

Why Professor Tullock Is Wrong on Austrian Theory of Business Cycles

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In the second volume of *The Review of Austrian Economics* Gordon Tullock (1987, p. 73) explains “why...the Austrian theory is not a serious contender for [the] honor [of] a correct theory of depressions.” I in turn will try to explain why Professor Tullock is wrong about the Austrian business cycle theory in particular and about Austrians in general.

PROFESSOR TULLOCK’S THREE NITS

THE ULTIMATE LIMIT OF INFLATION

“Before turning to [his] main criticism” Professor Tullock (1987, p. 73) starts with three “nits.”

First, Rothbard never explains why the inflation that is part of his theory cannot simply be continued or even accelerated. I understand why Mises without our modern experience thought that it was impossible, but anyone familiar with the present world must realize that inflations can, at least, continue for very long time and reach very high levels of monetary depreciation...I have lived through three hyperinflations and can testify that it is undeniably unpleasant, but not really a disaster. It’s flu, not pneumonia.

It may be true that Rothbard does not explicitly say this in his article “Economic Depressions: Causes and Cures,” which professor Tullock (1987, p. 73) uses as “canonical version.” But then, it would be more appropriate to criticize this specific article (which was intended to be more popular than scholarly), rather than Rothbard’s theory or the Austrians in general. Of course Rothbard (1993, p. 867) as well as Mises and other Austrians clarify this point extensively in their works¹.

The one basic limit, of course, is the necessity of the banks to redeem their money-substitutes on demand...In any case, they must redeem in standard money or its virtual equivalent. Therefore, every fractional reserve bank

¹ See, e.g., Rothbard (1993, pp. 867-871 and 875-877) and Mises (1998, pp. 431-445).

depends for its very existence on persuading the public – specifically its *clients* – that all is well and that it will be able to redeem its notes or deposits whenever the clients demand.

[T]he greater the degree of relative credit expansion by any one bank, the sooner will the day of redemption – and potential bankruptcy – be at hand (Rothbard 1993, p. 869).

And later he writes (1993, pp. 876) about the ultimate limit on inflation - the phenomenon of *runaway inflation*, or *hyperinflation*. Surely we are not able to forecast when this “terrible limit that will in the end conquer any inflation” will occur. But if government continues to expand the money supply or even accelerates the rate of inflation,² eventually there comes a time when

[people] realize that they are gaining by buying now, instead of waiting until a future date when the value of the monetary unit will be lower and prices higher. In other words, the social demand for money falls, and prices now begin to rise more rapidly than the increase in the supply of money. When this happens, the confiscation by the government, or the “taxation” effect of inflation, will be lower than the government had expected, for the increased money will be reduced in purchasing power by the greater rise in prices.

But this will stimulate the government to even greater efforts of inflation, because it can profit from this process as long as the people use the money at all. But this cannot, as Rothbard points out (1993, p. 876) go on forever.

As the rise in prices continues, the public begins a ‘flight from money,’ getting rid of money as soon as possible in order to invest in real goods – almost *any* real goods – as a store of value for future. This mad scramble away from money, lowering the demand for money to hold practically to zero, causes prices to rise upward in astronomical proportions. The value of the monetary unit falls practically to zero.

² “The process of issuing money beyond any increase in the stock of specie” (Rothbard 1993, p. 851)

So we could see that Rothbard as well as Mises not only address the issue of the limitation of inflation, i.e., its continuance and acceleration, but also deal with this subject very extensively in their major works.

ABOUT LEARNING AND FORECASTING

Professor Tullock (1987, p. 73) then carries on with his second nit, "Rothbard's apparent belief that business people never learn."

One would think that business people might be misled in the first couple of runs of the Rothbard cycle and not anticipate that the low interest rate will be later raised. That they would continue unable to figure this out, however, seems unlikely. Normally, Rothbard and the other Austrians argue that entrepreneurs are well informed and make correct judgments. At the very least, one would assume that a well-informed business person interested in important matters concerned with the business would read Mises and Rothbard and, hence, anticipate the government's action.

It is wrong to maintain that Rothbard or other Misesian Austrians³ believe that a man is not able to learn. Rothbard and Mises always stressed that although the future is not completely certain, man can know something about the future state of affairs. And if he possesses any knowledge this means that he is able to learn.⁴ Austrians do not argue "that entrepreneurs are well informed and make correct judgments," they only say that entrepreneurs try to anticipate future prices of various producer's and consumer's goods in order to allocate their present resources in such way as to maximize their profits. The more able of them will gain and so increase their wealth; the less able or unsuccessful will lose and their assets will be decreased. Of course all people will strive to better their chances, for example by learning,

³ Unfortunately there are the nihilistic Lachmannians, which have to be distinguished from Misesians.

⁴ See for example Hoppe (1997).

to forecast future prices, but it is plausible to assume that *they will never succeed in doing this 100% correctly*. What is more important, to avoid any depression all men have to anticipate their future individual purchasing power of money at the same time immediately after the money supply has increased, i.e., the loan market interest rate must not be influenced by the inflationary credit expansion; it has to remain at the free-market magnitude. Even if some people would anticipate the future prices 100% correctly, while others do not, this would not mean that these people would not embark on some projects which will eventually prove unrealizable. On the contrary they would try to earn as much money as possible by buying certain higher-order producer's goods, because their prices will rise most, and then selling them before the end of the boom. Naturally the presence of such farsighted individuals would enhance the adjustment process. Also important is the fact that the world is continuously changing. The businessmen, in order to correctly forecast the future, must separate the different causes of changes in the market data; the effects of inflationary credit expansion and the effects of real changes in people's preferences and market conditions. This makes the whole forecasting issue even more complicated. This is all that Rothbard would maintain.

But now, let us assume that the people anticipate inflation, i.e., inflation does not produce widespread occurrence of error which is necessary for a existence of a business cycle. So where can we find the error? This question is answered by Guido Hülsmann (1998, p. 21) in his pathbreaking article on "General Theory of Error Cycles"

Recurrent clusters of errors can be deduced from the existence of government activities. This is because the latter can be interpreted as manifestations of error – which sooner or later will lead to crises

[depressions]. There are many specific error cycles: the monetary business cycle, the military-imperialistic cycle, the social security cycle, etc.

According to Hülsmann (1998, p. 14) the first type – the monetary business cycle – is based “on government meddling [fractional-reserve banking, central banking and option clauses, and fiat money] with money rather than on changes of the quantity of money *per se*.” This, of course, not only explains why the increase in the supply of money proper (e.g., gold) does not cause boom-bust cycles, but it also solves the anticipation problem.

CYCLICALITY OF BOOMS AND DEPRESSIONS

The third of Professor Tullock’s nits refers (1987, p. 74) to “Rothbard’s apparent belief that the depression and booms are cyclical.”

There are statistical tests that will detect cycles if they exist and these have been applied to the historic data. The result of the tests is a random walk rather than a cycle. Since Rothbard urges as one of the strong points of his theory explaining the cyclical nature of depressions and booms, this statistical finding would seem to be of considerable importance to him.

Let us first clarify the different concepts of depression by Rothbard (Austrians) and Tullock. Depression, according to Rothbard, is a recovery phase after a boom period, which was caused by inflation. On the contrary Tullock defines (1988, p. 147) depression as “a situation in which general conditions are very bad and, most importantly, there is very high unemployment.” Of course, such a situation can occur anywhere and anytime and is not dependent on previous inflation. Any large natural catastrophe could bring about such a state of affairs or any violent intervention by government (e.g., taxation) in the market or any abrupt change in the preference schedules of people. But first, to say “that the Austrian theory of depressions does not help

understanding what the ordinary citizen thinks of as a depression" is highly inappropriate. One has to read only Ludwig von Mises' *Human Action* or Murray N. Rothbard's *Man, Economy and State; Power and Market* and *America's Great Depression* to find answers on these issues. These as well as other Austrians deal with these topics very extensively. And second, if we accept such a broad definition of depression, then every big change in market data which would temporarily lead to a "worsening" of the living standard of the people has to be called a depression. But this "worsening" is nothing else than mere purposeful adjustment of men's actions to new conditions with the aim to maximize their want-satisfactions. Hence, we had to call also a abrupt decrease in people's time preferences as a cause of depression, because such incident would inevitably temporally lead to very bad general conditions with high unemployment. In short, Austrians understand and examine depressions as far as they are part of the business cycle. And, as Rothbard put it (1993, p. 764) "there can be no business cycle in the purely free market." As well as there can be no deflation without previous inflation, although professor Tullock (1988, p. 149) says something very different:

It is possible to have [a] reduction in the first derivative of money supply without a preexisting inflation.

From a Rothbardian (Austrian) point of view, if he includes in this definition of the money supply also any kind of uncovered (partially or fully) money-substitutes then he makes a logical contradiction. Because how can fiduciary media exist if they have not been previously issued, i.e., if there is no previous inflation? And how is it be possible to decrease the quantity of fiduciary media or fiat money (deflation), if there are no uncovered money-substitutes (without previous inflation)? And if he does not include any uncovered money-

substitutes, i.e., his first derivative of money supply consists only of standard money (money proper) and money-certificates, then the decrease of their amount is not deflation.⁵

The further point is the difference between (economic) theory and (economic) history. With the help of historical data we can only describe certain historical events but not interpret them. And also we are not able to discern the various effects which have caused these events. For example, we can actually observe that during a certain period there was an increase in demand for a certain commodity after the price of this good had risen. Would then Professor Tullock maintain, on the basis of these historical data, that actually there is no law of demand or law of diminishing marginal utility?

When Rothbard writes about the “cyclical nature of depressions and booms” he refers only to a qualitative relationship between these two phenomena. He only says that after every boom inevitably there has to follow, sooner or later, a depression. But we do not know when it really comes and how long it will last.

PROFESSOR TULLOCK’S MAJOR OBJECTION

THE CREDIT EXPANSION INCREASE NEITHER SAVINGS ...

Now let us turn our attention to Professor Tullock’s major objection:

That if the process that Rothbard describes did occur, there would be many corporate bankruptcies and business people jumping out of the windows of office buildings, but there would be only minor transitional unemployment. In fact, measured GNP would be higher as a result.

⁵ See Rothbard (1993, p. 851)

After citing Rothbard, Professor Tullock starts to explain how he came to the above-mentioned conclusion. According to him, due to government inflationary measures, i.e., credit expansion (1987, p. 74) “savings that are available for building factories must have increased. In fact, they have.” Because, as he continues, the government has transferred “a certain amount of money from the general citizenry into the investment accounts and, hence, the money for building these additional factories is made available.” He even says that this inevitably follows from Rothbard’s words. It is astounding that such an excellent economist as Professor Tullock also succumbs to the illusion which Rothbard (1993, pp. 853-854) warns us of.

Superficially, it seems that credit expansion greatly increases capital ... Since the new ‘bank money’ is apparently added to the supply of savings on the credit market, businesses can now borrow at a lower rate of the interest; hence inflationary credit expansion seems to offer the ideal escape from time preference, as well as an inexhaustible fount of added capital. Actually, this effect is illusory... In the first place ... existing creditors are injured. This will tend to discourage lending in the future and thereby discourage saving-investment. Secondly, ... the inflationary process inherently yields a purchasing-power profit to the businessman, since he purchases factors and sells them at a later time when all prices are higher ... Hence, he will undoubtedly be tempted to consume out of these profits and thereby unwittingly consume capital as well. Thus, inflation tends at once to repress saving-investment and to cause consumption of capital.

It is precisely this fact, that the amount of savings does not change due to inflationary credit expansion, that is the main difference of this situation as compared to a situation with decreasing time preferences. In the former case there is no additional restriction of consumption

and therefore there is no transfer of real resources "from the general citizenry to the investments accounts. (Tullock, 1987, p. 74) " There are only more uncovered money-substitutes facing the same amount of previously accumulated capital. In the latter case there is new additional restriction of consumption, i.e., transfer of real resources from the consuming public to entrepreneurs. So, to say that in the former state of affairs we have a genuine rise in savings is the same as to maintain that government can create new capital out of thin air. I am sure Professor Tullock would agree that government cannot increase the real GNP, i.e., create more real goods, by issuing new money substitutes. But how can he then come to the conclusion that through the same procedure government can create more real capital goods without decline in the quantity of consumer goods? The part of total income of owners of original factors of production spent on consumption does not change by virtue of credit expansion. Because as Rothbard (1993, 856) explains, under credit expansion

the original factors now receive increased money income. In the free-market example, total money remained the same. The increased expenditure on higher stages was offset by decreased expenditure in the lower stages. The "increased length" of the production structure was compensated by the "reduced width." But credit expansion pumps new money into the production structure: aggregate money incomes increase instead of remaining the same. The production structure has lengthened, but it has also remained as wide, without contraction of consumption expenditure.

... NOR CAPITAL

After clarifying that the credit expansion does not lead to a genuine increase of savings, let us proceed further with Professor Tullock's point (1987, pp. 74-75) that

the interest rate is of great significance in deciding whether or not to build a new factory, buy an expensive machine, etc., but of very little significance in deciding how much to produce in an existing factory.

Clearly, the businesspeople who made [new capital] investments [during the period of the artificially depressed interest rate and have completed them] will lose money; some of them will go bankrupt. But this is a sunk cost. There is no reason why this equipment should stop being used. () What happens is that the products of these industries would have to be sold at a price that covered their operating cost but not their capital cost.

The same according to Professor Tullock (1987, p. 76) refers to

those factories that have not yet been finished when the interest rate rises. Whatever has already been built is once again a sunk cost, cost that should be ignored in deciding whether or not the machinery or factory should be finished. Thus, if the interest went from 3 to 5 percent, most factories that are more than about 40 percent finished would still be completed. () the additional investment necessary to complete the machinery or the factory would be capable of paying 5 percent.

Of course, Professor Tullock is right, what has been already invested is "a sunk cost." The Austrians would be the last to deny this. But the problem lies elsewhere. As we have seen, there are no more genuine savings available. The time preferences did not change. So the problem is not only if "additional investment is capable of paying 5 percent," but the fact that there is not enough savings to realize such investment. Or if we use part of savings for this purpose, we will miss them in other place, in some factories of original structure of production. This is because there is only enough savings to reproduce and utilize factories in the original structure of production. Naturally, it can turn out that it is still profitable to complete some of the new malinvestments, but this is only because the projects have already been started. (Even so, savings must be used to finish these projects.

Thus there will be an insufficient amount to maintain the original structure of production.) Once used, the capital goods required for its completion will not be reproduced, because at the natural rate of interest the project is not profitable. The other problem is the utilization of these new investments. To do that you need to combine them with original factors of production. And to do that you need savings too. But there are not enough savings to utilize the new investments and also the original. So it will be necessary to abandon some capital goods exactly because the opportunity cost (the price of original factors that have to be mixed with these producer's goods) is larger than the revenues received for products manufactured by these (mal)investments. Of course, we can always choose among various alternatives to allocate existing savings in order to maximize profit. But it does not change the underlying fact: there are not enough real resources to complete, to utilize and reproduce new investments started during the boom and at the same time reproduce and utilize all equipment in the original structure of production. As Rothbard (1993, p. 857) eloquently put it:

The situation is analogous to that of a contractor misled into believing that he has more building material than he really has and then awakening to find that he has used up all his material on capacious foundation (the higher stages), with no material left to complete the house. Clearly, bank credit expansion cannot increase capital investment by one iota. Investment can still come only from savings.

THE CREDIT EXPANSION CAUSES IMPOVERISHMENT...

We now know that not only is there no real rise in savings, but that some of these real scarce resources have been channeled due to the mirage of artificially decreased interest rates to less effective investment projects, i.e. there has been a consumption of capital

which started right at the outset of credit expansion. There are now malinvestments over the whole structure of production, but concentrated in the higher stages. So when there is now less capital than before the inflation, the marginal productivity of labor has decreased as compared to the state of affairs before the boom, and so has the living standard. To use the words of Rothbard (1993, p. 863)

Because of the malinvestments, however, the boom always leads to general *impoverishment*, i.e., reduces the standard of living below what it would have been in the absence of the boom. For the credit expansion has caused the squandering of scarce resources and scarce capital. Some resources have been completely wasted, and even those malinvestments that continue in use will satisfy consumers less than would have been the case without the credit expansion.

... AND UNEMPLOYMENT

Now we shall examine the issue of unemployment because according to Professor Tullock (1987, p. 77):

in an Austrian-style depression, there would be a good deal of unemployment in the capital goods industries, but...[b]ecause of the size of the capital goods industries compared to the rest of the economy, however, the forcing down prices in other industries made necessary by this unemployment would once again cause bankruptcies but not unemployment.

The problem with this statement lies in the fact that there is a "misemployment" throughout the whole economy and not only in capital goods industries. And due to the consumption of capital there is now "needed" less labor over the whole economy as well in consumer's goods industries at the real wage level before the boom. So to employ the same quantity of labor the real wages has to decrease. And it is plausible that such large adjustment to such abrupt and extensive

shock needs “some” time. During the depression, as Rothbard (1993, p. 859) notes

malinvested business become bankrupt, and original factors must suddenly shift back to the lower stages of production. The liquidation of unsound businesses, the “idle capacity” of the malinvested plant, and the “frictional” unemployment of original factors that must suddenly and en masse shift to lower stages of production – these are the chief hallmarks of the depression stage.

Hence, “the desire to argue that the inflation that [Austrians] object to is the actual cause of the subsequent contraction,” which Professor Tullock (1988, p. 149) sees as “[t]he basic flaw in the Austrian’s line of reasoning,” is no desire but inevitable truth deduced from economic theory.

EVERY GOVERNMENT INTERVENTION DECREASES LIVING STANDARD

Professor Tullock (1987, p. 77) also considers

another way of stimulating investment. Suppose that the government taxed consumer goods and used the money to subsidize investment. Suppose further that after a while, it stopped the subsidy. This not good policy, but the effect would be that production after the end of the subsidy would be higher than if no such subsidy had been offered. Indeed, we have a sort of example in the farm program.

First we must note that such a violent action from the side of the government can really lead to increased savings, *forced savings*. And so it is different from a boom caused by an inflationary credit expansion, a boom which creates a business cycle. Second, it makes a difference if such a program is realized throughout the whole economy

or only in certain sectors at the costs of others. In the latter there can be transfer of capital goods from one (unsubsidized) sector into other (subsidized) one. But in the former there can be no such transfer. Although Professor Tullock stresses that he does not agree with such a policy, he maintains that this can lead to an increased living standard. This is, of course, wrong, because people always act so as to maximize their well-being. And if government interferes with the free-market this restricts the free will of people to act in such a manner and so inevitably leads to reduction of living standard. The people follow the second best solutions. Naturally, the government's intervention could reduce such goods which are not included in GNP and "stimulate" such which are part of it, thus create a fallacy of allegedly increased well-being of people. If, for example, due to additional taxation people are willing to take another (part-time) job or to work generally more than before to sustain their real monetary income, the real GNP can increase. But this does not mean that people are now better off. Without the government intervention they clearly preferred leisure to additional working time, and thus their "total psychic profit" after the violent intervention must have declined. And the rise of the real GNP can be observed only because the marginal value of forgone leisure is not included in it.

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