). This theory is reasonable and difficult to reject for an Austrian school economist, although other people, economists and non-economists alike, with a more positive view of the creative possibilities of state action, might find the story of the origin of money as a matter of royal proclamation more plausible (North 2012b, 173–74).

We must therefore conclude that the origin of money and the regression theorem as explained by Menger and Mises seem more consistent with human behavior than the state theory of money (North 2012b, 175). But this is a matter of conjecture, of developmentalism, not something we can deduce from the timeless axioms of human action.

3. THE ORIGIN OF MONEY AND ITS STATUS IN THE THOUGHT OF MENGER AND MISES

So much for the proposition that the origin of money is a matter of historical conjecture. But would Mises and Menger themselves

in this paper is precisely that the Menger-Mises theory of money does not require historical evidence to be accepted as valid. I thank Dr. David Gordon for this point.

recognize this interpretation of their thought? Or would they lay claim to a much stronger position?

Menger

In the case of Menger, there are some statements that would suggest that he was not opposed to the idea that the state could play a role in monetary affairs, including in introducing the common medium of exchange in the first place. In *Origins*, for instance, he writes that the state may not have introduced money, but that it certainly plays a role in standardizing it and perfecting goods in their monetary function (Menger 2009, 51–52). Similarly, in his *Principles* (Menger 2007, 262), Menger writes that “although the state is not responsible for the existence of the money-character of the good, it is responsible for a significant improvement of its money-character.”

The strongest statement Menger makes that seems to agree with North’s interpretation of the theory of the origin of money appears in his *Investigations*. Here he gives a précis of his theory of the origins of money, but he admits that not only can government authority serve to perfect and help smooth out the workings of the monetary system, it can even introduce the use of money through legislation (Menger 1985, 153). This is only true of modern conditions, when, e.g., a colony is formed from elements of an old culture. The primary, original way money emerged is still the same, but part of Menger’s argument for this is the absence of any evidence of state involvement in the process. Menger thus seems to agree with North that the origins of money are indeed a matter of conjectural history.

Yet this agreement is only apparent. Throughout his writings, Menger insists that he is using the same method in dealing with all the problems of economic science: “The methods for the exact understanding of the origin of the ‘organically’ created social structures and those for the solution of the main problems of exact economics are by nature identical” (Menger 1985, 159). He insists on understanding economics, including the origins of money, in terms of individuals and their actions led by their own interest:

As each economizing individual becomes increasingly more aware of his economic interest, he is led by this *interest, without any agreement, without legislative compulsion, and even without regard to the public interest*, to give his commodities in exchange for other, more saleable, commodities, even if he does not need them for any immediate consumption purpose (Menger 2007, 260).

All that is needed for the emergence of media of exchange is the existence of a different degree of marketability of the different goods brought to market: “*The theory of money necessarily presupposes a theory of the saleableness of goods*”² (Menger 2009, 21; cf. 2007, chap. 7). And while Menger may concede a role to the state in the modern management of money and in the introduction of money to new territories today, he is quite insistent on the organic origin and development of money as a market phenomenon: “Money has not been generated by law. In its origin it is a social, and not a state institution. Sanction by the authority of the state is a notion alien to it.” (Menger 2009, 51; cf. 2007, 261). This is not to say that Menger does not engage in historical conjectures. His account of how the precious metals came to be used as money is a hypothesis, not an historical account. But it builds on and presupposes his theory of the marketability of goods, just as he uses this theory to interpret the historical example of Mexican society at the advent of the Spanish conquerors (Menger 2007, 268–70).

Mises

If Menger can at times be interpreted in a way conformable to North’s view on the origin of money, Mises is much more adamant about the logical status of the regression theorem. Indeed, he writes (Mises 1981, 131–32) that it “provides both a refutation of those theories which derive the origin of money from a general agreement to impute fictitious value to things intrinsically valueless and a confirmation of Menger’s hypothesis concerning the origin of the use of money.” Mises also insists on the general *a priori* nature of monetary theory when he writes (Mises 1998, 38, 40): “In the concept

² ‘Saleableness’ and ‘marketability’ are both English translations of the same German word, *Absatzfähigkeit*. Throughout, when not quoting, we have chosen to use the terms ‘marketable’ and ‘marketability’ exclusively.

of money all the theorems of monetary theory are already implied” and: “Unaided by praxeological knowledge we would never learn anything about media of exchange. [...] Experience concerning money requires familiarity with the praxeological category *medium of exchange*.” Since he explicitly refers to his explanation as the regression theorem,³ it should be clear that he considered it part of the general body of economic theory, deducible from the basic axiom of human action.

To Mises, then, the origin of money follows once the conditions for it are given. In addition to an economic order based on division of labor and private property in the means of production (Mises 1981, 41), these conditions include a difference in the marketability of goods (Mises 1998, 398, 403). But once these are given, individuals will begin the process that will eventually result in the adoption of the most marketable good as money (North 2012a, chap. 1). That it must take place as a market process follows from Mises’s regression theorem: the value of a good as a medium of exchange presupposes an already existing objective exchange value which can only come from demand for it based on its use value (Mises 2016, 60).

And so it appears that neither Menger nor Mises really saw themselves as doing conjectural history. To them, the origin of money and the regression theorem are just as theoretical as the rest of economics. This is not to suggest that Menger and Mises necessarily agreed on all matters of epistemology and method, except for the fact that they were both rationalists in the broad sense of the term and wanted to explain economics on causal-realist lines. But Menger was an Aristotelian while Mises at least sounded like a Kantian.⁴ However, both were agreed that economics, including monetary theory, is a science best investigated by means of deductive reasoning, and that it rested on universally valid first principles or axioms, as Mises would say, and that the conclusions deduced from these were just as valid as the axioms themselves.

³ Mises’s first use of the term, so far as we can see, is in *Human Action*, p. 406. But the argument is clearly present in *Theory of Money and Credit*, and Hülsmann (2007, 236) writes that the regression theorem “would become one of the pillars of his monetary thought.”

⁴ However, it has been argued persuasively that Mises was much more Aristotelian than he might at first appear. See on this point Hülsmann (2003, 1–liv).

Nevertheless, it is still quite possible that they were mistaken. We therefore need to move on to an examination of the theory itself.

4. RESPONSE TO THE CHALLENGE: THE LOGIC OF THE TEMPORAL REGRESSION

“Can a governmental authority, even if it were the most violent and the most persistent, attribute an exchange value to an object, which has no exchange value at all for the human beings that take part in the commercial life?

[...]

The government authority could declare just as well that a mountain is twice as high as it is in reality or that two pounds are actually six pounds.”⁵

Gary North is not the only economist who has thought it necessary to relegate the regression theorem to the status of historical conjecture. Professor Selgin (White et al. 2014) is of the opinion that “[t]he regression theorem itself constitutes [...] but one particular solution [to the question of the origin and value of money]—a solution that might now be labeled ‘backward-looking’ expectations-formation.” Even Professor Hülsmann (White et al. 2014), citing Dr. North’s essay, thinks that “[f]rom an epistemological point of view, the regression theorem does not seem to be an element of Misesian praxeology. It does not concern an *a priori* causal relation.” For while the subjective value of money depends on the expected future purchasing power of money (PPM), these expectations are not necessarily based on the prior PPM, or the earlier objective exchange value in Mises’s terms. We should therefore rather speak of a progression theorem, since it is the expected future prices that determine present valuations of money (Hülsmann 1996, 169, note 21). Laurence Moss (1976, 21) has even stated that Mises was quite mistaken when he thought the only way the demand for money can be consistently incorporated into the general body of utility theory was by way of introducing historical prices.⁶

⁵ (Knies 1885, 1:189; quoted and translated in Gabriel 2012, 44–45)

⁶ However, Moss concedes (p. 28) that Mises’s use of historical prices to explain expectations-formation about future prices is “of great doctrinal importance.”

The notion that the regression theorem is not part of the corpus of theoretical economics or praxeology is thus one that seems to be gaining ground among monetary theorists. In what follows, we intend to reassert what we think is Mises's own conception of the regression theorem as an integral and necessary part of monetary theory. Even Menger's theory of marketability can, we contend, be shown to have universal validity, and the difference in degree of marketability to be a necessary precondition for the emergence of any media of exchange.

Before we proceed, however, we must make explicit the definitions of the concepts we are discussing. Money is simply the most commonly accepted medium of exchange. It does not matter that 'most commonly accepted' is an imprecise definition, since everything that is true in regards to money is true of all media of exchange (Mises 1998, 395). But it does mean that a precise definition of medium of exchange is required. Mises (*ibid.*) writes that

Interpersonal exchange is called indirect exchange if, between the commodities and services the reciprocal exchange of which is the ultimate end of exchanging, one or several media of exchange are interposed.

While Rothbard (2009, 189) says that

The tremendous difficulties of direct exchange can be overcome only by *indirect exchange*, where an individual buys a commodity in exchange, not as a consumer's good for the direct satisfaction of his wants or for the production of a consumer's good, but simply *to exchange again* for another commodity that he does desire for consumption or for production.

From these statements about the purpose of media of exchange, the following definition emerges: a medium of exchange is a good desired not for consumption or production purposes, but in order to exchange it against other economic goods.

As with 'medium of exchange,' marketability is a concept restricted to goods in a market economy. It has no applicability to a household economy or a socialist commonwealth. Marketability means the facility with which a good can be sold at prices that conform to the general economic situation (Menger 2007, 248), that is, without too much of a discount below expected market prices. Marketability, then, is a question of degree, of more and less

marketable goods. That commodities must differ in their degree of marketability and that this fact is of importance for the emergence of media of exchange we will explain below.

The Regression Theorem

Praxeology is a science that deals with change through time. Change and temporal sequence are inseparably linked, and since action aims at change, it is in the temporal order (Mises 1998, 99). Yet most of economic theory can be elaborated without regard to time. The price of a capital good, for instance, is determined by the discounted marginal value product. While this determination looks to the future, the theoretical determination is essentially timeless, as is shown by the fact that it is elaborated under conditions where the element of uncertainty and change is assumed away (Rothbard 2009, chap. 7; cf. Mises 1998, 245–51 on the evenly rotating economy).

The regression theorem, however, and the explanation of the origin of money need to incorporate the temporal dimension. It describes a series of events that must follow one upon the other in order to establish how money came to exist and why it has the value that it has in the present moment:

The central difficulty was the interdependence between the subjective value of money (SVM) and the PPM. Money was valuable because it had purchasing power, but the purchasing power resulted from the SVM. This seemed to be an instance of circular reasoning, not of causal analysis. But Mises could solve this problem by developing an explanation which he found in Wieser: SVM and PPM did not determine one another *simultaneously*—which would have precluded causal analysis—but *diachronically*. Today's SVM determined today's PPM, which in turn determines tomorrow's SVM, which determines tomorrow's PPM, etc. (Hülsmann 2012a, 10)

Or, as Mises put it: if the history of prices of any consumer or producer good were to be wiped out, the price system would soon reestablish itself, since these prices only depend on the judgment of actors as to the good's ability to alleviate present and future needs. But were all knowledge about the value of money to disappear, it would be impossible to reestablish the system, precisely because the use of a good as a medium of exchange is dependent on knowledge

of its past purchasing power. Men would have to start over with the process of selection of the more marketable goods as media of exchange (Mises 1998, 408).

It is this temporal nature of the theory that may suggest a historical conjecture instead of logical analysis. Benjamin Anderson, whom we have already had occasion to cite, objected to Mises's theory precisely because he wanted a logical analysis of the value of money. He thought the temporal regress, although interesting, hypothetical and abstract and not really compatible with a logical analysis of the present forces determining the value of money (Anderson 1917, 103–4). The question therefore is: can a logical argument, *contra* Anderson's implication, integrate the temporal element into our understanding of the value of money?

Indeed, the laws of logic are more than capable of doing the job. We may take Aristotle for our guide in this question (*Posterior Analytics* 95a10–96a19, 1984, 1:157–59. The example of the house is on p. 158). In the form of a syllogism, we start with the (later) effect and want to deduce the (earlier) cause. We do this, as with all syllogisms, by connecting them by means of a middle term that persists through time from cause to effect. Aristotle gives the following example: Consider a house. We can know from the existence of the house that there must have been stones. This is so because in order to have a house, there must have been a foundation on which to build it; and before there was a foundation, there must have been stones out of which to make the foundation. From the fact of the house now we can reason to the existence of the stones earlier.

Two features of Aristotle's argument are perhaps of special interest to our present considerations. The first is that such reasoning must proceed from effect to cause. This is so since there will be an interval of time between the existence of the cause and of the effect, and during the interval it will obviously be incorrect to say that the cause has caused the effect. The second is that the connection between cause and effect, the middle term, must be coeval with both—but cause and effect need not be coeval with each other. Now, in Aristotle's own example, stones and house do in fact need to exist simultaneously once the house is constructed, but we can easily think of other examples where this is not the case. The clearest example is perhaps that of a child and his father: from the

existence of a child now, we can infer that his father once existed, even if he does not now exist. To return to the sphere of economics, when we see a price offered for a good, we can infer that the good is subjectively valued by someone, and that this subjective value is precisely the cause that moves him to offer something in exchange for it—abstracting from speculative demand for the moment.

How does this apply to the regression theorem? It highlights, first of all, that Mises was correct in asserting that he delivered the proof for Menger's hypothesis as to the origin of money. Beginning at one end of the chain of causation with the existence of money of a given value, Mises traced the cause of this value back through time, through the subjective estimations of future exchange value based on the objective exchange value of the moment just past, to the point when the objective exchange value was based only on the good's use-value (Mises 1998, 406). Precisely because it is an argument proceeding from effect to cause is this certain. This is not to say that Menger's argument did not proceed in basically the same manner. But he began *in medias res*, so to speak, with the cognition by the economic subjects in a barter economy of the higher marketability of some commodities, and therefore laid himself open to the criticism that his reasoning from there to the existence of money is a mere conjecture.⁷

The other point worth emphasizing is that cause and effect need not exist at the same time. It is enough that there is an intermediate cause, or series of causes, leading from the existence of money today back to its origin in the first demand for a good with an objective exchange value for use as a medium of exchange. The use-value that is the terminus of this series of causes need not be present throughout. Again, Mises was the first to clear up this point in the earlier theories.⁸ Anderson (1917, 102) was quite right in doubting that an "emotion" felt 10,000 years ago could have any

⁷ To be clear, we think the logical structure of Menger's argument is the same as Mises's: he began from the fact that some goods were chosen as media of exchange and sought for the explanation in the array of market exchanges based on the difference in marketability.

⁸ An economist named Oppenheim argued already in 1855 that money could continue to function as such once its original use-value has disappeared (Menger 2007, 319). So Mises may have had a forerunner in taking the theory of the value of money to its logical conclusion.

direct connection to the value of money today. No one claimed that it should. All the regression theorem claims is that at one point there was a good with objective exchange value based on such an “emotion” which was then gradually adopted as money. This is necessary since we need prices of goods—objective exchange value—in order to have a marginal utility of money (Rothbard 2009, 277, note 22). If we keep in mind the importance of the marketability of goods, we can see that this objective exchange value must have been a more or less constant phenomenon through space and time in order to ensure the adoption of a good as money. But as a matter of logic, as soon as a good is valued as money, its value can persist even should its use value disappear entirely. Rothbard (2009, 275) makes this point clear:

Once a medium of exchange has been established as a money, money prices continue to be set. If on day X gold loses its direct uses, there will still be previously existing money prices that had been established on day $X - 1$, and these prices form the basis for the marginal utility of gold on day X . Similarly, the money prices thereby determined on day X form the basis for the marginal utility of money on day $X + 1$. From X on, gold could be demanded for its exchange value alone, and not at all for its direct use. Therefore, while it is absolutely necessary that a money *originate* as a commodity with direct uses, it is not absolutely necessary that the direct uses continue after the money has been established.

The value of money, in short, has two components: its use value and its exchange value, and these are analytically distinct. Strictly speaking, only the second source of value is necessary for a money to function as such, and it is precisely its exchange value which has a temporal component (Rothbard 1988, 180–81). It relies on knowledge of past objective exchange value in order for the economic actor to form his present judgment about the subjective value to him of units of the monetary good. And this objective exchange value must at some point have originated in valuations based only on use value. But once the good is established as money, it can persist solely on the basis of its exchange value.

An argument made by Professor Kirzner in an unpublished paper can help us clarify what we are claiming for the nature of money. Kirzner correctly points out that the way out of the circularity in the explanation of the value of money is to take account of expectations

in its determination. Mises's regression theory, according to Kirzner, is just one way to do this (Kirzner n.d., 6). However, he goes on to say (*ibid.*, 7) that

It should be observed, in any event, that insofar as potential buyers of *any* commodity base their price bids for it on anticipated—if speculative—possibilities of resale, these bids involve price expectations in exactly the same way as do those for money."

With this we cannot agree. This is to collapse specifically monetary demand into a general speculative demand and to erase the distinction between monetary goods and goods simply held in anticipation of selling them in the future at a profit. Speculative demand means demand based on the expectation of future profit. Speculative demand like all entrepreneurial action is about dealing with uncertainty. As such, all action is speculative, since there is always an element of uncertainty attached to it (Mises 1998, 254; Huerta de Soto 2010, 15ff). But speculation is especially about bearing uncertainty and, in the market economy, about maximizing profits.

Monetary demand is specifically demand for a medium of exchange based on the expectation of being able to exchange it for units of the goods the actor really wants. It is about minimizing uncertainty in the actor's future market exchanges by increasing the marketability of the goods he brings to market (Hoppe 2012). While there may at times be a particular speculative component in this demand—if, for instance, the actor adds to his cash holdings in anticipation of an expected increase in the PPM—the demand for money is *sui generis* and determined by the anticipated use value of the goods that can be exchanged against each unit of money and the subjective value of owning a marketable good. The yield from money held in cash balances is derived from the services it renders, i.e., from the expected future exchanges the actor expects to carry out with it (Hutt 1956, 198. Hutt recognized that part of the value of money might be speculative, but the main determinants of the value of money are still the expected future exchanges, as the speculative element is derived from this expectation). Mises at one point expresses this by saying that, in the case of money, subjective use value and subjective exchange value coincide (Mises 1981, 118). Or, rather, in order to make clear the distinction between the value of holding money and of its services, the use value of

money is derived from its subjective exchange value.⁹ The value of the marginal unit of money depends on what the actor expects to be able to exchange it for, and the size of the individual's cash holding therefore depends on knowledge of the objective exchange value of money in the way Mises explained. Acquiring and holding money, then, is not in itself a speculation in future uncertainties, but an attempt to reduce the costs inherent in future exchanges by increasing the chances of quickly and easily completing one's market transactions.

This should, we think, also answer Hülsmann's objection. While we agree entirely that it is expected future prices that determine the present demand for money, such expectations must have a starting point. If this starting point is not based on prior exchange value, whatever array of prices the actor assumes is completely arbitrary. But the demand for money is precisely not arbitrary, so the value of money must be traced back in time to the point when acting man first demanded a given good for its services as a medium of exchange based on his appraisal of the good's already existing objective exchange value as determined by demand based on its use value and on his judgment as to its expected higher marketability.

The Theory of Marketability

The concept of marketability might appear to depend on empirical assumptions as to the qualities of the goods exchanged in the market. Our contention is that no such assumptions are needed—goods exchanged in the market must by necessity differ in their marketability. Hoppe (2006, 182–83) suggests as much, although he does not expand on this point. For there to be any market and division of labor, there must be a plurality of goods serving different ends. Demand for these goods cannot be equal—if they were equally in demand, this could only be because they were considered equal in their services, in other words, equally good at helping man achieve his ends. But this would, as Hoppe claims, mean that they were simply units of the same type of good. The

⁹ Salerno (2015, 74) and Edwards (1985, 53) make clear that Mises made this distinction, even if he did express himself imprecisely at times. In this case, this is due to the influence of Wieser on Mises's thought, *cf.* (Hülsmann 2007, 238–39).

basic cause of difference in marketability, then, is unequal demand.

A few general remarks can be made about differences in marketability. Those goods demanded by more people will be more marketable than those goods that have a narrower market, i.e., goods with a 'deeper' market are more marketable.

Other causes also influence the degree of marketability – durability, for instance. Menger's (2009, 29–32) detailed exposition of what influences marketability introduces various empirical assumptions, but it is still a matter of theory, not conjecture.

A Note on the Challenge of Bitcoin

Has the emergence of bitcoin and other crypto-currencies as media of exchange disproven the Mises-Menger account of the emergence of money? After all, bitcoin were intended to serve as money by its creator(s), and since it has market value now, this would seem to suggest that its value need not be based on a prior commodity value. Economists who have analyzed the issue do not think that the regression theorem has been invalidated by bitcoin. Davidson and Block (2015) argue that bitcoin is not a challenge at all, since the regression theorem only applies when money emerges out of barter; Barta and Murphy (2014) argue that since bitcoin is a medium of exchange now, it clearly cannot contradict the regression theorem; Konrad Graf (Graf 2013, 3–4) writes that “[n]o contradiction between Bitcoin and the economic-theory insights associated with the regression theorem is possible”; and, finally, Peter Surda (2012, 38–43) argues persuasively that bitcoin conforms to the regression theorem.

The reason for debate on this subject is, we think, that bitcoin and other crypto-currencies were designed to be media of exchange. It could thus seem that private individuals had simply willed a new medium into existence. But the intentions of the suppliers are completely irrelevant—the nature of a good depends on the nature of the demand for it, not what the producers had in mind when they produced the good. What is often called the first transaction where bitcoin was used as a medium of exchange shows this clearly. On May 22 2010, one person “laszlo” bought 2 pizzas paying with 10,000 bitcoins. On the surface, this may look as the first use of bitcoin as a medium of exchange. In reality, what happened was that one person,

“jercos”, in search of bitcoins, bought 2 pizzas using his credit card to trade for 10,000 bitcoins because he knew someone were willing to make this trade. If any good in this exchange was used a medium of exchange, it was the pizzas, not the bitcoins. It may be very hard to find out why exactly people valued bitcoin before it was used as a medium of exchange, but it is hopefully clear that some such value is necessary in order to be able to use bitcoin and all other crypto-currencies as media of exchange. What is different in the case of bitcoin from the original emergence of money out of barter is that only one price needs to be established before bitcoin can be used as a medium of exchange—namely, their price in terms of already established money.

5. IS THERE A PLACE FOR CONJECTURAL HISTORY?

The regression theorem is then not a matter of conjectural history. But this does not mean that we cannot make historical conjectures about how events unfolded and institutions were established. In the field of money, however, such conjectures cannot contradict the basic theory.

The account of the emergence of money that Menger gives us can be said to be conjectural history. Based on economic theory, he suggests how and why the precious metals specifically were selected as money due to their greater marketability. There was a constant, widespread demand for these goods for use and at the same time a widespread supply of them, making it easy to bring them to market. From these broadly historical facts or assumptions, Menger describes how the monetary metals were gradually chosen as the most commonly used media of exchange in a process parallel to and dependent on the accumulation of capital goods and the intensification of the division of labor. As such, it is a highly plausible story, and one which seems to receive some confirmation from Menger’s Mexican example¹⁰—but other conjectures are possible. It is not possible, however, to make a historical conjecture at odds with the core of the Menger-Mises theory—that the medium of exchange must have had a preexisting exchange value not based

¹⁰ More recent scholarship is also highly suggestive of the origin of money as a market phenomenon, completely independent of state sponsorship or interventions. See (Le Rider 2001, chap. 1).

on its monetary use, and that the selection of the medium was due to its greater marketability.

Can we, then, make conjectures that concede a larger role to the political power in the origin of money? Only if the actions taken by that power in pursuit of its goal of introducing indirect exchange or influencing the choice of the money commodity conform to the laws of economics (Mises 1981, 83–94). Three broad approaches may be used by the state in its attempt to influence the choice of media of exchange:¹¹

1. It can try to increase the objective exchange value and increase the marketability of some goods by always being ready to buy them in the market and sell them again against the commodities the market actors want to sell. This procedure is obviously limited by the economic resources of the state, but could possibly decide the issue between two goods of roughly the same quality competing for the role of most common medium of exchange. So the state may decide the choice between the gold standard and the silver standard, as, for instance, the US government did by demonetizing silver in the Crime of '73.
2. It can try to confer use value on some goods and make them more suitable as media of exchange by making them legal tender for the settlement of debts. Yet forcing people in a barter economy to substitute the sovereign's favored commodity for the one the parties to the exchange have agreed on simply disarranges all credit transactions. Credit is already very heterogeneous and probably very rare in a barter setting, and it is not conducive to the formation of money and credit markets to prevent them from operating to the profit of the market participants. Any government intervention substituting a means of payment for the one voluntarily contracted will serve to expropriate one party to the exchange to the benefit of the other. Instead of facilitating markets, this will make them cease functioning altogether.

¹¹ These remarks concern exclusively the influence of government on the emergence of money out of a barter economy. Mises himself discussed issues dealing with bimetallism and other monetary policies current at the time in the reference just given, while George Selgin (1994, 821–24) has applied Mises's insights to the introduction throughout history of new fiat money. I thank Dr. Patrick Newman for this reference.

3. It can try to confer use value on some goods and make them more suitable as media of exchange by making all taxes payable in these goods.¹² It could in this way make otherwise valueless things quite valuable. But another step is needed before they can become money—they must be recognized as the most marketable goods in the free estimation of the market.

These brief and by no means exhaustive remarks should be enough to make the point clear: if government intervention in the origin of money is to have any effect, it is only so long as the government conforms to the law of the market and recognizes that the choice of the monetary good is a matter of the relative marketability of the different goods. Any conjectural history of the origin of money that neglects this point is consequently inadmissible.

6. CONCLUSION

We have here tried to answer those economists who have begun to doubt the logic of Mises's regression theorem. Specifically, we have dealt with the challenge raised by Dr. North to the regression theorem and Menger's account of the origin of money. We have tried to show that these parts of monetary theory are truly praxeological laws, deduced from the basic principles of the science under the specific conditions needed for monetary exchange. Every time we come across a society using money, the value of the monetary good will have arisen in conformity to Mises's theorem.

This is not to say that there is no room for conjectural history in describing the origin of money. We have suggested that Menger's account of the establishment of gold and silver as money is in fact a historical conjecture—but it is based on economic theory, the theory of the marketability of goods, and only accounts so based will have any right to scientific standing.

Dr. North ends his essay with writing that he finds himself "knee-deep in developmentalism. This is not where I planned to be when I first read *The Theory of Money and Credit* in 1963." Hopefully, the present essay will be a help to him and other monetary theorists who find themselves trapped in the slough of developmentalism.

¹² Kuznetsov's (1997) idea about administrative goods is an example of this.

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TAKING GOVERNMENT OUT OF POLITICS: MURRAY ROTHBARD ON POLITICAL AND LOCAL REFORM DURING THE PROGRESSIVE ERA

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ABSTRACT: This paper analyzes and elaborates on what Murray Rothbard would have included in Chapter 10 of his nine-chapter manuscript on the Progressive Era (Rothbard 2017). In Chapter 10, Rothbard planned to describe the political and local reforms of the fourth party system (1896-1932). The reforms included voter registration, ballot changes, direct election of senators, the primary system, attacks on machine politics, the institutionalization of civil service, and the expansion of city governments. While many historians have argued that these changes were designed to expand democracy and reduce corruption, Rothbard would have shown how they were intended to restrict democracy and centralize power in the hands of established elites.

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A vital part of urban progressivism, as shall be seen further below, was a frenetic attack on the “corruption” of politicians... (Rothbard 2017, 285).

Democratic or legislative decisions were messy, “inefficient,” and might lead to a significant curbing of statism, as had happened in the heyday of the Democratic Party during the 19th century. But if decisions were largely administrative and technocratic, the burgeoning of state power could continue unchecked.... In short, government, in virtually all of its aspects, should be “taken out of politics” (Rothbard 2017, 440–41).

1. INTRODUCTION

The Progressive Era contains nine full chapters of Rothbard’s unfinished manuscript as well as later published essays on material Rothbard wanted to discuss (Rothbard 2017). Chapter 9, “The National Civic Federation: Big Business Organized for Progressivism,” documents the cartelizing state and local reforms pushed by big business, big government, and court intellectuals in the early-twentieth century. In Chapter 10, of which only notes remain because it was unfortunately not written, Rothbard would have continued his analysis of local Progressive Era interventions by analyzing both their political and urban reforms. Some of his important insights were included in the later published essays in *The Progressive Era* as well as in other writings (Rothbard 1962, 1974, 2011 [1978], 1995).¹ Rothbard’s lecture series “The American Economy and the End of Laissez Faire: 1870 to World War II,” given at Brooklyn Polytechnic in 1986, followed the format of the unpublished manuscript of *The Progressive Era* and continued where Rothbard left off. Immediately after finishing with the material provided in Chapter 9, the lecture series moved into his notes on the political and local reforms of the era (Rothbard 1986). Using his published writings and lectures, this paper discusses what Rothbard would have written about in the tenth chapter of the book.²

¹ Rothbard also briefly discussed these issues in Chapter 6 of *The Progressive Era*, “1896: The Collapse of the Third Party System and of Laissez-Faire Politics.”

² When citing material Rothbard planned to discuss, this paper will reference Rothbard’s published essays and lectures instead of the notes he used because they are readily available for the reader to consult (Rothbard n.d.).

Rothbard's central thesis was that the political and local reforms of the era—changes in voting procedures and how elections were conducted, creating new appointed committees, eliminating various elected positions, centralizing city power, and so on—were all measures that actually restricted voter choice and increased the power of insulated bureaucrats and special interests. All of this was cleverly done in the name of democracy and anti-corruption, when in reality it was just a camouflage to increase government power at the expense of local districts and individual voters. In addition, these interventions were part of a pietist, moralist assault on liturgical voters (e.g., ethnic Catholic minorities) and carried racial undertones. Much of what people complain about the modern political system on all levels of government, including the dreaded "Swamp," has its roots in these "enlightened" reforms.

2. POLITICAL REFORM: EXPANDING DEMOCRACY BY RESTRICTING DEMOCRACY

The increased government intervention during the Progressive Era, beginning during the McKinley (1897–1901) and especially the Roosevelt (1901–1909) administrations, could only take place after a seismic shift in the political realm. When the third party system (1854–1896) of fierce ideological and ethnoreligious conflict devolved into the fourth party system (1896–1932) of bland party similarity, this allowed for increased technocratic and governmental rule. Rothbard attributes this change to the collapse of the *laissez-faire* contingent of the Democratic Party, namely the liturgical Bourbon Democrats of the Northeast and the Midwest, of which President Grover Cleveland (1885–1889, 1893–1897) was champion. Before, these Democrats had formed a mighty bulwark that helped block many interventions on the state and federal level. President Cleveland and his allies worked to try and defend the gold standard, lower tariffs, and limit government spending such as by blocking increases in Civil War pensions.³ But in the important presidential election of 1896 the Bourbon Democrats, already weakened in the 1894 midterm elections from the aftermath of the harsh Panic of

³ For more on the battle over Civil War pensions to Union veterans, see Rothbard (2019).

1893 (for which they were unjustly blamed), were overthrown by the southern and western Populist Democrats. These pietistic and interventionist populists were led by William Jennings Bryan on a holy crusade of silver inflation and socialistic reforms. The modern interventionist Democratic Party was born. The Bourbons either left politics altogether, stayed in weakened positions in the Democratic structure, or joined the Republican Party.

The Republican Party was traditionally more interventionist than the Bourbons and was also the party of Yankee pietism, populated by evangelical Protestants, as opposed to the Democrats who were dominated by liturgical Lutherans and Catholics. Republicans and Democrats had traditionally fought over various social issues, such as prohibition, public schools, and immigration, with Republicans taking the more interventionist and Democrats the more *laissez-faire* stance. This extended to the economic realm. But with the threat of William Jennings Bryan on the left, the new Republican Party under the newly moderate William McKinley became less pietistic and more center statist. Liturgicals, notably the German Lutherans, left the Democratic Party en masse in 1896 for the Republicans, delivering a crushing victory for McKinley and the Republicans. As Rothbard put it:

In short, the election of 1896 left the United States with a new party system: a centrist and moderately statist Republican Party with a comfortably permanent majority of the country, and a minority Democratic Party roughly confined to the one party South and to Irish-controlled big cities of the Northeast and Midwest, which were nevertheless a minority in those regions. Gone was the sharp conflict of ideology or even of ethnic-religious values; both parties were now moderately statist in different degrees; both parties contained pietists and liturgicals within their ranks. The McKinley Republicans were happy to be known as the “party of prosperity” rather than the “party of great moral ideas.” The familiar lack of clear and genuine ideological choice between two dominant parties so characteristic of modern America was beginning to emerge. Above all, there was no longer a political party, nor a clear-cut constituency, devoted to the traditional American ideology of *laissez-faire* (Rothbard 2017, 178).

The stage was set for the fourth party system of general Republican dominance, and the Republicans increased their partisan lead in virtually every region except the South and the

thinly populated Mountain states. The lack of a viable rival party to the Republicans, the increased intervention and similarity of Republicans and Democrats, and a decline in ethnoreligious issues to rally the masses, led to a drop in voter turnout. For example, from 1840–1896 voter turnout in presidential elections outside of the South was 70–84 percent. In 1896 it was 78.3 percent, but afterwards declined to 59.7 percent in 1916. It has remained at 50–60 percent ever since (Rothbard 2017, 195).⁴ The stage was set, then, for the Progressive Era and the alliance of big business, big government, and court intellectuals to take over the political and economic system. The new corporate elite and their interventions would stand in the middle-of-the-road between “unworkable” laissez faire capitalism (because it prevented the establishment of monopolies) and extremist socialism (because it led to threatening confiscatory legislation) (Rothbard 2017, 163–97).

But voter turnout did not only decline from a decrease in ethnoreligious emphasis and the perceived similarity between the parties. In fact, there were new political “reforms,” beginning in the 1890s, that had ostensible democratic motivations but were really designed to reduce voter choice, especially among poorer, liturgical voters. They include changes in voter registration, the Australian secret ballot, the short ballot, women’s suffrage, political primaries and referendums, and the direct election of senators. Rothbard planned to devote significant space to these issues in Chapter 10.

Voter registration requirements and other restrictions became prominent during the Progressive Era. These included poll taxes and literacy requirements. They placed additional regulations on voting (such as to disallow alien voting), increased the time it took to become a citizen, and made it more difficult to become one. The ostensible reason was to reduce election fraud and increase transparency, but the real intended effect was to reduce participation of certain minorities, such as ethnic urban immigrants. These immigrants were generally liturgical (i.e., Catholics and Lutherans from southern and eastern Europe), who tended to vote for the Democrats

⁴ For a recent work summarizing the research on the decline in voter turnout in American politics, see Burnham (2010). In contrast to other political scientists, Burnham argues that the decline in turnout was real and not due to a drop in voter fraud, which was relatively insignificant.

and supported them on social issues (Rothbard 1986, 1:05–07, audio source).⁵ Nowhere was this restrictionist trend clearer than in the case of the South where restrictive Jim Crow legislation and racial hostility towards blacks caused voter turnout to plummet.⁶

The progressives openly praised the drop in voter turnout, since it allowed for “better” voting by more “knowledgeable” people and put planners and bureaucrats in greater control. As Thomas Leonard writes:

The progressive economists—or certainly the most outspoken among them—were not egalitarians and never entertained the notion that expertise could work through the people. They were frank elitists who applauded the Progressive Era drop in voter participation and openly advocated voter quality over voter quantity. Fewer voters among the lower classes was not a cost, it was a benefit of reform (Leonard 2016, 52).⁷

The adoption of the Australian “secret” ballot, beginning in the early 1890s, also fits this trend. Before, the parties themselves, particularly the urban political machines, distributed their own party ballots to make sure their constituents voted. With the Australian system the government provided both the ballot and the slate of candidates from which the different parties’ voters could choose. Again, a noble feature ostensibly enacted in order to increase transparency and reduce voter intimidation, but the real intended effect was twofold. First, it weakened urban party machines, which were mainly Democratic, by reducing their important function of providing ballots and whipping up the masses, educating them, and getting them to vote. Outside of the

⁵ This clearly went hand in hand with the movement to restrict immigration and introduce quotas during this period (Rothbard 2017, 151–56, 190).

⁶ Whereas voter registration requirements in the big cities was generally at the behest of rural pietist Republicans, in the South it was due to Democrats who wanted to disenfranchise blacks. Despite voter turnout plummeting in the South, the Democrats actually increased their partisan lead there while it fell in other regions (Rothbard, 2017, 40, 193–94). On the staunch racism of southern Democrats, see Bartlett (2008, 61–92). For the populists’ racism, which has generally been downplayed, see Postel (2007, 173–203).

⁷ For a review of this very important work, see Newman (2017).

South this benefited Republicans.⁸ Second, the government could decide who got on the ballot, which weakened third parties. Once again, voter turnout decreased. The short ballot innovation of the time period also had similar motivations and effects. Before, the people voted on a wide range of government positions. Now, the number of elected positions was reduced (i.e., shortened). This diminished voter participation because people would be less interested in voting since there were less positions to vote on (Rothbard 1986, 1:02–05). In addition, as will be explained in more depth below, it was part of the general movement to take various elected positions out of politics because the “ignorant” masses did not know how to vote on certain issues, and protect the entrenched bureaucrats in those positions. Let the experts decide instead of the *hoi polloi*.

Admittedly, there was one significant area where the electorate was actually broadened. This was the women’s suffrage movement, which culminated in the nineteenth amendment that passed in 1920. This movement had been building since the 1880s on the state level and was a drive sponsored by moralists because pietist Yankee women were more likely to vote than their ethnic female counterparts. Progressives eagerly continued this trend in the early twentieth century because women were also more likely to vote for interventionist policies and candidates. Once again, the progressives were concerned more about improving the quality of the electorate rather than the quantity *per se* (Rothbard 2017, 156–62).

When discussing the political interventions designed to reduce voter turnout, it is important to note that Rothbard always emphasized that the major reason for the decline in voter turnout during the fourth party system was not the registration requirements. Instead, it was the reduced emphasis on ideology and increasing similarity between the parties. Voter turnout actually increased in the thinly populated western Mountain states from the increased competitiveness between the populist Democrats and Republicans in the region, and voter registration restrictions generally applied only to urban voters, while turnout declined in both urban and rural areas (Rothbard 2017, 191, 194).

⁸ In the South the government ballots were obtusely written so blacks could not read them. This helped the Democrats (Burnham 1970; Kousser 1974; Kleppner 1978, 465).

There were other examples of election reform that had different effects than traditionally assumed, effects which helped contribute to the decline in political ideology discussed above. These included the direct referendum, compulsory political primaries, and the direct election of senators (the latter fulfilled in the seventeenth amendment in 1913). All of these were deemed necessary to increase voter participation and the range of issues and candidates the public could “directly” control. In reality, the real motivation was to weaken political parties and centralize power in the federal government. When state legislatures and state parties chose presidential nominees, senators, and decided on platforms, it increased the power of the decentralized political party branches and state governments. This acted as a bulwark against federal centralization and increased government intervention. In this system the political parties and their local organizations were important and meaningful, they collected similar positions on issues to produce a coherent and salient ideology, an ideology that instilled in the public a desire to join a political party and be active in it.⁹ Now, since candidates could directly run for positions and the people directly vote on certain issues, the decision making function of the political party was circumvented and hence weakened. Now anyone could run based on their public relations and charisma, disassociated from the party’s ideology, and this helped turned politics into a bland popularity contest with little difference between both candidates and parties. Combined with the contemporary enthusiasm for statism, this was a disaster for any system of limited government (Rothbard 1986, 1:07–09). To quote Rothbard on the new dispensation:

For the new non-ideological party system and demobilized electorate meant also that the political party *itself* became far less important in deciding government policy. And, along with the parties, their constituencies—the voting public—became less important in influencing government actions. This decline of the political party as well as its voting constituency left a power vacuum which... the new order of experts, technocrats, and organized economic pressure groups rushed to fill. The dominance of the new elites alienated still more citizens and

⁹ The standard myth of late-nineteenth century politics was that the party bosses in smoke-filled rooms chose presidential candidates against the wishes of the voters. For a recent work that challenges this myth and argues that party bosses often opposed the eventual presidential nominee, see Haynes (2016).

swelled the ranks of non-voters. The way was paved for the Progressive period (Rothbard 2017, 196).¹⁰

3. LOCAL REFORM: REPLACING VISIBLE CORRUPTION WITH LESS VISIBLE CORRUPTION

Reforms in the Progressive Era not only centered around the institutional voting process, but also on urban reforms relating to the creation of bureaucratic committees and the territorial expansion of cities.¹¹ As with the above material, Rothbard also planned to discuss this in Chapter 10, particularly the attacks on political machines, civil service reform, the city council movement, and urban imperialism. Urban reform was all in the name of creating a more “efficient” city that could be better managed by appointed commissioners and business elites, since local party rule led to corruption, inefficiency, and moral problems. Writes Rothbard:

[During the Progressive Era there] was the growing insistence, by progressive intellectuals and corporate liberal businessmen alike, that democratic decision-making must be increasingly replaced by the administrative and technocratic. Democratic or legislative decisions were messy, “inefficient,” and might lead to a significant curbing of statism, as had happened in the heyday of the Democratic Party during the 19th century. But if decisions were largely administrative and technocratic, the burgeoning of state power could continue unchecked. The collapse of the *laissez-faire* creed of the Democrats in 1896 left a power vacuum in government that administrative and corporatist types were eager to fill. Increasingly, then, such powerful corporatist big business groups as the National Civic Federation disseminated the idea that governmental

¹⁰ On the seventeenth amendment weakening decentralized state control, see DiLorenzo (2008, 151–59) and Napolitano (2012, 75–92).

¹¹ Urban reform also included the drive by progressivist intellectuals and social reformers to “clean up the streets” and remove sweatshops, prostitution, gambling, drinking, and other alleged evils of the city. In many instances these movements were led by pietistic females driven to shape society and increase government intervention. Seemingly altruistic, for many of the reformers it was just part of the attack on ethnic liturgicals since many poorer immigrants worked in these occupations and enjoyed the maligned “nightlife” activities, especially drinking alcohol. Larger businesses also supported the drive to eliminate sweatshops to the extent that they cut down on local, cheaper competition. Since Rothbard (2017, 204–05, 208, 293, 340–50, 400–20) discusses these issues at length, they will not be pursued further here.

decisions should be in the hands of the efficient technician, the allegedly value-free expert. In short, government, in virtually all of its aspects, should be “taken out of politics” (Rothbard 2017, 440–41).

Elsewhere, Rothbard continued:

The Progressive period was marked by a conscious shift of urban political power from local neighborhoods and wards, representing the mass of lower-income and middle-income citizens, toward a centralized rule by upper-income and business groups. The shift was cleverly put forward as the ouster of “corrupt” political party bosses and “ward heelers” on behalf of efficient, “nonpartisan” technicians, invariably consisting of upper-income and business groups. It became important for upper-income groups to control municipal governments as the scope of government intervention and activity accelerated, and as governments increasingly became the coveted source of contracts, franchises, tax assessments, and subsidies (Rothbard 1974, 21).

The attack on “corruption” was the code word for an attack on the ethnic (and hence Democratic) party machine. Machines were party structures consisting of professional men who gathered ideologies, votes, and provided rewards to their supporters. They also ran many important city functions and municipal services. A rising politician needed to work with a machine in order to ensure they would get the right connections and move up the ranks. Tammany Hall of the Democratic Party in New York City is probably the most well-known example of an urban political machine (Riordon 1963). They were certainly corrupt in that they were susceptible to bribery, committed extortion, and gave out favors, jobs (patronage), and services based on loyalty and connections rather than need or merit. But, as Rothbard planned to discuss, they had their purposes. In the first place, as mentioned earlier, machines and local parties helped rally the masses and got them interested in political affairs. Second, their desire to “buy” votes of the poor through acts of charity like hot soup and turkey dinners acted as something akin to a private welfare system. This bribery performed a valuable service to new immigrants who had little knowledge of the new country they entered.¹² Lastly, sometimes paying the corrupt government

¹² It is no surprise that with the rise of inefficient government welfare, which began in the Progressive Era and accelerated during the New Deal of the 1930s, the

or party machine could cost less than the higher taxes and fees that might result from “uncorrupted” government (Rothbard 1986, 1:22–26).¹³ Rothbard, always a fan of the literary critic H.L. Mencken, a contemporary of the time period, planned to quote him on just this occurrence where Mencken discusses his father’s experience with urban reform:

He [Mencken’s father] had a very tolerant view of all other torts and malfeasances. He believed that political corruption was inevitable under democracy, and even argued, out of his own experience, that it had its uses. One of his favorite anecdotes was about a huge swinging sign that used to hang outside his place of business in Paca street. When the building was built, in 1885, he simply hung out the sign, sent for the city councilman of the district, and gave him \$20. This was in full settlement forevermore of all permit and privilege fees, easement taxes, and other such costs and imposts. The city councilman pocketed the money, and in return was supposed to stave off any cops, building inspectors or other functionaries who had any lawful interest in the matter, or tried to horn in for private profit. Being an honorable man according to his lights, he kept his bargain, and the sign flapped and squeaked in the breeze for ten years. But then, in 1895, Baltimore had a reform wave, the councilman was voted out of office, and the idealists in the City Hall sent word that a license to maintain the sign would cost \$62.75 *a year*. It came down the next day.

This was proof to my father that reform was mainly only a conspiracy of prehensile charlatans to mulct tax-payers (Rothbard [1962] 2009, 24; Rothbard 1986, 1:26–29).

The end of the machine and the rise of the appointed committee and “honest” politician was supposed to mark the end of political corruption and favoritism. In reality, it just meant the end of visible corruption in lieu of less visible corruption. Bureaucrats are not

party machine was crippled because there was less of a need for their charity. In addition, President Franklin Delano Roosevelt also used federal funds to circumvent and weaken party machines that opposed him, such as Tammany Hall (Cost 2015, 159–61, 181–82). Other forms of voluntary assistance, such as fraternal associations, have also declined (Beito 2000).

¹³ In his theoretical works Rothbard explained how defensive bribery, or paying the government to get an exception to some licensing or prohibitory requirement, is beneficial because it brings the economy closer to the free market. Paying corrupt government officials to operate a business is better than the alternative of not being allowed to operate at all. The Soviet Union survived partially because of this type of pervasive corruption (Rothbard [1962] 2009, 1141–42).

angels, they are responsive to outside pressure and they have an incentive to increase the size and scope of their agency to obtain more funding and power. Politicians too, can still obtain lucrative financial support for their campaigns and increase their personal wealth by passing beneficial legislation to special interests, or by threatening to pass hostile legislation in an attempt to extort donations.¹⁴

The institutionalization of civil service was part of the broader goal to attack corruption. Political patronage and the “spoils system,” where incoming parties victorious after an election provided jobs for their supporters by firing the rival incumbent parties’ officeholders or simply creating new jobs, are generally despised and thought to provide no benefit to society. Although the system was imperfect, Rothbard points out that it was a part of a noble tradition of trying to enforce rotation in office to prevent the creation of an unaccountable oligarchy. Civil service which protects government employees from “partisan” replacements and instead ensures promotion and tenure based on “objective” tests of merit leads to corruption in the form of an entrenched bureaucracy unaccountable to the public. In addition, it too incentivizes increases in the size of government since incoming parties will simply create new jobs for their supporters instead of providing them with old jobs. In other words, civil service leads to the “Swamp.”

It is extremely ironic that civil service was initially promoted by a group of independent voters in the Northeast initially known as the Liberal Republicans and later as the “Mugwumps.” They supported free market policies and were driven to support civil service by their Yankee pietist background. They wanted to make sure that government was run efficiently and above politics, and not without coincidence they thought themselves to be the best suited for the

¹⁴ In the visibly corrupt world of the late-nineteenth century, threatening to pass hostile legislation (such as a revision of a tariff) was referred to as “frying the fat.” Businesses would provide campaign contributions and other monetary perks to politicians and officials in order to avoid harmful legislation that was proposed solely to exact tribute. Businesses were put on a hot skillet, so to speak, and their juices (money) flowed out. In the modern economic literature this is known as the rent extraction theory. It is just as prominent in modern politics, if not more so, than before. The only difference is it is less blatant and well-known because politicians are thought to operate under stringent anti-corruption and campaign finance laws (Thayer 1973, 45–46; McChesney 1997; Schweizer 2013).

job. But by the time of President Theodore Roosevelt, civil service had turned into all that they despised, namely a vehicle to promote big government and statist interventions:

The disheartened reformers, indeed, looked at the fruits of their victory and found it only ashes. These had been genteel Brahmins and educated elites, convinced of the inherent right of their sort to rule, and embittered at the rise to power of the uneducated, the non-elite, the brash, self-made, *nouveau riche* industrialist. They were also devoted to the ideals of free trade, hard money, *laissez-faire*, and retrenchment of government, but their chief focus had been a permanent rule by themselves and their cohort. But they lived to see the triumph of their “merit system” result not in the retrenchment of government, but in its acceleration, and not in the triumph of themselves, but of the brash politicians and corruptionists they despised (Rothbard 1995, 74; see also Rothbard 2017, 123–24, 203–04).¹⁵

In line with institutionalizing bureaucrats and taking managerial decisions out of politics, during the Progressive Era various cities created small city councils that were dominated by the upper class and other privileged elites. This notably occurred in matters relating to public schools. For example, in Pittsburgh in 1910 there were 387 combined members of the local ward-elected school boards and the city council. Only 24 percent of the members were of the upper class while 67 percent were members of smaller businesses and workers’ organizations. In 1911 the Pennsylvania legislature imposed a new city charter and school board system on the city. The governor and state court judges now would appoint members of the smaller city council (they were later elected by the city at large) and city-wide school board. A new nine man city council replaced the older twenty-seven man city council, and the multitude of localized school boards (with previously 360 members) was streamlined into a fifteen man school board. Both were heavily dominated by the upper class (Hays 1964, 161, 163, 165; Rothbard 1974, 26–27; Rothbard 1986, 1:17–23).¹⁶ Other examples abound. Rothbard wrote

¹⁵ On the spoils system and civil service, see also Libecap (2007).

¹⁶ The city manager movement was another example of this trend. Cities would be run by business-led committees to make them more “efficient” (and inevitably funnel favors to privileged businesses), at the expense of local decentralized wards controlled by the lower class (Rothbard 1986, 1:10–12; Weinstein 1968, 92–116).

extensively about the pietist move to oust the elected school superintendent position in San Francisco in the 1910s (as the position was traditionally friendly to Catholic values), and there is no need to elaborate on it here (Rothbard 2017, 302–08).¹⁷ But perhaps more interesting was Rothbard’s brief insights into the important legislation of Oregon in the 1920s. In November 1922 the state of Oregon passed a law prohibiting private schools and compelling all students to attend only public schools. Oregon believed that public schools, controlled by the “right” people, would be better able to mold children with the “right” values. The main sponsor of the law was none other than the Ku Klux Klan, a pietist racist organization determined to destroy Catholic private schools and Americanize their ethnic youth.¹⁸ The public could not be trusted to run both public and private schools, instead, the power must be vested with the government.

The political aggrandizement of power on the local level also occurred in the fascinating situation of urban imperialism. Urban imperialism refers to the literal expansion of large cities through territorial conquest of surrounding towns, villages, neighborhoods, and other cities. Large cities would annex surrounding areas by lobbying state legislatures and courts, and if successful, the annexed areas would often have little say about their absorption into the larger city. This process had begun in the mid-nineteenth century and increased during the Progressive Era. The purported motivation of this, much like other political power grabs of the era, was to improve the efficiency of city management. In reality, the purpose was to increase the political and economic power of “downtown” interests (i.e., wealthy big business elites) at the expense of decentralized control. Milton Kotler explains: “The

¹⁷ However, it is important to remark in passing that like so many other anti-Catholic motivations held by the progressives, the burgeoning progressive movement in teaching pedagogy was driven by a desire to weaken liturgical practices in parochial schools. Catholics saw this as a drive to replace the relationship between the student and God with a new bond between the student and the social-democratic state (Woods 2004, 85–118).

¹⁸ The law was later struck down by the Supreme Court in *Pierce v. Society of Sisters* (June 1925). The Supreme Court argued that while children must attend school they cannot be forced to attend only public schools (Rothbard 1974, 24–25; 2011 [1978], 153–54). For a modern account see Gordon (2017, 139–61).

purpose of the imperial dominion of the city is to control the neighborhoods for the sake of the economic and political interest of the central business district, which had formerly been impeded by their political independence" (Kotler 1969, 14).¹⁹ The three-pronged goals were to monopolize political power of downtown or other favored interests, cripple the economic power of surrounding areas, and make these crippled economic areas disproportionately pay the costs of administrative government through higher taxes.

Traditionally, neighborhoods were independent political units with their own clubs, fraternal associations, and local hangouts. The local saloon was the organization where community members would discuss politics and their leader was the local saloonkeeper. The saloonkeeper was also generally the elected ward official who represented the community in larger political and party machine affairs. These urban neighborhoods were generally exclusively Catholic and ethnic in the late-nineteenth and early-twentieth century. In essence, they were small independent towns and villages (Rothbard 2017, 319, 323). As time went on larger political units, i.e. cities, would take over these units and weaken the political power of the neighborhoods. They continued this practice on a larger scale by taking over entire cities, cities whose political independence was threatening the growth of the larger city. Thus, Philadelphia in 1854 annexed more than twenty-eight districts, boroughs, and townships, most notably Germantown. In the case of New York City, the process had begun in 1866. At the time New York City had only included Manhattan and Staten Island. It soon gained Queens and the Bronx, and notably annexed Brooklyn in 1898, then the fifth largest city in the United States. A major reason for these expansions was a Republican attempt to break up the Democratic Party's stranglehold of the city by including surrounding areas which were more Republican (Kotler 1969, 2–3, 8, 14, 20).

Taking over surrounding areas would also increase the concentration of commercial and manufacturing interests in downtown

¹⁹ Rothbard was very influenced by this book and would have cited it in his discussion of urban imperialism (Rothbard 2017, 319; 1986, 1:36–42). For other contemporary scholars that cited Kotler and argued that decentralized control in urban affairs better satisfies consumer preferences, see Bish (1971, 155) and Bish and Ostrom (1973, 11).

through artificial economics of scale and industries moved from the surrounding areas to downtown.²⁰ This economic weakening of the surrounding areas was also partially due to discriminatory taxes on the subjugated territories. Higher taxes were levied on the hapless suburban residents (of course, without their consent) in order to subsidize the expansion of downtown interests. It is no surprise then that after Pittsburgh's takeover of Allegheny and other areas in 1907, the Pittsburgh Survey of 1912 noted that downtown business and residential areas paid taxes only roughly two-thirds the level of surrounding political units. These higher taxes would help pay for Pittsburgh proper's excessive railroad debt it had accumulated over the years (Kotler 1969, 15–22). Once again, localized control was reduced for greater power and pelf in the hands of the growing centralized state.

4. CONCLUSION

Rothbard had many important insights on the Progressive Era that extended beyond analyzing the economic policies at the federal and state level. They included both political and local reforms that described the marked transformation away from decentralized, voter driven control to appointed committees in enlarged political cities that were beyond the reach of individuals. The power of ethnic

²⁰ In fact, the noted increase in urban population during this time was in large part a consequence of cities taking over surrounding areas. Many urban problems of the era—overcrowding, adequate water and street provision, etc.—were partially due to cities getting unduly big through conquest (Kotler 1969, 22). In a similar vein, there is a natural limit to urbanization and city growth. When a city gets too large through government expansion and subsidization it gets harder to provide municipal services. This incentivizes the need for additional government subsidization, which only aggravates the problem and increases the dependency of government provision (Davies 1993, 49–57).

The initial justification for municipalizing or regulating various “public goods,” such as water, was that they were underprovided by the market. However, a major reason for this “under-provision” was that private companies were often threatened with the very same hostile intervention that was later thrust upon them. Faced with a reasonable prospect of political takeover, many businesses did not invest as much as they would have under a framework of secure private property rights, which created a self-fulfilling prophecy. Once politicians took these businesses over, they were incentivized to charge below-market rates to win elections at the expense of long term quality (Troesken 2015, 120–35).

minorities, such as Catholic and Lutheran immigrants and blacks, was reduced at the expense of upper class pietists. These initiatives, which included voter registration, ballot reforms, commissioned school boards, and urban imperialism, were all cunningly advocated in the name of expanding democracy and eliminating corruption. While the stated goals were noble, the actual intended motivations were more sinister: to restrict democracy to only those who would vote the right way and shift corruption and political power to less visible individuals and organizations. And here the progressives succeeded brilliantly.

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BEGINNING THE WELFARE STATE: CIVIL WAR VETERANS' PENSIONS

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JEL CLASSIFICATION: H55, H56, I38, N31, N41

EDITOR'S NOTE: The following essay was written while Rothbard was working on "Origins of the Welfare State in America," which was originally published posthumously in the *Journal of Libertarian Studies* in 1996 (Rothbard 1996). "Origins" was included as Chapter 11 in *The Progressive Era* (Rothbard 2017). The draft pages of "Beginning the Welfare State" label it as Section 4. Rothbard most likely took it out and rewrote "Origins" so it would focus more on the Progressive Era intellectuals and reformers in the early-twentieth century. It was referenced but not included in *The Progressive Era* due to space constraints (Rothbard 2017, 153). It is published here for the first time. In this short but highly illuminating essay, Rothbard describes one of the first significant welfare programs in America: pensions to Union veterans. He documents the pro-pension legislation pushed by the Republicans, who supported it to cement a significant interest group to their party and also spend the federal budget surplus caused by their high tariff protectionist policies. Fighting a rearguard battle was President Grover Cleveland (1885-1889, 1893-1897) and his wavering Democratic congressional allies. The 1890 Dependent and Disability Pension Act was an important step in paving the way for the welfare reforms of the Progressive Era and New Deal. For a recent analysis of Civil War pensions that is similar to Rothbard's, see Cogan (2017, 31–53).

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It is fitting that the welfare state began as one aspect of the Great Leap Forward into centralized statism: the victory of the North in the Civil War. Under the cover of the virtual one-party Congress during the war, the Republicans put through their long-cherished interventionist Big Government program, one they had inherited from the Whigs. The Republican Party, driven by postmillennial pietism and northern industrialists striving for government favor, put through an income tax that continued after the war, excise "sin" taxes on alcohol and tobacco, high protective tariffs for American industry, massive land grants and other subsidies for transcontinental railroads, inflationary fiat "greenback" paper money, and a centralized "national banking system" that destroyed competitive state banks and grounded a new inflationary banking system on the issue of federal government bonds.

The dominant wing of the Radical Republicans bent on crushing the South after the war was led by Congressman Thaddeus Stevens, a Pennsylvania ironmaster who provided strong support for protective tariffs and greenback inflation.¹ After slavery was abolished, the Republicans substituted for slavery the cry of "Rebellion," and tried to permanently tar the Democratic Party with the charge of treason. A favorite Republican campaign tactic was to "wave the bloody shirt," allegedly of a soldier who had died fighting the hated rebels. When the Protestant Reverend Samuel D. Burchard denounced the Democrats just before the 1884 election as the Party of "Rum, Romanism, and Rebellion," he summed up the Republican case.

Never has American society been as militarized as it was during the Civil War: 37 percent of all northern males aged fifteen to forty-four

¹ There were two wings of the Radical Republicans: the Charles Sumner pro-free trade and hard money school, and the victorious Stevensites. Stevens himself sat at the feet of the venerable Philadelphia economist and ironmaster Henry C. Carey, who, in periodic meetings known as the "Carey Vespers," instructed his eager disciples on the way in which greenback inflation could serve as a hidden tariff on imports and a subsidy to iron and steel exports. Carey's eager followers also included ironmasters and Republican Party leaders: Eber Ward, president of the Iron and Steel Association; John A. Williams, editor of the *Iron Age*; Thomas A. Scott, of the Pennsylvania Railroad; and Pennsylvania Congressmen Daniel Morrell, an ironmaster, and William D. Kelley, known affectionately for his devotion to the iron and steel industry as "Pig Iron" Kelley. The railroads also favored greenback inflation in order to whittle away the value of their heavy bond indebtedness (Dorfman 1949, 7–8; Sharkey 1959, 141–73; Unger 1964, 53–59).

as well as 50 percent of southern white males served during the war. Battle deaths were far greater proportionately to population than in any later war. The number of northerners killed was 18.0 per thousand of population, which is enormous compared to only 1.31 per thousand American deaths in World War I, and 3.14 per thousand in World War II. The surviving wounded in the North amounted to another 13.9 per thousand (Skocpol 1992, 103–04, 570, 586).

Pensions to Union veterans began early during the war, in 1862. A generous scale of benefits was voted by Congress for veterans who could prove they had incurred disabilities in combat or from “injuries received or disease contracted while in military service.” Furthermore, widows, orphans and other dependents of soldiers who died in military service also received pensions at the rate of total disability. Not only that, but dependent mothers or sisters of dead or injured soldiers could also receive pensions, provided that only one dependent at a time was eligible for each soldier. Secretary of the Interior John Palmer Usher proclaimed that this law was “the wisest and most munificent enactment of the kind ever adopted by any nation” (Skocpol 1992, 106–07; Sanders 1980, 138).²

At the beginning of the Civil War, the United States had been paying limited pensions to some 10,700 veterans and widows of previous American wars, totaling about \$1 million per year and declining steadily each year. As a result of the law of 1862, the U.S. veterans pension list had swelled by the end of the war to 127,000 people, with spending amounting to \$15.5 million. In 1866, Congress politicized and expanded the pension system further by authorizing the president to appoint pension claims agents in all pension offices throughout the country (Quadagno 1988, 37–38). In 1868, a five-year grace period was enacted to enable and encourage eligible veterans and their dependents to file their applications with the U.S. Bureau of Pensions, which administered the program. At the end of the five years, in 1873, the number of war pensioners reached a peak at 238,000 and started steadily declining thereafter. It seemed that all the eligible recipients had been gathered in, and in 1872 Commissioner of Pensions James H. Baker understandably

² Usher was a personal friend of President Lincoln and heavily invested in the newly chartered Union Pacific Railroad, which he aided against the Indians as part of his activities as Secretary of Interior (Burch 1981, 23–24).

declared: "We have reached the apex of the mountain."³ Baker couldn't have been more wrong.

The first act that transformed the Civil War veterans' pension scheme from a major but contained and declining program, into a massive, long-term welfare scheme, was the Arrears of Pension Act of January 1879. The Arrears Act allowed soldiers who suddenly discovered disabilities related to the Civil War to apply and receive in one lump sum all the accumulated pension payments they would have been eligible to receive since their discharge from the army. This provision was, of course, an open sesame for encouraging the discovery and application of disability claims, both genuine and phony. As a result, the number of new pension claims, which had totaled 18,800 in 1878, doubled to 36,900 the following year, and tripled the next year, 1880, to 110,600.

The Arrears Act stimulated not only new claims but also a mighty pressure-group movement of Union veterans dedicated to expanding the pension program. The major Union veterans group, the Grand Army of the Republic (GAR), sprang into action and its membership doubled from 45,000 in 1879 to 86,000 in 1881, and then more than tripled to 295,000 in 1885. In 1881–82, the GAR set up a Pensions Committee in Washington to lobby Congress and the Pensions Bureau. It is no accident that the most accelerated expansion of the GAR came during the 1880s, "immediately after" the GAR "began its aggressive campaign for government aid to veterans." Its membership reached a peak in 1890 at 410,000, or 39% of surviving Union veterans (Skocpol 1992, 111–12; Sanders 1980, 156).

The enthusiasm for the new lump sum pensions may be explained by the generosity of the payments. The average first payment in 1881 has been calculated at \$954 to disabled veterans and \$1,022 to army widows and other dependents. If we consider that the average annual earnings of nonagricultural employees at that date was about \$400, then we can see that the lump sum payments, at about

³ The interest in the largess was oddly limited. Of the 1.65 million Union veterans in civilian life in 1875, only 107,000 were disabled military pensioners, a rate of 6.5 percent. But this was only 43 percent of the formerly wounded veterans who were eligible. Furthermore, of the surviving dependents of Union soldiers killed during the war, or who had died soon after, only about 25 percent were receiving pensions in 1875 (Skocpol 1992, 108–10; Sanders 1980, 143).

two-and-a-half times the average annual wage, were handsome indeed and considered worth scrambling for. It is no wonder, too, that the number of disabled military pensioners had quintupled from 107,000 in 1875 to 520,000 in 1891, or that the percentage of veterans enrolled in the pension scheme had sextupled from 6.5 percent to 39.3 percent in the same period.

A contemporary critic sardonically and justly noted that “the effect of this law was to stir up a multitude of people to apply for pensions who had never thought of the matter before. In one year 141,466 men who had not realized that they were disabled until the Government offered a premium of a thousand dollars or more for the discovery of aches and disabilities, made application” (Skocpol 1992, 118).

The major impetus for the bill came from a lobbying campaign by a cadre of wealthy pension lawyers. Pension attorneys collected fees of \$10 for each application they helped through the bureaucracy of the Pension Bureau. From these fees, the pension attorneys built up a highly profitable business. Thus, one of the most prominent Washington pension attorneys, George Lemon, handled tens of thousands of cases at a time and reaped hundreds of thousands of dollars in income.⁴ Perturbed at the falling off of pension claims during the late 1870s, Lemon, determined to rescue and expand his profitable practice, launched the *National Tribune* in October 1877. The *National Tribune* was a newspaper Lemon sent to Union veterans across the country and agitated for arrears legislation as well as advertised Lemon’s own valuable services. Other leading pension attorneys also weighed in, one started a competing news sheet, the *Citizen Soldier*, and another, Captain R.A. Dimmick, set up a Soldiers’ Association to lobby for an arrears law.

Bills for pension arrears had been introduced in Congress ever since the closing of the grace period in 1873. The Republican Party was far more favorable than the Democrats; the final passage of the Arrears Act, in 1878–79, was overwhelmingly partisan. In the House

⁴ The pension attorneys, “by means of subagents and a very thorough system of advertising... were ‘drumming’ the country from one end to the other in search of pension claims.... Claims agents and attorneys were building up an enormous practice. Those most skilled in the system were gradually drifting to the nation’s Capital. There they divided their energy between handling claims and lobbying for more favorable pension legislation” (Skocpol 1992, 116).

of Representatives the Republican vote for the Arrears Act was unanimous, while the Democrats split forty-eight for and sixty-one against. Unsurprisingly, the pro-Union pension Democrats came from the North, while the opposition largely centered in the border and southern states.

The favorable votes of the northern Democrats may be explained by the fact that ever since 1875 when the Democrats captured the House, they were a viable national party on par with the Republicans. Indeed, the Democrats actually won the presidential election of 1876, even though it was "stolen" by Rutherford B. Hayes in the Electoral College. The northern Democrats, then, were anxious to prove to northern voters that they were not really traitors and they too had tender regard for the Union army. As a result of pressure in state legislatures by agents of pension lawyers in the respective states, the Senate vote for the Arrears Act was close to unanimous, forty-four to four.

How did the proponents propose to pay for the veterans' pensions? During the 1880s, the federal government enjoyed a hefty budget surplus, which amounted to 20 to 30 percent of total receipts. Most of the revenue came from the protective tariff, which comprised over 50 percent during the 1870s and 1880s. The northeastern Republican industrialists who formed the elite of the Republican Party therefore had an extra incentive to favor the veterans' pensions, an incentive beyond cementing the political support of the Union veterans to the Republican cause. For the provision of pensions provided an extra excuse to keep the protective tariff, in reaction to demands by resurgent Democrats for free trade and lower federal budgets.⁵

⁵ Theda Skocpol, attempting to deprecate the influence of northeastern industrial interests on behalf of pensions, notes that George Lemon, writing in early 1879 when there was little budget surplus, advocated an issue of greenbacks to pay for the pensions. She then naively comments that such a suggestion "surely did *not* appeal to eastern business interests [*italics Skocpol*]." Skocpol ignores the work of Sharkey, Unger, and others who demonstrated that the dominant Stevens wing of Radical Republicans strongly endorsed greenback inflation as well as protective tariffs (Skocpol 1992, 114; Sharkey 1959, 141-73; Unger 1964, 53-59; Dorfman 1949, 7-8).

On the horrified reaction of the Grant Administration to the original Supreme Court decision *Hepburn v. Griswold* (1870), which outlawed irredeemable fiat paper such as the greenbacks, see Unger (1964, 172-78). On Grant's appointment of two leading railroad lawyers to the Supreme Court, which quickly reversed the decision in *Knox v. Lee* (1871), see Paul (1991, 115-16).

Expanding potential pensions claims in the Arrears Act naturally led to a tremendous expansion of the federal agency solely empowered to process, adjudicate, and pay the claims, the U.S. Bureau of Pensions. The Pensions Bureau, anxious to expand its claimants and therefore its bureaucracy, beat the bushes looking for and encouraging potential claimants. In particular, Colonel W.W. Dudley, who was appointed Commissioner of Pensions by the incoming Garfield Administration in 1881, saw the possibilities and aggressively seized the potential for expanding the number of claimants and his bureaucracy. Dudley immediately pressed for more personnel and more medical examiners throughout the country to examine the pension claimants and process their claims. Dudley instructed the Bureau to draw up a list of army enlistees from every state and of pension applicants from invalids and dependents. He also compiled a list of every surviving soldier of the Union Army, with a list of their addresses, so that veterans could locate old army buddies to testify on behalf of their injuries. Dudley called on the Grand Army of the Republic for aid in drawing up the list, and in six months he had acquired a list of names and addresses of over 189,000 veterans. From 1880 to 1885, Dudley had built up the Pension Bureau from 379 employees with an administrative expenditure of \$935,000, to a bureaucracy with 1,680 employees that spent \$3.4 million.

Dudley also used the Pension Bureau to build up the Republican Party, and as one historian put it, Dudley's "one aim appears to have been that of building up a great political machine." Thus, during the 1884 presidential campaign in which the Democratic candidate Grover Cleveland was pitted against the Republican candidate James G. Blaine, Dudley moved out of Washington and into the electorally vital states of Ohio and Indiana, where he became a critical part of the Republican campaign organization. To promote the campaign, Dudley instructed the Pension Bureau in September to reject no pension applications until after Election Day, and ordered that claims from Ohio and Indiana be processed before all others. As a result, 5,000 pension claims were accepted from Ohio and Indiana during the 1884 fiscal year, a 40 percent increase from the previous year. Dudley also doubled the number of pension examiners in these two states during September and October of 1884, and used them also as organizers for the Blaine for President campaign.

The Pension Bureau, the Grand Army of the Republic, and the Republican Party acted in happy symbiosis: the GAR lobbied for greater appropriations and personnel for the Pension Bureau, which in turn processed more claims for GAR veterans, who in turn gratefully voted for the Republican Party. The Democratic state committee of Ohio attributed their defeat to Dudley's efforts, but Dudley could not keep Indiana from voting for Cleveland by a slim majority. Despite Dudley's best efforts, moreover, the Republicans narrowly lost the election to Grover Cleveland, who established the first Democratic Administration since the Civil War. Dudley resigned shortly after the election.⁶

Colonel Dudley's zeal is understandable, given his background and personal and political interests. Before his appointment, Dudley was a Republican national committeeman from Indiana as well as chairman of the Indiana invitation council for the Grand Army of the Republic. Dudley had tried and failed to win the Republican nomination for governor of Indiana in 1884, but he was promised the post of Secretary of the Interior should James G. Blaine win the election for the presidency.⁷

The Cleveland Administration did not abolish or roll back veterans' pensions, but it also did nothing to expand them. At the end of the first Cleveland term, administrative expenses of the Pension Bureau remained flat at about \$3.5 million while the number of employees actually fell to 1,550.

The latter half of the 1880s saw the peak of agitation over veterans' pensions. A movement developed in the GAR for "dependent" pensions for all Union veterans who became disabled at any time, even in peacetime after the war. The more radical even escalated

⁶ Dudley's Democratic successor, General John Black, excoriated the Dudley regime in the 1885 Report of the Pension Bureau: "the Pension Bureau was all but avowedly a political machine, filled from border to border with the uncompromising adherents of a single organization, who had for the claimant other tests than those of the law, and who required, in addition to service in the field, submission to and support of a party before pensions were granted.... People of one faith filled every one of the great agencies. Examiners, trained in unscrupulous schools, traversed the land as recruiting sergeants for a party..." (Sanders 1980, 145, 144–50).

⁷ On Dudley, see Dearing (1952, 263, 301–02). George Lemon did not help matters during the campaign by ungratefully denouncing Dudley's administration of the Pension Bureau for insufficient zeal (Dearing 1952, 305–06).

their demands to “universal service pensions,” which would simply ladle out pensions to all who had served in the Union military regardless of disability. Congress passed over a thousand private pension bills during the first Cleveland Administration, and President Cleveland took the unprecedented step of investigating, and actually vetoing, over two hundred of the bills. His actions of course greatly angered the GAR, which had already been convinced that he was a secret “Rebel” in any case.

Finally, the Republican-controlled Senate, joined by the Democratic House, passed a dependent pension bill in early 1887. The bill stated that all Union veterans who served a minimum of ninety days and who were disabled and dependent on their own labor, regardless when the disability was incurred or the kind of disability, would receive \$12 monthly. In a trenchant and courageous message, President Cleveland vetoed the bill, declaring that surely the “vast peaceful army” of veterans did not wish to become “objects of simple charity.” The law, Cleveland warned, would create an appalling increase in government expenditures, and would “stimulate weakness and pretended incapacity for labor,” and “put a further premium on dishonesty and mendacity.” The House Democrats were loyal enough to block overriding of the veto (Dearing 1952, 335; Sanders 1980, 140–41).

Cleveland’s vetoes enraged the veterans’ lobby, and the pension issue reached a climax in the presidential election of 1888 where it rivalled the tariff as the crucial issue. To oppose Cleveland, the Republicans selected Benjamin Harrison of Indiana, a Union General who was also an advocate of veterans’ pensions. Ever-growing GAR membership reached 373,000 that year. But more radical veterans’ groups were impatient with the GAR’s dual commitment to dependent pensions as well as the more radical universal service pensions. Thus, the Service Pension Association was formed and settled for nothing less than universal service pensions. Its president, General Alvin P. Hovey, rode to power as governor of Indiana on this issue in the 1888 election. Indeed, the pension issue swung the presidential election to Harrison by moving New York and Indiana from the Democratic to the Republican column in 1888, and these two states saw the most intense veterans’ agitation for the service pensions (Dearing 1952, 367–91; Davies 1955, 198–205; Jensen 1971, 22–26).

If the veterans elected President Harrison, they required a payoff. This came quickly when Harrison appointed as head of the crucial Pensions Bureau none other than the fiery leader of the radical veterans, the legless "corporal" James Tanner, twice commander of the New York GAR and close friend of the leading pension agitator and top pension claims attorney George Lemon. Tanner had trumpeted during the campaign that were he to be pension commissioner, "God help the surplus!" and that "I will drive a six-mule team through the Treasury." Tanner had also written to the great idol of the Union veterans, General William Tecumseh Sherman, that "If I achieve the [pension] office, I shall... run it on the idea that it is the duty of all of us to assist a worthy old claimant to prove his case rather than to hunt for technical reasons under the law to knock him out" (Dearing 1952, 393).

James Tanner quickly proceeded to do precisely that. Looking at previous pension grants, he "rerated" them by sending applicants thousands of dollars in back pensions, and even did the same for veterans who had not even bothered to apply for pensions. Moreover, Tanner widened eligibility and reduced the proof of disabilities so that money was virtually trundled out the door. Many of these quick settlements were clients of the "notorious" George Lemon. While Tanner's flamboyant methods caused President Harrison to fire him, his successor continued with similar administrative rewriting of the pension rules.

The more important payoff came in changing the pension law. While Harrison urged a dependent service bill, the rambunctious veterans, escalating their demands, denounced Harrison and demanded universal service pensions. The new commander-in-chief of the GAR, General Russell Alger, Diamond Match Company tycoon from Michigan who had longstanding presidential ambitions, whipped up the veterans to demand service pensions, while Republican Governor Alvin P. Hovey of Indiana denounced Harrison for lagging behind the veterans' demands.

The result of all this pressure was the second big leap forward in pensions, the Dependent and Disability Pension Act of June 1890, passed by the Republicans who were now in control of both houses of Congress. Republican support for this Harrison measure was unanimous, and the Democrats split on the issue. The Pension Act

provided for a pension to every veteran with ninety days service who suffered any disability, regardless of when it occurred. Any veteran who could certify that he was unable to perform manual labor was entitled to \$144 a year, and any veteran's widow could obtain the same. The veterans were delighted and 655,000 filed an application for new or increased pensions within the year, and 116,000 were approved. The number of veterans receiving pensions vaulted from 490,000 in 1889 to almost 970,000 in 1893. The number of Pension Bureau employees increased from 1,500 in 1890 to over 2,000 the following year, while administrative expenditures of the Pension Bureau increased from \$3.5 million to \$4.7 million. Meanwhile the GAR increased its membership from 373,000 in 1888 to a peak of 410,000 two years later.

Even the GAR, which was disappointed at not getting its universal service pension, rejoiced in 1890 and exulted that the Dependent Pension Act "is the most liberal pension measure ever passed by any legislative body in the world, and will place upon the rolls all of the survivors of the war whose conditions of health are not practically perfect." Indeed, since the disability eligible for pensions only had to be for *manual* labor, federal employees, for example, could continue to work at cushy desk jobs while collecting their "disability" pensions.⁸

The result of the 1890 law was an acceleration of pension payments to a new "budget-busting" plateau. Before 1879, federal pension payments had totaled about \$30 million per year, after the Arrears Act, it had been in the \$60–80 million annual range. But now, after the Dependent Pension Act, total payments vaulted to \$160 million a year and remained above \$140 million through the 1900s. Pension payments, which had amounted to about 11 percent of total federal expenditures until 1879, and about 23 percent in the 1880s, now increased to about 40 percent. Gone was the famous budget surplus; Jim Tanner had been all too correct. By the mid-1890s the federal budget was in deficit.

Heedless of these problems, the GAR and more radical veterans groups wasted little time in gratitude to the Harrison

⁸ Skocpol points out the suggestive fact that in 1910 over 37 percent of the population aged sixty-five and older in Washington D.C. collected Civil War pensions (Skocpol 1992, 138, 541). Also see Sanders (1980, 142–43, 146–47, 156) and Dearing (1952, 399–400).

Administration. Instead, their demands escalated and they began to talk increasingly of their "rights." George Lemon's *National Tribune* raised the banner: "Let us now gird up our loins for a vigorous battle for the remainder of our rights," of which the universal service pension bill took first rank.

But the veterans had gone too far. The increased spending and the deficit soured most of the public on veterans' demands, and, in the 1892 campaign Cleveland was able to effectively argue against fraud in Republican administration of pensions and their use to build a political machine. The Cleveland campaign talked not of repealing the pension law, but in making sure that the pension list was truly a "roll of honor." As a result, after 1892, the pension law was not expanded, expenditures reached a plateau, and the entire issue was allowed to dribble away slowly as the Union veterans gradually died off. The general retrenchment of further veteran demands was best expressed by the commander of the Tennessee GAR, who warned that a "policy of unreasonable exaction will surely react for it does not take a large reaction in the North joined to the fixed prejudice in the South to undo much of the pension legislation now on the statute books. Conservatism is demanded by the interests of the soldier himself" (Dearing 1952, 469–70).

Needless to say, Confederate veterans were not rewarded with goodies by the triumphant Union government.⁹ To the contrary, the vanquished South was subjected to a vast federal welfare relief program, appropriately enough under the auspices of the U.S. military, and its Bureau of Refugees, Freedmen and Abandoned Lands—popularly known as the Freedmen's Bureau. Established in March 1865, the Freedmen's Bureau flourished for four years, distributing massive aid to the freed blacks ("the freedmen"), established camps to provide government jobs for the blacks, plus hospitals, orphan asylums, and colleges. As enthusiasm for Reconstruction waned, and as people became increasingly concerned about the program establishing a permanent pauperized class of blacks, the Freedmen's Bureau program dwindled and was closed permanently in 1872. In his wise and perceptive veto message for

⁹ However, in the late 1880s and 1890s the former Confederate states enacted state level pension systems, but these states were poor and the programs were not nearly as generous as the federal program for Union soldiers (Skocpol 1992, 139).

extending the Freedmen's Bureau in 1866, a veto that was overridden by the Radical Republican-dominated Congress, President Andrew Johnson declared:

...the bill authorizes a general and unlimited grant of support to the destitute and suffering refugees and freedmen, their wives and children. Succeeding sections make provision for the rent or purchase of landed estates for freedmen, and for the erection for their benefit of suitable buildings for asylums and schools, the expenses to be defrayed from the Treasury of the whole people. The Congress of the United States has never heretofore thought itself empowered to establish asylums beyond the limits of the District of Columbia except for the benefit of our disabled soldiers and sailors. It has never founded schools for any class of our own people... but has left the care of education to the much more competent and efficient control of the States, of communities, of private associations, and of individuals. It has never deemed itself authorized to expend the public money for the rent or purchase of homes for the thousands, not to say millions, of the white race, who are honestly toiling from day to day for their subsistence.... Pending the war, many refugees and freedmen received support from the Government, but it was never intended that they should thenceforth be fed, clothed, educated, and sheltered by the United States. The idea on which the slaves were assisted to freedom was that, on becoming free, they would be a self-sustaining population. Any legislation that shall imply that they are not expected to attain a self-sustaining condition must have a tendency injurious alike to their character and their prospects (Axinn and Levin, 1992, 112).¹⁰

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¹⁰ Also see Axinn and Levin (1992, 89-90, 109-115) and McFeely (1968).

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BOOK REVIEW

CAPITALISM IN AMERICA: A HISTORY

ALAN GREENSPAN AND ADRIAN WOOLDRIDGE

NEW YORK: PENGUIN, 2018, 486 PP.

JOAKIM BOOK*

What could possibly go wrong when a former Fed chairman and the *Economist's* political editor walk into a publisher's office with an almost five hundred page manuscript? Quite a lot, it turns out. In *Capitalism in America: A History*, Greenspan and Wooldridge sketches American economic history through the lens of Schumpeterian Creative Destruction. The result is, to be polite, a mixed bag. It has the hallmarks of overly simplistic, broad-brushing and all-encompassing efforts of those formerly in the spotlight—looking back at their extended careers and trying to make sense of their experiences. It reads halfway between a dull encyclopedic account of major American businessmen and a vaguely-supported yet boldly-argued *Economist* column. It is neither as comprehensive as a full-scale account of American capitalism ought to have been, nor as shallow as we have become accustomed to from the pages of said magazine. Despite the book's many shortcomings, it is a magnificent overview of American business, describing the lives

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and deeds of many known and lesser known industrialists that propelled America forward, woven together into an overarching tale that cherishes creative destruction above all else (pp. 14–19).

The book's title leads one to believe that its object of inquiry is *Capitalism* proper, the monetary system of societal interactions characterized by private ownership of the means of production—or what Mises (2008, 1) described in the first sentence of *The Anti-Capitalistic Mentality* as “mass production of goods destined for consumption by the masses.” Instead, Greenspan and Wooldridge quote Schumpeter (2003, 83) to say that capitalism means creative destruction (“Creative Destruction is the essential fact about capitalism”), and then interpret creative destruction to roughly mean ‘industrial innovation’, after which they take the reader us on a fascinating journey through most major American industrialists, their businesses, their innovations and their achievements.

The book defies easy categorization, as it may serve as a brief introduction to political, social and predominantly business history and only tangentially does *economic* history. The common thread running through the authors' account is one of the Great Man Theory, perhaps first comprehensively expressed by Carlyle (1841) and recently compellingly opposed in Matt Ridley's (2011; 2015) more widespread accounts. Antithetical as it is to regular notions of capitalism as decentralized, coordinating, spontaneous or “anarchical” decision-making (Mises 1951, 120), the Great Man Theory states that history can be understood as the outcome of actions and ideas of a selected number of persons—the Great Men. Greenspan and Wooldridge devote pages and pages to these leading men of American industrialization: Eli Whitney and his cotton gin (pp. 46, 74–75); John Deere's and Cyrus McCormick's agricultural inventions (pp. 46–48); Oliver Evans' steam engine (p. 52); Henry Bessemer's steel inventions (pp. 99–102) and Carnegie's steel empire (pp. 126–28); Edison's light bulb (p. 105); Ford's and Sloan's automobiles (pp. 107, 209–13); Rockefeller's revolution of the oil business (pp. 128–30); J. P. Morgan's domination of the world of money (pp. 130–31); Bell's telegraph (pp. 109–10); and Swift's refrigerated railroad cars (p. 119).

Occasionally, however, impersonal and decentralized trends make appearances, for instance through institutional and infrastructural achievements including the Erie Canal (p. 51), the railroad boom (pp. 96–98) and the importance of the Chicago futures market

(p. 120). Even more recent business trends are described, such as Silicon Valley's overtaking of Massachusetts' Route 128 corridor (e.g. Saxenian, 1996), explicitly attributed to its "decentralized, free-wheeling and porous" (p. 353) nature. Indeed, the praise of Silicon Valley is further described as:

a living embodiment of the principle of creative destruction as old companied died and new ones emerged, allowing capital, ideas, and people to be reallocated. (p. 353)

The dissonance between the "decentralized, freewheeling and porous" aspects of capitalism and the significance of the authors' top-down approach goes entirely overlooked. Indeed, sometime around the mid-twentieth century in the authors' story, they change from describing Great Men to describing Great Presidents: a few examples include JFK (pp. 302–03); LBJ's Great Society and Nixon's closing of the gold window (pp. 305–06); and of course the authors' beloved achievements of the Reagan Era (pp. 326–31) that allegedly "created the conditions for a business revival, removing the shackles that had bound business ever tighter" (p. 329). Admittedly, some prominent business leaders make brief appearances (Jack Welch at GE; George Mitchell, whom the *New York Times* (2013) called "The Father of Fracking"; Bill Gates; Larry Page and Sergey Brin) but their importance is secondary to the main, now political, storyline.

There are at least three areas that warrant serious criticism: the idea of a wartime 'prosperity,' the authors' use (and presentation) of data, and the big elephant in the room: central banking, especially considering the deficient accounts of the *Great Recession* and *Great Depression*.

Firstly, perhaps the most morbid celebration of wartime ever, Greenspan and Wooldridge argue that the American human capital stock during World War II was "upgraded" (p. 270) and that the war acted as "a huge on-the-job training program" (p. 270). In a paragraph that cannot be read with a straight face, they argue not only that a contributing benefit to American wartime prosperity was that demographics such as women massively entered the labor force and learned valuable skills, but astonishingly enough that soldiers coming back from the war "with new skills, from organizing groups of people to repairing jeeps" (p. 271). Never mind the human capital

literally destroyed among the four hundred thousand-odd American military casualties (not to mention many more wounded), or the millions upon millions of people whose skills were redirected into uniquely specific wartime production lines, the “human capital” value of which were highly doubtful. Neither does the madness end here, as the authors maintain—contrary to common sense and indeed both sound economic theory and empirics—on the basis of four(!) selected indicators that Americans at home were better off during the war. Noticeably, Robert Higgs (1992, 50–53) debunked the main myth that real consumer spending increased dramatically, and I leave the relevance of the other three exhibits to be judged by the reader (gambling on horses increased by one-and-a-half times; half a million new businesses were created; eleven thousand new supermarkets were constructed).

At this point, one sincerely hopes that the nonsense will end, but alas, it does not. Rather than explaining the immediate post-war boom in economic data (double digit GNP growth between 1945 and 1946) as a return to capitalism from a wartime command economy, Greenspan and Wooldridge invoke the infamous pent-up demand argument. The dissonance is quite remarkable. Instead of the real income growth and improved living standards in wartime America—posited no fewer than six pages earlier—the authors argue that Americans “made up for the deprivations of the depression and war” (p. 276). American households could not have *both* seen their incomes and living standards grow tremendously during the war *and* suffered deprivations of war, leaving many needs and demands unmet. Of course, they were not, and the conviction stems from misapplied GNP numbers deflated with an inappropriate price index (Higgs 1992, 45–52).

In another oft-repeated argument, pundits denounce the idea that government spending during the New Deal got America out of the Great Depression, only to turn around and claim that government spending during World War II got the job done. Greenspan and Wooldridge do precisely this: “War spending provided the stimulus that the economy needed” (p. 268), they write, but just a few pages earlier, the authors dismissed the New Deal’s emphasis on spending, since it was “offset by job destruction in the private sector” (p. 254). What, one might ask, is so “miraculously” different with government spending on tanks and munitions for use overseas

compared to government spending on bridges and public works at home (Murphy 2012)? The dissonance is surreal.

Second, Greenspan and Wooldridge use a very peculiar selection of data in making their many arguments. Often, they report irrelevant or at least unconventional versions of fairly standard statistics: real GDP during World War II (p. 268), rather than *per capita* real GDP; comparing *nominal* US national income with the national incomes of Germany, Japan and Italy (p. 262) as if country-size GDP is of any concern; ignoring massive territorial and population changes when contrasting the GDP of Germany in 1946 with Germany in 1890 (p. 276), or the doubling of “America’s real GDP” (p. 361) between 1980 and 2000—conveniently hoping that the reader had overlooked the emphasis on tens of millions of immigrants some 15-odd pages earlier. Sometimes, the authors refer to “the nation’s real income” (p. 304), presumably meaning price-deflated GDP, but most of the time they settle for reporting what look like nominal, unadjusted, numbers, which over a time span of 250 years amounts to little more than rubble. How is the national output to be rendered legible between vastly different eras of American history (population, institutions, territorial expansion), with no recourse to comparability adjustments of any kind? Besides, a well-read economist with rough knowledge of historical price and income series (or readily available access to measuringworth.com) might decipher the present-value equivalent of money prices, but the employment figures of GM of 1 million in 1960 (p. 288), conveys very limited information beyond the obvious statement that GM was a large company even then.

Remarkably, the only time *per capita* numbers are reported (p. 387), they are used to make the Congressional Budget Office’s dire projection of the long-term potential growth rate for the U.S. economy (1.7 percent/year) *even worse*; with population increases, the per capita potential growth is therefore well below 1 percent, which emphasizes the gloomy outlooks for America. One does wonder why recourse to per capita numbers was superfluous for close to four hundred pages.

More saliently, all graphs not presenting fractions are given in logarithmic scale, for rather puzzling reasons. In long-term time series they are often warranted (for example: stock market index

on p. 222, business productivity and worker output on p. 93, or prices and wages on p. 175), since nuances in earlier periods would be entirely swamped by the curves' exponential increases. But in a few cases, the frequent use is both unneeded and contributes to concealing rather than supporting the authors' main message (as for miles of railroad construction on p. 97 and wholesale price of steel on p. 100 and p. 145).

Third, central banking is suspiciously downplayed for a book on American economic history co-authored by the second longest-serving chairman of the Fed. It makes an appearance discussing the accidental invention of the Fed's 1922 Open Market Operations (p. 235) and a minor comment on monetary policy in the 1980s (p. 331), in addition to a rather brief inclusion during the Great Depression and the Great Recession. The Great Depression, noticeably,

was a consequence of the shattering of a stable world order, underpinned by fixed gold-standard-linked exchange rates, and by the war and the failure of the Great Powers to adjust to a changed distribution of economic and financial power and to put a sustainable new system in its place (p. 226)

In a twist as remarkably as the dissonances of wartime America (see above), Greenspan and Wooldridge conclude that Keynes's "barbarous relic"—the gold standard—was barbarous only in the *wrong* way: "the fetters that doomed the international economy were not Keynes's fetters of gold but the fetters of pride" (p. 229), since its only problem was the price at which foreign countries pegged their currencies against the dollar, not the many problems associated with a centrally-regulated pseudo-commodity standard (Rothbard 2010, 68–98).

At one point, the authors even go as far as blaming "America's quirky banking system" (p. 234) at least compared to Canada, before invoking Friedman and Schwartz's banking failure explanation of the Great Depression. Rather, the very brief account of the Great Depression contains nothing but irresponsible stock brokers, Irving Fisher's debt deflation and the Smoot-Hawley tariffs (pp. 230–33).

The Great Recession fares no better, prefaced by generic quips like "bubbles are endemic to capitalism" (p. 375), and "people's

animal spirits exceed their rational powers" (p. 375) before castigating derivatives and their "notional value" (p. 381). The blame for the crisis is squarely placed on securitization, the exuberance of lenders and the thriftiness of Asian savers (pp. 376–79)—the so-called 'Savings Glut'—allegedly forcing down interest rates with a powerless but nevertheless noble Fed standing by (p. 385). Indeed, the swift and competent actions of the Fed, the "superior quality of the official response" (p. 385) prevented another Depression. Their grand achievements included rescuing major financial institutions, performing stress tests and lowering short-term interest rates to boost the economy—remarkably so considering that no less than six sentences earlier, the authors had entirely discounted this transmission mechanism in their quest to exonerate the Fed.

There is a superficial attempt at criticizing low-interest rate arguments (explicitly that of John Taylor) by placing the beginning of the housing boom before the interest rate cuts in 2001, and specifying that originations of a subsection of mortgage lending "peaked two years before the peak in home prices" (p. 385), allegedly undermining any low-interest rate arguments. The attempt is unconvincing to say the least.

While the first eleven chapters provide broad sketches of American business from 1750 to the present, the value of which is questionable, chapter twelve ("America's Fading Dynamism") offers a more extensive view into what Greenspan and Wooldridge see as America's biggest challenges. This is also their best and most pertinent chapter, putting the blame of America's woes in many of the right places: overburdening regulation, stricter labor markets and massively reduced (social, geographical, economic) mobility; the explosive cost of education, its unenlightened pettiness (p. 394) and the stagnation of Americans' educational attainment; and the core reason of America's failures: "the growth of productivity-suppressing entitlements" (p. 404). They spend eight pages emphasizing well-appreciated facts such as the legislative permanence of entitlements alongside more surprising ones—for instance that since 1965 entitlements have grown faster (10.7 percent/year) under Republican presidents than Democratic ones (7.3 percent/year, p. 405)—and another five pages on how regulation is crippling entrepreneurial innovation in favor of lawyers, bureaucrats and consultants. By comparison, acquitting the Fed of blame during the

financial crisis and criticizing low-interest rate arguments is done in less than a single page.

Huddled among its many shortcomings are many flashes of brilliancy: quotable quips, accessible summaries of business trends and revolutionizing innovations (the so-called robber barons, automobiles, the rise of Silicon Valley and the financial services innovations of recent decades), a devastating critique of FDR's New Deal and a surprisingly Rothbardian position on monopolies (p. 132). Moreover, the entrepreneur is front and center, albeit more of a hands-on type than the kind we find in the Austrian entrepreneurship literature (e.g. Kirzner 1999, Salerno 2008). At least, one must admit, the authors embrace the entrepreneur as driver of economic change, a trait they describe as synonymous with America itself:

American entrepreneurs were drawn from every level of society but united by their common assumption that every problem was capable of solution so long as you thought hard enough. (p. 45)

In summary, despite the book's many flaws of technical, economic and statistical nature, there is some value to it, especially the two finishing chapters that identify some of America's greatest challenges. The message is ultimately one of optimism, of belief in the power of entrepreneurial innovation and (mostly) benign impact of creative destruction. Greenspan and Wooldridge argue that every time America has been pushed to the brink she has come back stronger (pp. 28, 449), and despite her current challenges, we should not despair.

This is a history of American capitalism only if one believes that capitalism is the actions and consequences of America's many noticeable businessmen. Favorably judged, that amounts to a birds-eye view of American Big Business, 1750 to the present, a much more apt title for what the authors are doing: paying homage to the unmatched wonders of creative destruction.

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BOOK REVIEW

CONFUCIAN CAPITALISM: SHIBUSAWA
EIICHI, BUSINESS ETHICS, AND ECONOMIC
DEVELOPMENT IN MEIJI JAPAN

JOHN H. SAGERS

CHAM, SWITZERLAND: PALGRAVE MACMILLAN, 2018, XVI + 245 PP.

JASON MORGAN*

Shibusawa Eiichi (1840–1931) is one of the most respected figures in modern Japanese history. Often referred to as the “father of Japanese capitalism,” Shibusawa rose from humble origins—he was the son of a small-scale indigo farmer and spent his boyhood helping in the family fields and with keeping the books—to become the most powerful business magnate in Japan. He was involved in the founding of hundreds of corporations (many of which are still in operation today), sat on the boards of countless organizations and firms, and was in the Ministry of Finance before being appointed president of the First National Bank of Japan. He was also a devoted philanthropist. The founder and supporter of hospitals, schools, charities, and social service programs, Shibusawa is today

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remembered mostly for being an “ethical capitalist,” or, more specifically, a “Confucian capitalist.”

Why “Confucian”? From the time he was a boy, Shibusawa, at the behest of his Confucianist father, studied the Chinese classics every day with a scholar in a nearby village, eventually committing much of the Confucian corpus to memory. Later eschewing neo-Confucianism and its metaphysical innovations, Shibusawa was most fond of the *Analects*, one of the original Confucian texts compiled by Confucius’ followers after his death. Unlike the neo-Confucianists, Confucius had a generally positive view of trade and business, and Shibusawa agreed that commerce ethically practiced could be beneficial for society as a whole. This Confucian grounding was the motif of Shibusawa’s entire career. In his business dealings and charitable activities alike, Shibusawa cited the *Analects*, and Confucius’ social-mindedness in general, as the guiding principles of his public activities.

So why the renewed interest in a long-deceased Japanese industrialist with a fondness for Spring-and-Autumn Period Chinese philosophy? In the wake of the 2008 financial meltdown and subsequent acceleration of the boom-bust cycle, many in academia and beyond have increased their calls for the taming, if not outright abolition, of capitalism. In *Confucian Capitalism: Shibusawa Eiichi, Business Ethics, and Economic Development in Meiji Japan*, John H. Sagers—whose other works include *Origins of Japanese Wealth and Power: Reconciling Confucianism and Capitalism, 1830–1885*—wants to revisit his earlier thinking about Japan, Inc. (the close relationship between government and business that was the secret of Japan’s success until the end of the bubble economy in the early 1990s) in order to emphasize that “the system [Shibusawa helped build] now needs to be dismantled.” (viii–ix) As Sagers puts it:

Shibusawa’s Confucian capitalism was essentially an ideological strategy to create both ethical guidelines and a positive new identity for the commercial classes. First, Shibusawa called himself a business leader or ‘person of practical affairs’ *jitsugyoka*, which he defined in contrast to several characters of Japanese society: the government official, the military leader, the politician, the scholar, and the old-fashioned merchant. Where government and military officials defended the nation and carried out policies, *jitsugyoka* produced valuable goods and services that contributed to the people’s well-being. Unlike the newly emerging

politicians, *jitsugyoka* did not pander to public opinion and pursue narrow self-interest. Unlike scholars, *jitsugyoka* were not concerned with abstractions, but focused on practical affairs. Unlike Tokugawa-era merchants who were greedy for gain for their households, *jitsugyoka* worked for the good of the whole nation. Furthermore, his Confucianism allowed him to define himself in contrast to foreign and domestic liberals who called for Japan's wholesale Westernization. (113–14)

Critical of “corruption in high places and an economy mired for decades in seemingly inescapable stagnation” (217), Sagers argues that corporations must practice greater corporate social responsibility (CSR) (4) and posits Shibusawa as the model for his proposed reforms.

Divided into eight chapters, Sagers' book is a thematic biography of a famous figure in which the theme largely eclipses the biography. Only two of the chapter titles—the introduction and the conclusion—contain the name “Shibusawa Eiichi.” All the rest zoom out to take in the social and economic changes taking place before and during Shibusawa's long life. Protectionism, business networks, stock exchanges, central banks, labor unions, the gold standard, war financing, infrastructure, bureaucratic involvement in corporate governance, and the influence of technologies and ideas from America and Europe are just some of the big topics Sagers tackles here. This is an ambitious book, and one worth reading if only for the scope of the hundred years or so of modern Japanese history it takes into account.

And yet, as in old Japanese maps, there is a cloud bank obscuring some of what Sagers purports to examine. Indeed, this book, for all of the valuable information it offers the reader, suffers not so much from peripheral blurring as from macular degeneration. There is a big blind spot right in the middle of the book's field of vision. Namely, one wonders what Sagers means by the term “capitalism.” Sagers uses the word in the title of his book and on page after page in his text, but in the end we never quite know how he understands it.

The closest we get is when Sagers quotes historian of capitalism Joyce Appleby in defining capitalism as a “relentless revolution.” Awkwardly, Sagers then has Shibusawa “answer” Appleby (from more than one hundred years before Appleby wrote her volume) that Confucianism was the key to maintaining old societal values

while advancing business in a given polity. (22)¹ But is this purported dichotomy between capitalist and society—framed by Appleby, endorsed by Sagers, and apparently confirmed and then overcome by Shibusawa Eiichi—real? Did Shibusawa “answer” Appleby’s challenge by pursuing a kind of “Confucian capitalism” that took the edge off the Northern European variety? Is the “capitalism” of which Sagers and Appleby write capitalism at all?

Elsewhere in the same book that Sagers quotes above, Appleby writes:

There can be no capitalism, as distinguished from select capitalist practices, without a culture of capitalism, and there is no culture of capitalism until the principal forms of traditional society have been challenged and overcome. (119)

Is Shibusawa Eiichi the exception to the Appleby Rule, then? Was Confucianism really the skeleton key that allowed Shibusawa to unlock the business potential of a traditional society while leaving its traditions largely in place? And is the thing, “capitalism,” that Sagers argues needs reforming really capitalism at all?

The notion of a “Confucian capitalism” is plausible if the premise that “capitalism” is a destructive force, a “relentless revolution” continuously clear-cutting social practices in the quest for more and more money, can be shown to apply in all cases. But if capitalism is not really that at all—that is, if capitalism is just human nature, one of the ways in which human beings attempt to survive and thrive—then “Confucian capitalism” as a heuristic device loses much of its analytic power.

Indeed, if we widen our scope a bit further we can see that the use of the term “capitalist” can be, and has been, applied so willy-nilly to so many different things that it breaks down and is virtually meaningless. Shibusawa Eiichi used technologies such as the joint-stock corporation and the stock exchange to distribute risk and raise money for his various plans. But the Chinese do this, too, and in a way that out-capitalists the very representatives of capitalism themselves. If the Chinese do not have an Applebian “culture of capitalism,” then surely the set phrase can have no ideological

¹ Citing Joyce Appleby (2010, 7).

purchase, and must be rejected. And if that definition falls, then so, too, does Sagers' thesis, that some kind of philosophical harness, such as Confucianism, is needed to promote virtue among the industrialist class.

Unfortunately for Sagers, Confucius' homeland is a buzzing, blooming capitalist Tilt-a-Whirl. As Kai-fu Lee points out in *AI Superpowers: China, Silicon Valley, and the New World Order* (2018), Stanford-based entrepreneurs once laughed at Chinese startups as cheap knockoffs, but now admit that they cannot keep up with the competitiveness of the Chinese market. American companies routinely fail in China, according to Lee, because they do not take the time to study Chinese culture. If capitalism really does destroy local practices, then China should be indistinguishable from Palo Alto. But as anyone who has ever been to China can attest, China is very much *not* the Bay Area. In other words, "capitalism" has not destroyed anything. It has amplified existing cultural norms and enriched great swaths of humanity. Is this the thing that Sagers thinks needs reforming?

What about elsewhere? In *Debt: The First 5000 Years*, David Graeber reminds us that commerce, and the intricate financial practices and social networks that make commerce possible, have long been a central feature of the Islamic world. This may not qualify as Appleby's "culture of capitalism," but it hardly matters, because business in the *dar al Islam* is still firmly rooted in the religious and cultural practices of the region. Whatever capitalism is, it has been very polite to its Muslim hosts—so culturally quiet, in fact, that one hardly notices it's there. In Africa, too, despite the Orientalist fantasy of the eternally childlike native, men and women prefer to prosper, to thrive materially while improving their social standing. Cheats and con artists always try to turn a quick profit at the expense of morality, but such people are readily sifted out of the market everywhere. (It is only when government intervenes to protect scofflaws, as it does in the United States for the robber barons in Goldman Sachs, that "capitalism" can be said to inflict harm on local societies.) Getting rich, testing schemes, doing good by doing well—these are not somehow proprietary to the West. So, one is left wondering, if "capitalism" is a universal, then how is it modified by Confucianism?

Indeed, even the “Confucian” aspect of Shibusawa’s thought was more complicated than might first appear. For example, in arguing in favor of protectionism after initially supporting English-style liberal trade policies for Japan, Shibusawa cited Adam Smith’s *Theory of Moral Sentiments* in advocating a business approach oriented to society as a whole, and not beholden solely to the entrepreneur. (138) Adam Smith as *reining in* “capitalism”? (It might be time to bring in the fainting couch for Mr. Krugman.)

And when Sagers chides Shibusawa for his too-cozy relationship with government bureaucrats and the managerial state, one wonders if this, too, can really be called capitalism. Sagers himself uses what is arguably the correct term—“crony capitalism”—to describe this inherently corrupt arrangement. Drawing on the work of Morikawa Hidemasa, an earlier Shibusawa scholar, Sagers writes:

Morikawa [...] noted that Shibusawa Eiichi’s name always comes up when it is fashionable to criticize big business as in the case of the 1970s Lockheed scandal or the oil shock and scholars like Tsuchiya [Takao] say that today’s managers need to look again at Shibusawa Eiichi’s thinking to solve contemporary problems. But for Morikawa, the system of crony capitalism known as ‘Japan, Inc.’ (*Nihon Kabushiki Gaisha*) that Shibusawa helped create was the root of Japan’s problems. (220)²

But is “Japan, Inc.” capitalist in any real sense of the term? Shibusawa himself floated back and forth between finance and government (he was the recipient of a coveted *amakudari* golden parachute from the Finance Ministry into the “private” sector in 1873 [90]), and used his connections transecting the osmotic membrane between economy and state to enrich himself enormously. It is highly debatable, then, that Shibusawa Eiichi was a capitalist at all, unless “capitalist” also means “crony capitalist,” in which case it means nothing at all. If the state picks winners and losers and uses the implied threat of fines and incarceration to enforce bureaucratic fancy, then perhaps Sagers’ and others’ critiques of such a system as a fault of “capitalism” are greatly misplaced.

Lastly, on whether Confucianism is the best leaven for the purported excesses of “capitalism,” even though it is beyond doubt

² Citing Morikawa Hidemasa (1976, 72–73).

that Shibusawa's Confucian beliefs inspired him to pour enormous amounts of money into social welfare programs, it can hardly be said that the *Analects* is the only book to have spurred the wealthy to part with some of their gains for the sake of the commonweal. The Islamic merchants Graeber mentions grounded their business ethics solidly in the *Quran*, for example, and Christian and Jewish businessmen and -women have done incalculable good for humankind through charitable giving that, quite frankly, puts the Confucianists to shame. Jacob Schiff, Richard DeVos, Howard Ahmanson, Jr., Julius Rosenwald—these tycoons stooped to embrace the forgotten and destitute because the God of Jacob and Abraham, or the Son of Man, said it was good to do so. Even today, Judeo-Christian America remains the most charitable nation on earth. Given all this, one question that might be posed to advocates of Confucian capitalism is, "Why did you pass up capitalism of the Torah, the Hadith, and the New Testament?"

However, these questions for broadening the scope of Sagers' investigation should not be interpreted as detracting from his work. He has clearly scoured the archives in search of material, and his book is an important stepping-off point for debates about this important topic. At the very least, Sagers is correct in his assessment that Japan, Inc.'s days are probably over. As the recession in Japan racks up birthdays and the government continues to shoot arrows from its Keynesian quiver at the indifferent beast, it must be clear to all candid observers that further intervention in the economy is not the answer to capitalism's woes. Sagers' book is a valuable contribution to the deliberations about where to go once—and may the day come quickly—the bureaucrats in Japan and elsewhere grow tired of failure and adopt a more Daoist approach by doing precisely nothing to "help" capitalism recover. It may very well be that a "Confucian capitalism," wherein philanthropy is couched in Confucian practices, is a viable solution to the two lost decades (and counting). Whatever the eventual outcome, Sagers' work is very useful in thinking through the answers to the pressing questions Japan faces as crony capitalism dies a very drawn-out death.

For those considering buying and reading Sagers' book, though, a word about style. Sagers is to be commended for his research, but many of his paragraphs felt like pachinko runs, and there is a cubism to Sagers' argumentation that frequently mystified your

humble correspondent, even after multiple tries at comprehension. The syntax of this book is not for the faint of heart. Sagers darts about from topic to topic, and grasping at the meaning of a given passage can be a bit like trying to catch eels in a pond.

And then there is the glossing trouble. Sagers uses a lot of Japanese terms, which is a good thing, but he glosses them, well, diversely. For example, on the very same page (75), Sagers glosses *shokusan fukyo* (Sagers must mean *shokusan kōgyō* (殖産興業)) as “promoting production and building wealth and strength” and then, about two dozen lines later, as “promoting production for a wealthy country.” On page 62, Sagers gives the exact same phrase as “promote production, encourage industry.” Which is it? Other terms are similarly kaleidoscopic, but *gapponshugi* wins the prize. *Gapponshugi* is a Shibusawa neologism referring to the ‘pooling of monetary capital, managerial talent, and labor to serve the public interest.’³ Sagers glosses this term repeatedly, and with substantial variation. Sometimes it is just ‘pooled resources,’ but elsewhere Sagers adds a political valence: “resources united to build enterprises that served the nation.” (69; see similar gloss on 97) Important terms like these should be made consistent, especially when much of the argument hangs upon how they are translated.

As Shibusawa himself might have said, though, if you want something, you’ll have to work for it. This dictum applies in full force for anyone who is about to wade through the tall grass of this often challenging book. *Confucian Capitalism* is a welcome return to the life and philosophy of one of the greatest Japanese magnates of the past two hundred years. It is also an opportunity to set the record straight on whether Shibusawa Eiichi—or Japan, Inc.—was, or is, “capitalist” at all.

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³ 45, citing Shimada Masakazu (2011, 30–34).

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BOOK REVIEW

AUSTERITY: WHEN IT WORKS AND
WHEN IT DOESN'T

ALBERTO ALESINA, CARLO FAVERO, AND FRANCESCO GIAVAZZI
PRINCETON: PRINCETON UNIVERSITY PRESS, 2019, XVI + 245 PP.

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Austerity is, plain and simple, living within one's means for normal people. The policy of austerity is for governments who spend a relatively lavish budget beyond their means and then—periodically—have to retrench their spending in excess of tax revenues or face dire economic consequences. This usually entails either increasing taxes, cutting spending, or both.

Austerity policy is a political hot potato, or so some claim. Citizens do not want their taxes increased or their benefits reduced. Government employees do not want their budgets reduced and certainly do not want to see cuts in staffing or, God forbid, cuts in their own salary and benefits.

Not surprisingly there is an ongoing political debate over the effectiveness of austerity policy. Some people believe it is necessary

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and can be harmful? Government employee unions, government contractors, and progressive-socialist groups expend money and effort lobbying against austerity, while taxpayer-based groups spend money supporting austerity plans that reduce spending rather than increase taxes.

It is easy to muddy the political waters because it is difficult to properly measure the results of the various types of austerity plan. Does a plan consist mostly of tax increases or does it consist mostly of government spending reduction? Then there is additional confusion because the results of any plan will be affected by other factors such as monetary policy and regulatory policy which have simultaneous impacts on the economy and the government budget.

However, it is critical to get the right answers because there will be a need for corrective austerity plans to deal with current government budgetary extravagance in the near future. Government debt in many countries has already grown beyond sustainable levels. In the US, the federal government routinely runs trillion-dollar deficits and is headed towards a fiscal cliff of severe economic decline even before the banner of the Green New Deal was raised.

When the next recession does hit the US, it could result in a significant decline in GDP and this will result in lower revenue for the government and increased expenditures for things like welfare and unemployment benefits. Another related concern is a rise in interest rates which would significantly increase the amount of interest payments on the national debt. If both a recession and higher interest rates were to occur simultaneously, which seems likely, austerity policy could be a necessity.

A new book by Harvard economist Alberto Alesina, and Carlo Favero and Francesco Giavazzi, both of the University Bocconi, addresses these issues. In *Austerity: When It Works and When It Doesn't*, they provide a comprehensive empirical examination of thousands of fiscal measures implemented by 16 advanced economies since the late 1970s. Central to their analysis is the distinction between austerity plans that rely mostly or wholly on tax increases and austerity plans that rely mostly or wholly on cuts in expenditures.

They find that tax increase-based plans, i.e., TB plans, are deeply recessionary in the short and medium terms and are ineffective at addressing the problems of debt. In contrast, they find plans

that are expenditure reduction-based plans, i.e., EB plans, are not deeply recessionary in the short and medium terms and are effective at addressing the problems of debt and can even lead to an economic expansion.

This finding invalidates the Keynesian complaint that government spending cuts reduce aggregate demand and causes deeper recessions. The main reason the Keynesian view is invalid is that credible spending cuts give entrepreneurs and investors confidence that no tax increases will occur in the future. Immediate and planned spending reductions are a signal that taxes will be lower, or at least not higher, in the future and this is good for the economy. Furthermore, EB plans can even trigger economic expansions and are not necessarily a “political kiss of death,” as some have alleged.

Chapter 3 provides several case studies of countries that have employed TB or EB plans and what they experienced. Several countries adopted austerity measures in the early 1980s. For example, Belgium had a budget deficit of 16.4 percent of GDP in 1981. In response, authorities announced a multi-year austerity plan that cut spending the equivalent of 6.5 percent of GDP, while raising revenues only 1.8 percent. The economy contracted in 1981 and then turned positive, reaching 4.3 percent growth in 1988. In contrast, between 1982 and 1986 Ireland adopted an austerity plan based almost entirely on tax increases. Nearly every aspect of the Irish economy experienced higher taxes totaling almost 7 percent of GDP. As a result, the economy remained sluggish, the deficit was not reduced, and the debt to GDP ratio increased from 74 percent to 107 percent by 1986. In 1987, Ireland adopted a new austerity plan based entirely on spending cuts and the economy quickly recovered. This chapter is by itself worth more than the price of the book.

Comparing TB and EB plans in Chapter 7, the authors find EB plans are better than TB plans in terms of output, consumption, and much better, as we would expect, in terms of investment. Also, as we would expect, EB are superior to TB plans in terms of consumer and business confidence. In terms of EB plans, plans based mostly on cuts in transfer payments and those based mostly on general cuts in government spending are both superior to TB plans.

The authors try to weed out the impact of other policies and aspects of austerity plans. So, they examine the potential impacts

of money policy, exchange rate movements, and structural reforms in labor and product markets, e.g. deregulation, and their results still hold. They also find that EB plans were far superior to TB plans in terms of reducing the debt-to-GDP ratio, a primary reason for austerity plans in the first place.

In chapter 8 the authors examine the impact of austerity in the post-2008 Financial Crisis. Their result that EB plans are superior to TB plans is sustained, but the authors caution:

One should keep in mind that fiscal policy was not the only player in the field: banking crisis, collapse of confidence, the credit crunches also played a role. It would be simplistic to attribute everything that happened in Europe between 2010 and 2014 only to fiscal policy. (p. 158)

Chapter 9 addresses the question of how the state of the business cycle, i.e., expansions or contractions, should impact the austerity plans (not much). Chapter 10 addresses the impact of austerity plans on reelection bids and whether they are necessarily a political kiss of death (normally they are not).

This is an important book with consistent results favoring EB austerity plans over TB austerity plans in terms of both current output and the national debt. Essentially, the evidence supports the Austrian approach to recovery after a boom-bust cycle, but is also generally applicable.

There are a couple of items that would have improved the book. The first is that the authors do not fully exploit the issue of EB plans that relied mostly or wholly on cuts to government employment, either the number of employees or cuts to salaries, benefits and pensions in order to balance the budget. The current discussion of austerity seems to concentrate on making taxpayers worse off with tax increases or citizens worse off because spending cuts often restrict access to government benefits and programs.

Another approach to austerity would be to reduce the number of government employees, their salaries, benefits and pensions which are typically excessive. One benefit of this approach is that if politicians and bureaucrats knew in advance that they would suffer from profligate deficit spending, there would probably be less wasteful spending in the first place. In other words, make politicians and bureaucrats suffer rather than taxpayers and citizens.

Another item that needs to be addressed is the value of government spending. Keynesians claim that austerity makes us worse off because GDP will fall more than otherwise due to decreased government spending. However, as Simon Kuznets, one of the founders of national income accounting, made clear, government output is not measured in the marketplace so its value is unknown. Most government spending is of either of strongly negative value or certainly worth less than \$1 per \$1 of government expenditure—and very little of it is worth more than a dollar. Even college freshmen are taught that GDP is an inaccurate measure of economic well-being, but apparently econometric analysis has yet to catch on to that fact. By the way, if this problem were addressed, it would only strengthen our authors' findings.