

Time and Power

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Abstract: The paradigm developed by Garrison (1999) depicts the effects of investment on the structure of production and intertemporal consumption. However it ignores political institutions and policies in shaping economic development. This paper incorporates political factors into the Garrison paradigm. In particular, it incorporates the insights of Olson (2000) and de Soto (2003) into the Hayekian paradigm depicted by Garrison.

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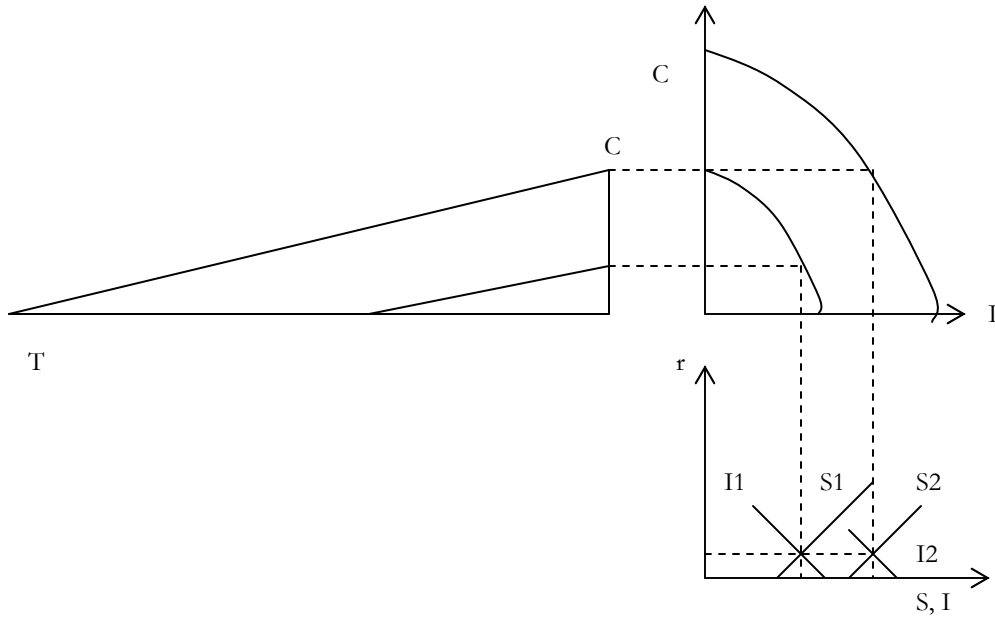
Introduction

The Austrian theories of capital/money and calculation are a part of a single system of ideas. Yet, the calculation literature has advanced into areas where Austrian monetary-capital economists have barely explored. The economic calculation literature explores issues in political economy. The modern Austrian literature on money and cycles has its origins in the same place as where the calculation argument began. While *The Theory of Money and Credit* is best known as the source of modern Austrian monetary and capital theory, Mises also began to develop his critique of socialist calculation in this book. This paper aims at reuniting the Austrian political economy and Austrian capital theory by incorporating political factors into the Austrian theory of capital accumulation and growth, as Developed by Garrison (1999). More specifically, this paper develops a framework for analyzing different issues in political economy or public choice from an Austrian perspective.

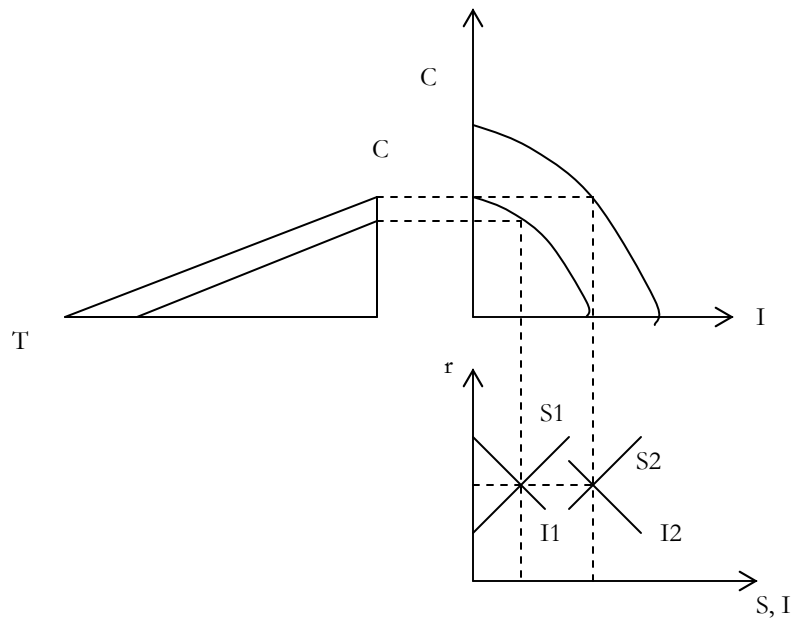
The first part of this paper develops a basic analytical framework for analyzing issues in political economy from an Austrian capital-based perspective. The second part examines the effect of changes in the rate of time preference on the political factors related to economic performance. The third part examines changes in the prevailing public ideology. The final part examines collective action problems.

Capital Based Political Economy

Garrison (1999) extends the work of Hayek (1931) by combining the Hayekian triangle with a production possibilities frontier and a savings-investment credit market graph. Garrison depicts different rates of savings, capital accumulation, and economic development by showing how different savings rates affect the expansion of the hypotenuse of the Hayekian triangle and the production possibilities frontier. Figure one depicts a high savings-high growth scenario.



In the above figure a high savings rate lengthens the structure of production by making longer-term Investment projects profitable. The profitability of longer-term projects is represented by the length and flatness of the hypotenuse of the Hayekian triangle. In figure two we see the low saving/slow growth scenario.



The relatively high interest rate in figure two shortens the structure of production by making longer-term projects unprofitable. Consumption is relatively high in the initial time

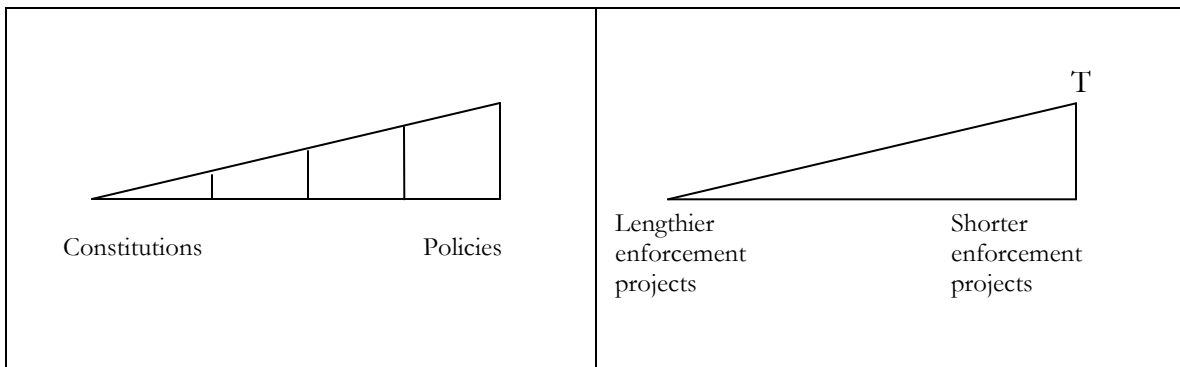
period, but advances little in the subsequent time period. The above depiction of economic growth emphasizes the rate of savings and time preference. Time preference is central to Austrian capital theory. It also emphasizes intertemporal coordination through investment and savings decisions (especially with trade cycle theory) and the structure of production, as depicted by the triangle. However, exclusive emphasis on the rate of savings and capital accumulation ignores institutional and political determinants of growth. Exclusive focus on capital accumulation and savings rates takes the role of institutions as granted.

One of the key advantages of Austrian economics over mainstream Walrasian economics is that it goes beyond the pure logic of choice by incorporating the real institutions, the time element and uncertainty, and evolutionary processes into economic theory. Garrison incorporates the second of these two elements into his analysis of accumulation and development, but largely passes over the first. While there is no a-priori reason to assume that institutional and political arrangements matter more than time preference in determining the rates of accumulation and growth, there is an active and insightful literature on the importance of institutional arrangements in determining economic progress. Given the importance attributed to these factors by many prominent scholars, they should be incorporated into Austrian macroeconomics as effectively as possible.

Hayekian triangles provide a simple means of depicting the vertical structure of production. How should we think about the political structure of production? Lopez (2002) characterizes policies as short run political capital and constitutions as long run political capital. While it is true that historically constitutions have changed slowly and often have significant long run effects, there is no logical reason to associate constitutions with the long-run and policies with the short run. Constitutional changes and their effects can all play out in short time periods. Public projects can take years or even decades to complete, and can

have effects that last even longer, *even if such projects do nothing to alter the constitution*. Long-term public projects like bridges, dams, monuments, and roads can take far longer to complete, and can also produce longer lasting effects than can constitutional reforms. Roman roads are still in use, the Jefferson Memorial still stands, and we are still living with the results of the Manhattan project- for better or worse. It is better to think simply in terms of lengthier and shorter public projects, regardless of whether they are constitutional or policy orientated.

Table 3: The Political/Legal Sector Structure of Production



Numerous studies focus on institutional factors in determining economic growth. De Soto (2000) argues that state recognition of extralegal property held by the poor leads to increased economic development and prosperity. His discussion of property rights treats them as a medium of exchange that eliminates the need for a double coincidence of trust. Official recognition of property rights of poor squatters enables them to engage in trade and use their commerce on the basis of enforceable contracts. This reduces the risk of trading with persons outside of known and trusted persons, like family and close friends. This reduced risk extends the scope of markets, facilitates finance, and leads to greater gains from trade and incentives for investment and innovation. The crucial issue to De Soto is the “mystery of political failure”. American political authorities formalized the property of

“squatters”, or pioneers, in the American West in a series of legislative acts. Formalization and enforcement of property rights in America spurred economic development. Yet, officials in places like Egypt, India, and the Philippines not only fail to emulate this experience, they often harass the poor and enforce special interest privileges.

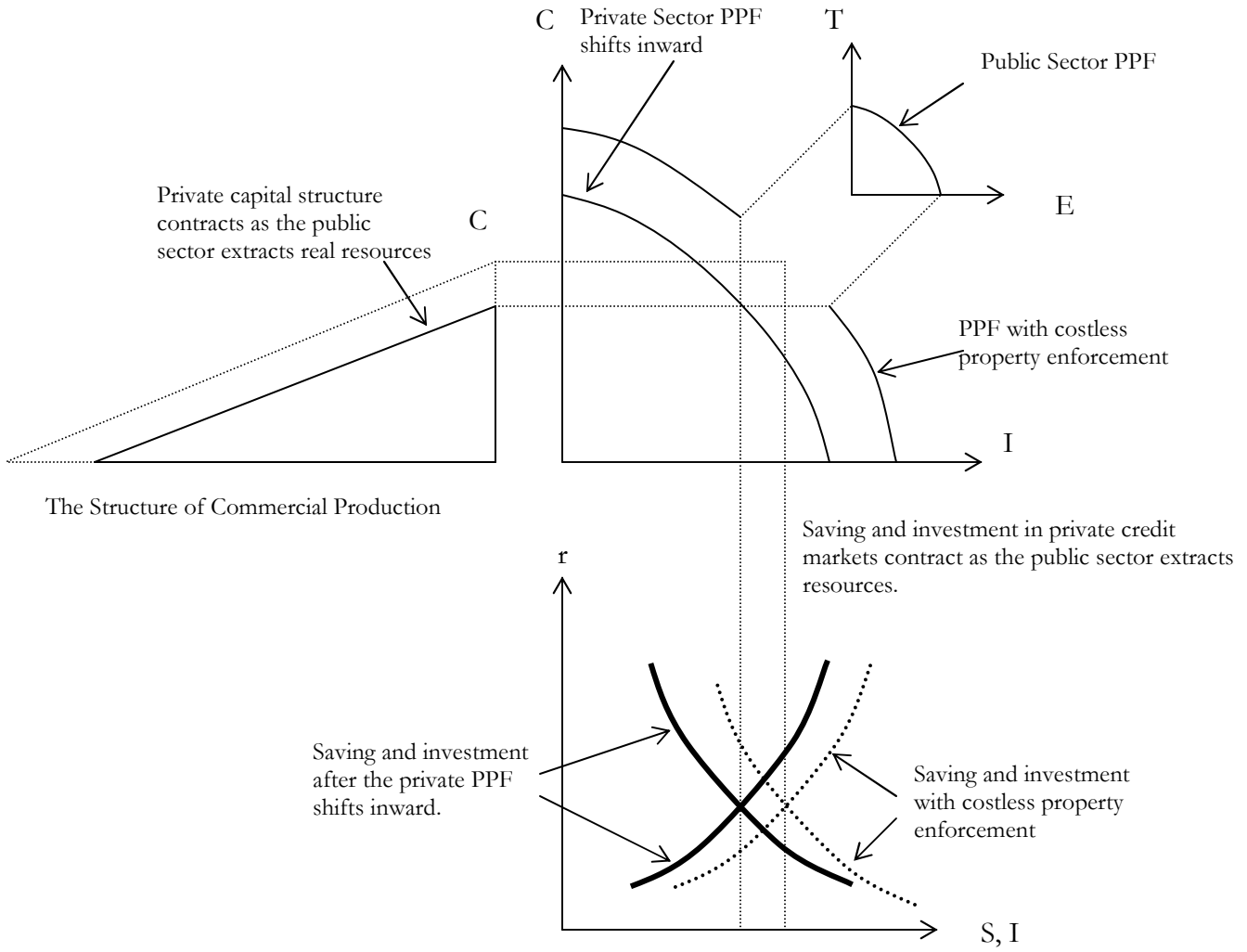
Olson (1996) recognizes the importance of institutions in economic development. Olson (2000) recognizes the ubiquity of markets and the importance of secure property rights. He conceives of the state as a sedentary bandit. It provides the service of eliminating roving bandits, but acts as a monopoly bandit. As a monopolist, the state has an incentive to promote the ‘encompassing interest’ of secure property rights, so that it can extract rents from a larger economy. However, collective action problems lead to disproportionate influence of special interests. Special interests act as roving bandits, and this raises explicit and implicit taxes. These taxes impinge upon economic development. Power is necessary for prosperity because it is needed to minimize roving banditry. However, special interests subvert power to their own ends all too easily. Such abuse of power reduces prosperity.

This paper accepts the arguments of Olson and De Soto as valid. This being the case, there is good reason to consider ways of incorporating their arguments into the Austrian theory of capital and economic development. As previously noted, Garrison (1999) focuses on the time element and time preference, but says little about the institutional determinants of the overall rate of economic development. Incorporation of institutional determinants of development into Austrian capital theory should lead to a richer overall theory.

Ideally, property rights enforcement is costless. Instead, we must devote resources to property rights enforcement, and some amount of involuntary transfers (theft, taxes...) is inevitable. These charges amount to an effective rate of taxation that diverts resources from investment in economic capital (I) and consumer goods production (C).

Olson (2000) raises the issue of time horizon in enforcing property rights, describing a head of state with a long time horizon who enforces property rights. Given that the dictator or elected officials make intertemporal decisions concerning public revenue, we can think of public budgeting decisions in terms of lower and higher order goods. Pure income transfers amount to lower order or final political goods (T). Property rights enforcement amounts to a political higher order good- an investment in future transfers (E). The sum of T and E subtract from the production possibilities frontier. Taxes (or security fees in an anarchistic system) extract a public (or security industry) production possibilities frontier out from the commercial or industrial PPF. Most any actual type would likely draw upon either investment or consumption disproportionately. For analytical purposes we can assume a tax that is neutral as far as current consumption and current investment are concerned. The tax in our example will cause a parallel inward shift of the PPF. The private sector triangle and saving/investment schedules contract as the public sector expands, as shown below.

Extraction of the public PPF out of the Private PPF

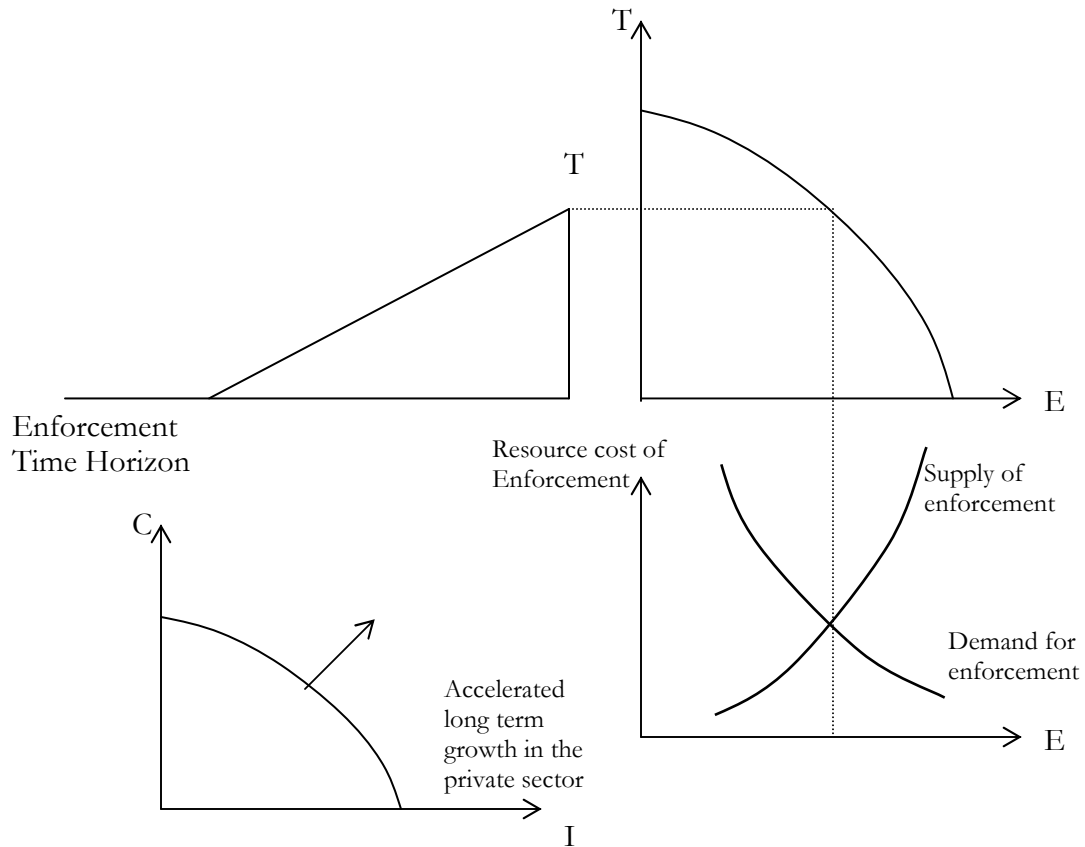


The extraction of funds to finance ostensibly public enterprises need not be funded through simple taxation. Public enterprises can be financed through the accumulation of public debt, or deferred taxation. The accumulation of debt raises issues with interest rates and private capital accumulation. Deficit issues have been dealt with before (see Buchanan and Wagner 1977, or Buchanan, Rowley, and Tollinson 1987). Deficit issues are obviously important to the paradigm developed in this paper, but these issues should be dealt with in a separate paper. The work of Higgs (1985) on ideology receives limited attention in this paper, and deserves careful and extensive attention in a separate paper. Property enforcement issues will occupy the remainder of this paper.

Since property rights enforcement amounts to investment in future public revenues, we can think of different types of enforcement as stages of public security production. In some cases, there are programs that proceed in stages of different length. A project to catch a common thief may be of a particularly short length. A project to break up a gang of professional thieves may involve a lengthier process of investigation and pursuit. This establishes a basis for a public structure of production.

We can combine the Hayekian triangle for public production with the public sector PPF. The decision to protect or transfer property and income depends upon the supply and demand for property enforcement. There is a real price concerning the resource cost of enforcing property rights. Private agencies charge monetary fees for these services, but the public authorities extract taxes. While taxation does not represent a real price, and the actual price might not be known, for analytical purposes we can assume that some kind of political exchange establishes a price for public sector property enforcement. The combination of the three public sector graphs results in the same framework that Garrison developed for his

analysis of business cycles and economic development, as seen below. We can also include the private PPF to view the effects of public sector activity on the private sector.



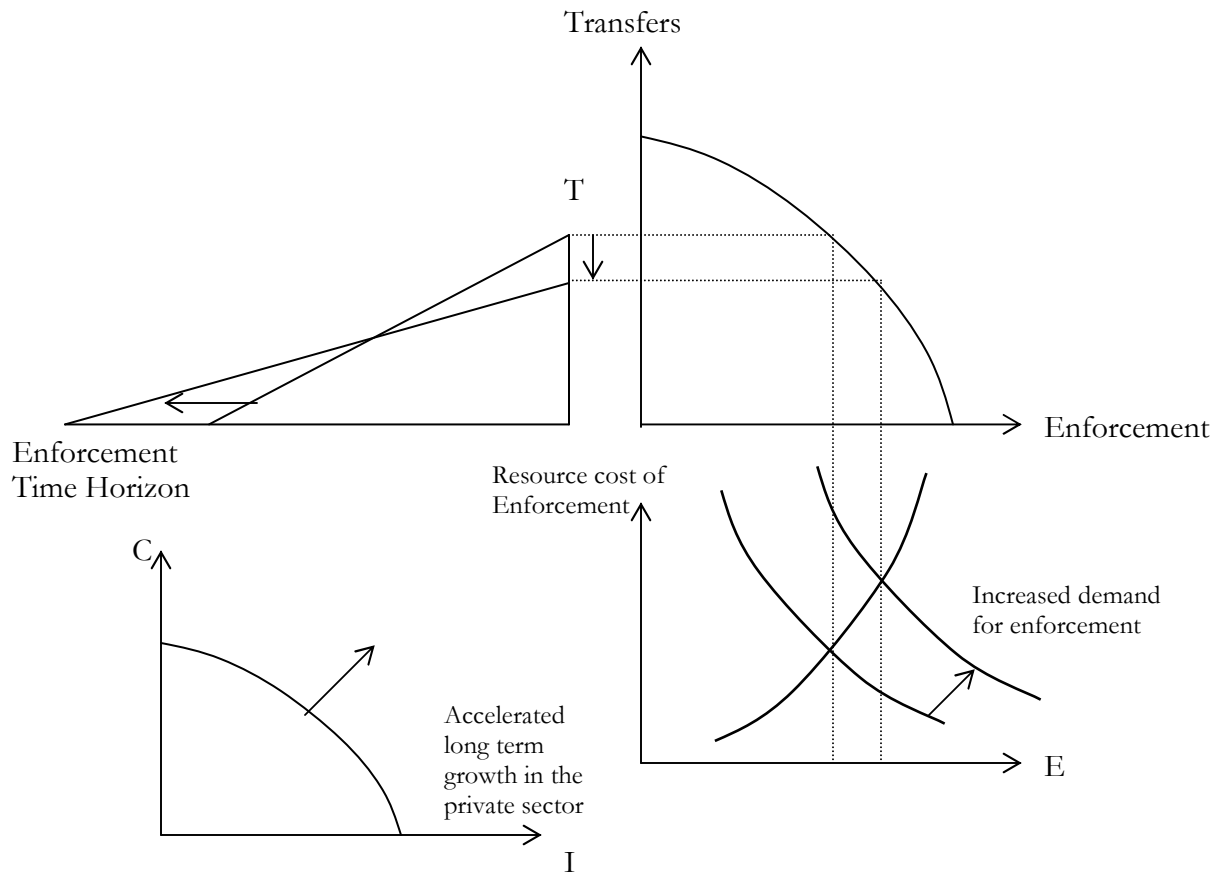
Of course, there are those who suggest that state provision of legal and protective services are unnecessary. For example, Benson (1990) proposes full privatization of police and courts. The Benson proposal would integrate all legal and protective services into the commercial structure of production. Benson makes an intriguing proposal for institutional reform. However, Mises and Hayek generally assumed the existence of at least a minimal state, and this is the situation that we actually face. With the existence of such a state, with its coercive powers to tax and regulate, specific problems arise. In contrast to private legal production, the state can either protect or violate property rights. Olson (2000) examines problems with limiting state powers. Olson discusses the time element, but the Garrison

paradigm sheds new light on these issues. The next section of this paper examines the problem of limiting state powers in terms of the Austrian time oriented framework.

Enforcement and Time Preference

By examining the structure of transfer production, we introduce a new element to the issue of intertemporal choice in transfers. While Olson (2000) discusses the time horizons of sedentary bandits, he does not consider property rights enforcement projects of different length. The issue this raises is the supply and demand for property rights. On the demand side, property owners perceive different possible future states of the world with different degrees of security in property. On the supply side, members of the security industry, either public or private, offer security services at different prices.

The preferences of property holder determine the demand schedule. The relative abilities of members of the enforcement and transfer industries determine the supply conditions. Some set of explicit and implicit prices, including taxes and regulations, bring about some degree of plan coordination, provided that there exists a significant tendency towards equilibration in this market. We can link this market to the enforcement industry structure of production through the enforcement industry PPF. This established some split between resources available to the transfer industry. We can also see a growth in the enforcement industry with an increase in the demand from property rights.



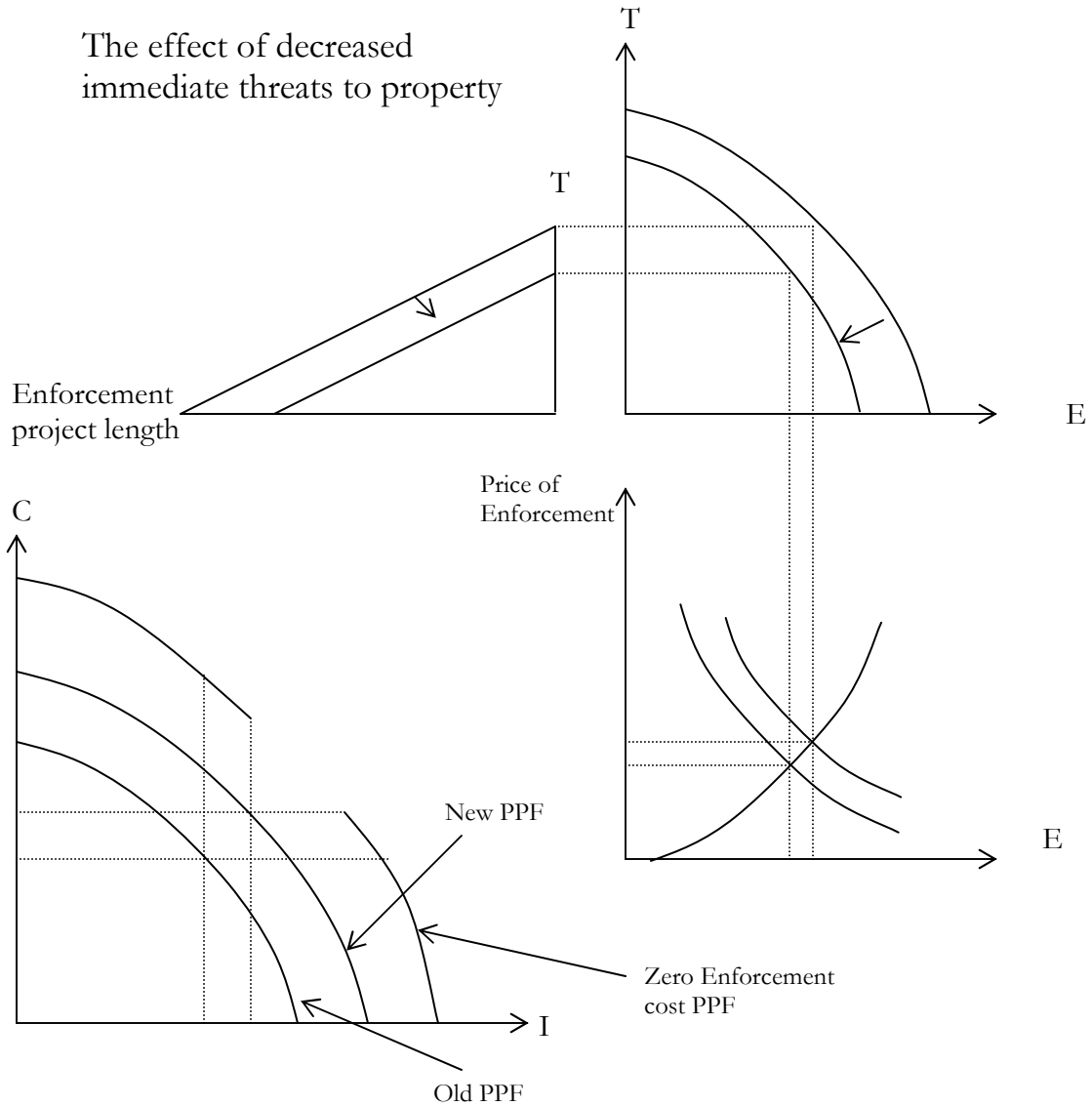
Those concerned with property rights ‘decide to forgo’ some immediate transfers to free up resources to invest in enforcement. Some enforcement projects, which were previously too ambitious, now become feasible, and the length of the enforcement structure of production increases. Assuming that the new enforcement projects are reasonably successful, property becomes more secure. Such a shift represents a type of ‘supply side economics’ approach to this subject- cut current transfers to grow the economy *and realize greater future transfers as economic development accelerates*. More secure property rights can reduce immediate transfers, but improved economic conditions combined with the persistence of the state can lead to even higher future transfers.

The effect of increased security in property rights on the industrial/consumer goods industry varies according to its cause. An increased desire to protect property may be the result of a general reduction in the rate of discount. Such a change in time preference will result in an increase in savings. This lowers interest rates and increases investment and the rate of development.

Enforcement and Belief

Ideological beliefs also serve as a determinant of property enforcement. The adoption of a more favorable view of property rights, or an increase in 'property preferences', changes the demand for property rights enforcement. Its effect on allocation differs from that of a change in time preference in several ways. A change in the public mindset will increase the willingness of people to devote resources towards property protection. A change in time preference might also change the willingness of devote resources towards property protection, but incorporating this effect into the first example would obscure the affect of a change in time preference on intertemporal allocation. The intertemporal shifts will likely dominate anyway. For this reason, the time preference example assumed a fixed division between the enforcement and commercial PPF's. However, greater respect for property rights will decrease the demand for public enforcement services, and shift resources into the production of private goods (i.e. expand the private sector PPF).

The effect of decreased immediate threats to property

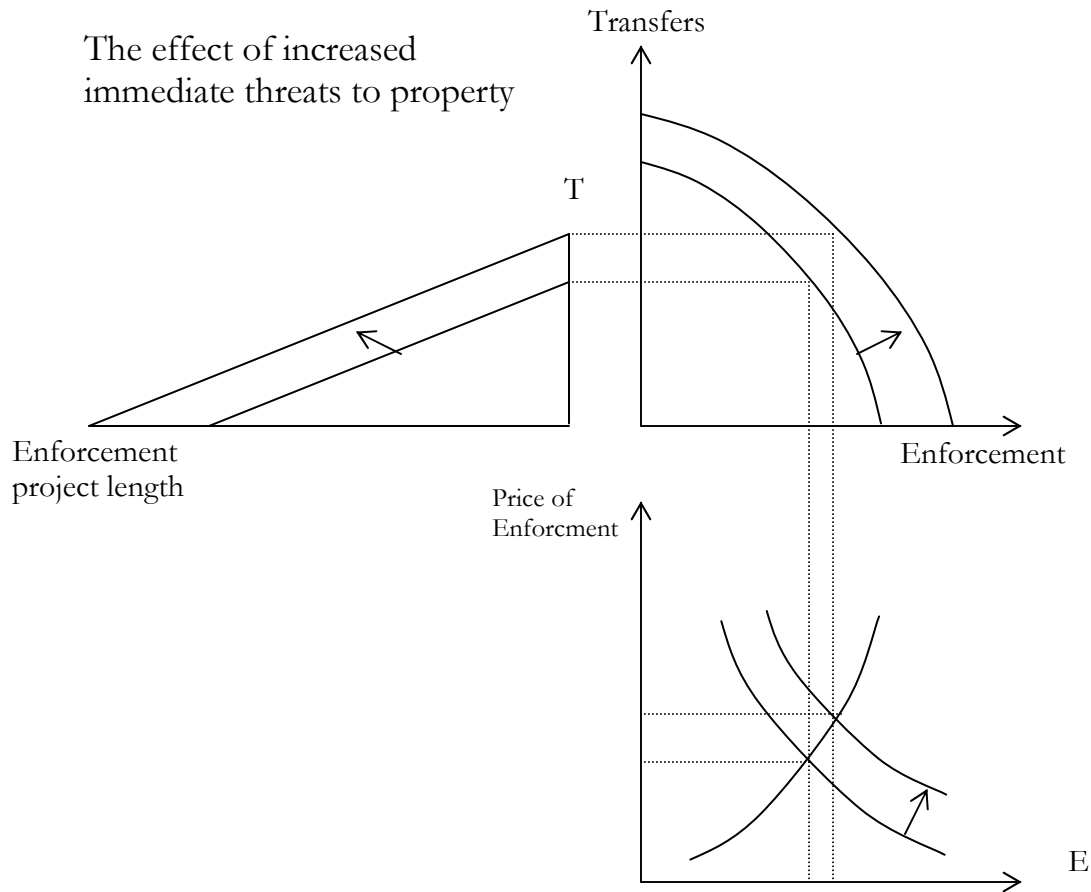


Greater respect for property rights decreases the demand for public property enforcement because citizens do not feel as threatened by crime. Given a drop in crime and a corresponding drop in the need for police and court services, citizens will likely demand real tax cuts. The public law enforcement industry contracts with demand. This industry will grow with the rest of the economy, but as a smaller percentage of the total. In other words, the gap between the actual commercial PPF and the hypothetical zero enforcement cost PPF will diminish. Greater security of property at lower cost implies faster GDP growth. This

analysis raises some interesting questions. Respect for property rights might seem to entail a self-reinforcing process- as respect grows prosperity ensues, as prosperity results from secure property rights these rights should gain even greater respect. History tells a different story. Hayek (1944) notes that as people came to expect progress they became impatient with laissez faire. People failed to recognize the role that secure property rights and limited government had played in their past success. These factors must be considered carefully in this section of this paper. Beliefs may be fully exogenous to the process being described. We should not merely assume that the public perceives connections between greater security with limited government and increased prosperity.

Second, increased disdain or disregard for property rights by some increases the demand for public property rights enforcement by others. As the perceived threat to property rights increases, voters will demand greater protection. This, of course, refers to private criminal activity. As people lose respect for law and property they will be more willing to commit overt theft. Further problems arise when disrespect for property becomes integrated into the political process.

With a change in 'property preferences' people can devote more or less resources in total to property rights enforcement. This shifts the enforcement PPF outwards or inwards. With a change in available resources, there can be significant entry into or exit from the law enforcement industry. The supply of enforcement schedule shifts outwards. It may rotate as well, if entry means more competition and elasticity of supply. Ordinarily, the expansion of a PPF will lead to an expansion along both axes, but greater availability of public resources will increase the total number of transfers, as depicted below.

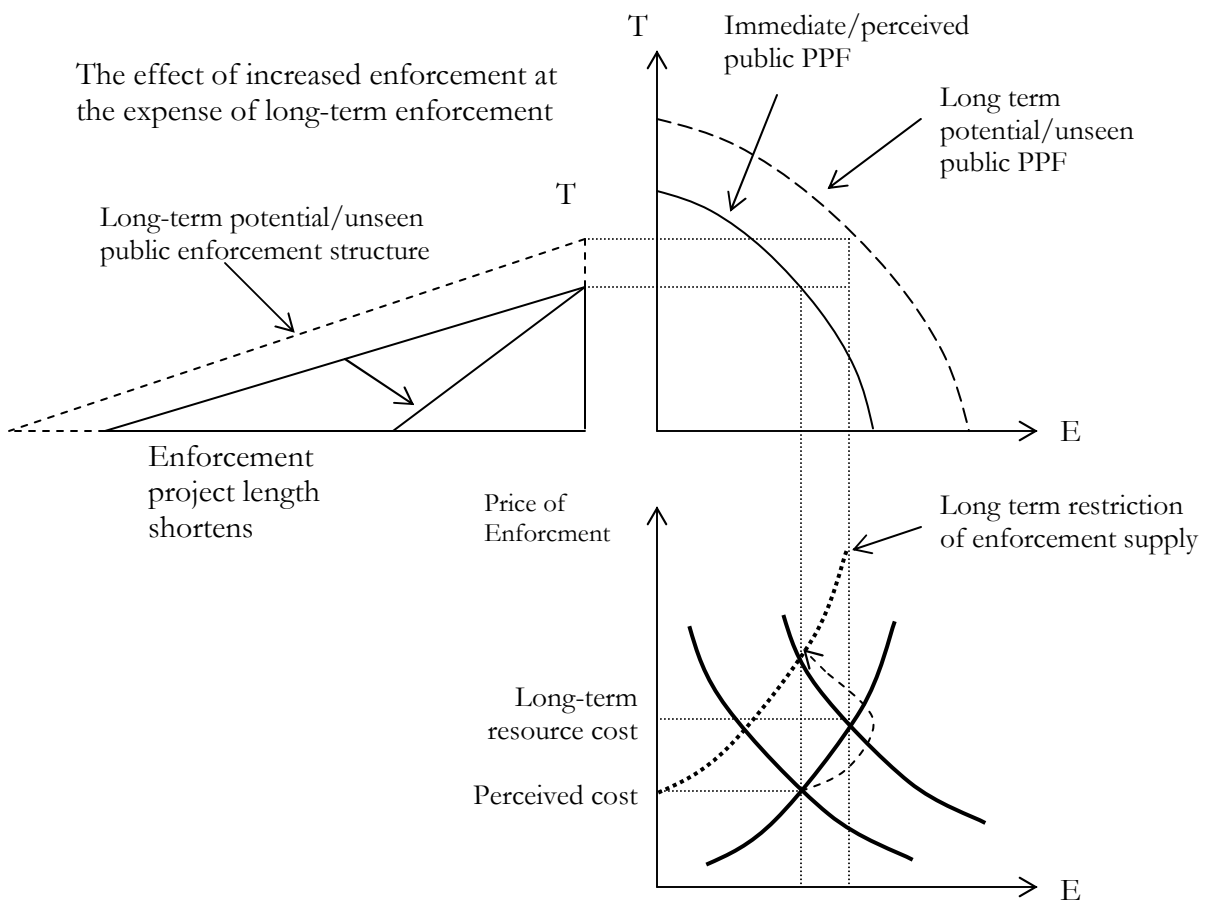


The police could shift some resources out of longer-term projects (i.e. police academy instructors can be moved to active law enforcement). Immediate threats to law enforcement are dealt with effectively, but at the expense of the long-term security. This will hold true provided that people discount the value of security in more distant time periods than in more immediate time periods. That is, if we assume- a positive rate of time preference.

Another question concerning changes in beliefs arises at this point. In Garrison's model increased investment demand necessarily lengthens the structure of production. In the case of law enforcement there is no necessary connection between the desire for greater property protection and a longer time horizon. Increased demand for protection may derive from the onset of a short-term crisis. Higgs (1985) argues that a ratchet effect involving differences

between perceived and actual costs of government solutions to crises leads to shifts in ideology. The preceding analysis fails to depict this ratchet effect clearly.

Authorities could meet an increase in the immediate demand for law enforcement by scrapping long-term enforcement projects. This would free resources to deal with more immediate problems, at an apparent cost of zero. This, of course, would result in a restriction of supply over time. That is to say, the public sector PPF would not expand out at the rate implied by the former structure of enforcement production. As the resources, which were diverted into short-term enforcement, are expended the level of enforcement will return to its original level.



According to public perception authorities have ‘turned stones into bread’ by attaining a point beyond their PPF constraint. The general conclusions that we draw from this are no

different than from Higgs (1985). However, we can now see more clearly why public beliefs change. By appearing to have attained a point beyond the PPF the authorities seem to have achieved what had previously seemed impossible. In this example the perceived price of enforcement remained constant. If implicit taxes replace some prior explicit costs, the perceived costs will fall. Of course, explicit taxes may also rise to fund part of the increased cost of law enforcement. In any case, real and perceived costs diverge.

Since the supply of enforcement derives from a given amount of resources drawn from the private sector permanent increases in supply can derive only from either increasing total tax revenue or from investing tax revenue in long term projects. If officials meet increased demand for enforcement by scrapping long-term projects they will set a self-reversing process into motion. This process will initially create the impression that officials have met the increased demand for enforcement at zero cost. Such an apparent feat will, as Higgs notes, lead citizens to view government more favorably. However, officials will necessarily return to their former level of enforcement service, as they have failed to invest in expanding their capabilities, and are merely expending more of a given amount of resources on short-term enforcement. If the public fails to perceive the lost potential long-term improvement in the public sector (as is likely) they will underestimate the costs of prior enforcement, and therefore overestimate the productivity of the public authorities.

It is certainly possible for the tax base to change over the period of the cycle in question. The initial increase in enforcement will make property more secure than it otherwise would have been. Of course, this does not mean that actual security will be greater. If the increased demand for security derived from increased threats then the increase in supply may only slow the rate of decline in actual security. The subsequent reversion to the level of supply (as opposed to the level of realized security) may leave property substantially less secure. This

would have obvious implications for the overall rate of economic growth, which would in turn affect the tax base and the public PPF.

Encompassing Interests versus Roving Banditry

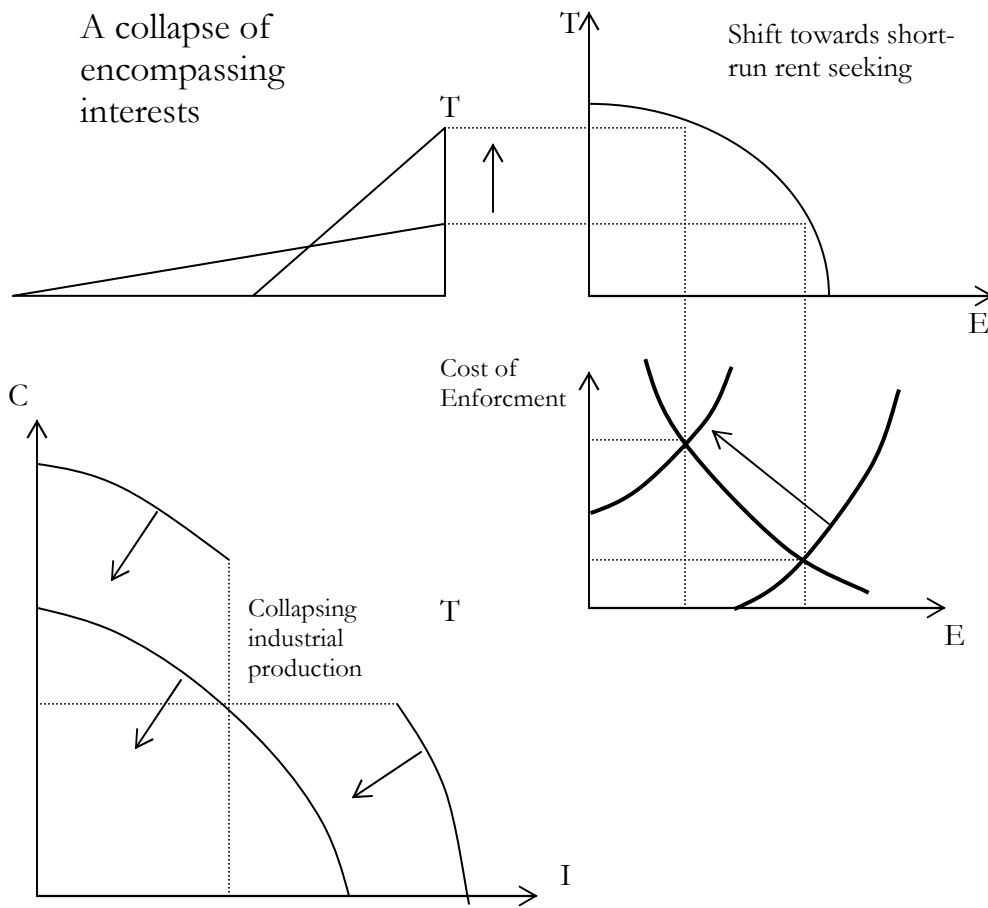
Evidence from Gwartney et al (1999), De Soto (2003), and Dawson (2007) suggests that economic development requires secure property rights. State officials benefit by restricting ‘roving banditry’ (Olson 2000). By acting as a monopoly sedentary bandit, the state creates conditions for stronger economic growth and higher future tax revenues. The time horizons of state officials can vary greatly, but there are significant incentives for state officials to pursue the ‘encompassing interest’ of property rights preservation.

Conversely, collective action problems influence state officials to transfer income from the general population to special interests. Collective action problems effectively obscure the interest in or preferences for property rights enforcement, and lead to under-valuation of long-term encompassing interests in public policy. This causes a decrease in the total amount of resources available for property rights enforcement. Thus the public sector PPF shifts inwards, the structure of enforcement production contracts, and the supply side of enforcement shifts inwards.

Olson asserts that a strong and feared leader can reduce rent seeking by special interests. Olson (2000) points to the example of how Stalin disciplined the Soviet Bureaucracy. Since Stalin effectively controlled the entire country he had a strong interest in its overall economic performance. This gave Stalin an incentive to both invest in industry and to stifle bureaucratic rent seeking. Thus Stalin pushed the supply of enforcement for the public property, which he controlled, and limited rent seeking transfers. In the post-Stalin era Soviet officials exerted less control over their bureaucrats. This leads to a collective action problem, whereby Soviet bureaucrats had a collective interest in the long- term prospects of

the Soviet Union, but a short-term interest in rent seeking. This amounted to a restriction of the supply of enforcement services and a shift towards transfers.

Given that in this case the public sector controlled industry increased transfer activity had serious and direct consequences on industrial production. Without an independent private sector to resist increased rent seeking by public officials rent seeking, the effects of this rent seeking were bound to be far worse than in Western welfare-regulatory states.



While Olson describes the coordination problem effectively, the graphics in this section make the aggregate effects and the time element clearer. Roving banditry amounts to a shortsighted feeding frenzy that is equivalent to a major shift in time preferences. Here we can see how institutional factors can obscure time preference. The time preferences of the

Sedentary Bandit shape public policy, but the time preferences of roving bandits in the bureaucracy are obscured by externalities that stem from the absence of clear claims over extracted rents. Officials have an interest in defending income and property gained through rent-seeking, but the rent seeking process itself is exceedingly short sighted, and will lower total gains over time.

Conclusion

This paper takes the first steps in developing “capital based political economy”. Austrian capital/cycle theory clarifies the time element in macroeconomics by focusing on capital investment. Public Choice theory focuses heavily on the role of institutions in economic performance. While Austrians have stressed that *time matters*, Virginia Public Choice scholars have emphasized that *institutions matter*. These insights from Austrian and Virginian economics are anything but mutually exclusive: institutions and time both matter.

Austrian capital theory has done much to demonstrate the importance of time in the workings of the market process. Public Choice theory has yielded important insights into how public officials use the power of the state. We can better understand the public process by making the time element explicit. This paper helps us to visualize and understand the time element in the public process. Hopefully, the capital based approach to political economy will help us put the roles of the private and public sector into better perspective, so that we can find a better balance between government and commerce than currently exists.

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