

Economic Booms: Bad for Your Health

By Mark Thornton

In the Austrian school's theory of the business cycle, the "boom"—even though it sounds good—is the cause of the business cycle and all its attendant problems. The "bust"—even though it sounds bad—is the recovery where all the problems of the business cycle are put right. The Austrian view is shared by many economy and stock market professionals who dub any retreats from overdone conditions as "corrections."

The mainstream of economists however has the exact opposite perspective—the expansion is good and the contraction is bad. Some, including Milton Friedman, even hold to a "plucking model" of the business cycle where the boom is the normal condition and any contraction is just some misguided government policy "plucking" the economy temporarily downward off its normal trajectory. In this view, the boom is an unmitigated good state of affairs, and the bust is an unnecessary and absolute bad event.

One very large body of statistical data that hints the Austrians are correct—and the mainstream has neither paddle or rudder—is the evidence on human health and mortality. The evidence strongly supports the idea that when an economy goes into recession, humans become healthier and the rate of death decreases.

Sustained long-term economic growth, of course, is good for human health and life expectancy. Americans today are healthier and have longer life expectancies than Americans of 1900 or 1800. Life expectancy is longer and child mortality is lower in wealthy countries compared to poor countries. Americans are healthier than Africans and Asians because of higher levels of wealth and income. Poverty is clearly not good for your health.

But what about the business cycle when government generates periods of overly speculative investing and even stock market hysteria followed by unemployment and bankruptcy? What are the health consequences of an economic frenzy fueled by money creation?

Four statistical studies using data from all 50 American States, 50 Spanish Provinces, 16 German States and 23 OECD Countries have found that increases in unemployment correlate with a decrease in the rate of death. For

example, Christopher Ruhm, an economist at the University of North Carolina at Greensboro found that a one-percent increase in the unemployment rate is correlated with a one-half percent decrease in the rate of death.*

Surprisingly, no calls have been forthcoming from the economics profession to decrease the money supply by 99% which would supposedly increase the unemployment rate to 99% and therefore lead to virtual human immortality. Not surprisingly, even when mainstream economists and government bureaucrats become enlightened to the fact that health improves during recessions, they fail to make the connection that the boom phase of the business cycle is bad for human health and life expectancy.

The reasons for the statistical relationship between health and the economy should be obvious for all to see, but most are blinded by obedience to the notion that stock market and economy-wide booms are all-out good for us. Here are some reasons to think otherwise:

- During the boom more people are working than normal and they are working longer hours. This means that we collectively have less time for exercise—a prime ingredient of good health.**
- During the bust, people have more time to exercise. Not surprisingly, after the "longest peacetime expansion in U.S. history" Americans had become the fattest people in the history of the planet.**
- The boom also means that people have less time for sleep, while during the bust there is more time for sleep, rest, and relaxation. Not only does a good night sleep make you more productive at work, better able to learn, and have fewer wrinkles on your face, it also helps you live longer.**
- As the great boom of the 1990s came to an end, Americans had become the most sleep-deprived population on the planet, popping record amounts of sleeping aids to go along with all their psychotherapy pharmaceuticals.**
- The combination of fatter paychecks, larger stock market portfolios, and less free time during the boom phase mean that people are more likely to eat "fast food," engage in thrill seeking activities, and to overtax themselves with duties and obligations—thus driving up their stress levels.**
- Recessions are difficult too, especially for the unemployed breadwinner, but people are more likely to return to normal lifestyles and engage in less stressful activities and home production—like home cooked meals, gardening, and fixing things around the house.**

James Grant ends his great book, *The Problem with Prosperity* with a chapter titled "Reversion to the Mean." His point is that all booms cause and eventually result in a bust.**

In Ruhm's statistical analysis he finds a similar type of "reversion to the mean" behavior related to health. When the economy goes into recession, or the correction phase, not only do people lose weight, but the fattest people lose the most weight. Also, the recession leads smokers to moderate their habits and for obsessive smokers (40 or more cigs a day) to cut back the most. Both results suggest a return to moderation, normalcy, and healthier lifestyles.

I'm sure that the more lifestyle statistics and surveys examined, the more evidence that would pile up in favor of the notion that the "boom" is bad for you. The Austrians have taught that inflation is analogous to a drug that "stimulates" and eventually kills the patient. Bastiat has shown that the inflation mentality can lead to perpetual world war. Health statistics have now conclusively shown how inflation of money and credit, along with the boom in the economy and stock market, kills us in our individual daily lives.

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*** Christopher Ruhm, "Healthy Living in Hard Times," NBER Working Paper No. 9468 (Cambridge, MA: National Bureau of Economic Research) February 2003.**

**** James Grant, *The Problem with Prosperity: The Loss of Fear, the Rise of Speculation, and the Risk to American Savings* (New York, NY: Random House) 1996. See his AEN interview.**

How Government Statistics Lie

Robert Blumen 7/2/2003

Richard Benson explains in this piece -- *Government Statistics: Lessons in Cooking and Spinning* -- how most government statistics are fabricated, padded, tweaked, or otherwise pushed and squeezed to come out more favorably than what the data shows. One example is that in the CPI, inflation

is made to look lower by replacing house prices, which are inflating, with owner-equivalent rent. Rents are falling, in part because of the housing bubble. But when calculating personal savings, home price appreciation is counted as saving. Besides being completely wrong from an economic standpoint (increases in the price of an asset that someone owns do not constitute savings), these adjustments make inflation look lower and savings look higher.

Our economic statistics could now fit in great works of fiction like *Animal Farm*, *Brave New World*, *1984*, *Fahrenheit 451*, etc. Because the government has “fixed a CPI problem” that wasn’t a problem we can lose jobs every month, and shrink the real economy, yet show real GDP growth and solid productivity gains. Dishonesty or spin in government continues: The US has economic and productivity growth that is guaranteed - by definition; the US has 15% of GDP and Personal Income that is made up, “imputed”; and, a definition of savings that makes savings positive only because of the housing bubble.

Economics and Measurement

By Gene Callahan

The quantitative treatment of economic problems must not be confused with the quantitative methods applied in dealing with the problems of the external universe of physical and chemical events. The distinctive mark of economic calculation is that it is neither based upon nor related to anything which could be characterized as measurement.

-- Ludwig von Mises, *Human Action*, II.3

A great revolution in the physical sciences occurred between the 15th and 18th centuries. Measurement and the subsequent establishment of quantitative formula relating various measurements gradually replaced the Aristotelian search for the proper classification of physical phenomena. As Whitehead says of Aristotelian teachings, "these doctrines said to the physicist to classify when they should have said measure" (1967, p. 45).

But, as so often happens in human affairs, a new idea produces an

overreaction. The idea of measurement, so successful in the physical sciences, came to be seen as the *sine qua non* of all human knowledge. The notion that if something hasn't been measured, then we don't know anything about it, came to be commonplace.

Measurement in the physical sciences depends upon the postulate that certain elements in the situation being measured are constant. A meter is always a meter, whether Joe or Mary or Sam is doing the measuring. And that meter should stay constant over time. Even Einstein, in formulating his theory of relativity, which contends that measurements of length are dependent on the observer's frame of reference, still must posit some unchanging elements, such as the speed of light, in order to formulate physical laws based on that idea.

However, once we enter into the realm of human action, there are no quantitative constants. Human action springs from the meaning that humans attach to their situation. Since that is the case, as knowledge is gained, as life is lived—in short, as time passes—the meanings humans attach to the circumstances of their world will alter. Such alterations are inherently unsusceptible to quantitative measurement or prediction. We cannot measure an interpretation, nor can new human meanings be predicted in advance—otherwise, they would not be new!

Let's say we examine the copper market over a course of many years. We will find that different prices were paid and different quantities of copper were sold in each year. People's desire for copper fluctuated. The fact that from the point of view of chemistry copper remained identical during the period is irrelevant to economics. As Mises puts it:

External objects are as such only phenomena of the physical universe and the subject matter of the natural sciences. It is human meaning and action which transform them into means. Praxeology does not deal with the external world, but with man's conduct with regard to it. Praxeological reality is not the physical universe, but man's conscious reaction to the given state of this universe. Economics is not about things and tangible material objects; it is about men, their meanings and actions. Goods, commodities, and wealth and all the other notions of conduct are not elements of nature; they are elements of human meaning and conduct. He who wants to deal with them must not look at the external world; he must search for them in the meaning of acting men.

Once we realize that economics deals with human meaning and not the physical characteristics of economic goods, the futility of searching for eternal, quantitative economic laws should be clear. No one would consider measuring what "war" or "liberty" means to people. Meaning is not available for measurement, and, in any case, meanings are in continual flux. What having a horse meant to a person in 1800 is entirely different than what having one means to a person in 2003, with the availability of Internet connections, automobiles, trains, and planes.

The price of something like Priceline.com stock over the last few years illustrates the primacy of meaning in human action. What owning a share of Priceline meant to the average investor in early 2000 was phenomenal yearly increases in the stock's price and a share in the "new economy." On March 10, 2000, at the height of the dot-com bubble, a share of Priceline traded for \$94.50.

A mere nine months later, Priceline had much the same web site, the same technology, and many of the same employees. Yet on December 29, 2000, a share traded for \$1.31. By then, the meaning of owning Priceline for most investors was to have been a sucker, taken in by hype, holding an asset that just kept declining in value. The physical characteristics of what was owned had changed relatively little, but the meaning attached to that ownership had altered dramatically.

"But," the advocate of economic measurement may ask, "what about money?" Can't we use the "measuring rod" of money as a common unit, thereby measuring what different goods meant to people at different times?

However, money is itself an economic good, and its meaning to acting man fluctuates just like the meaning of all other such goods. Quite aside from variations in the quantity of money altering its value, the meaning of money itself will vary from person to person and for the same person across time. The acquisition of money may be a man's main pursuit in life until, one day, a religious conversion completely alters its importance for him. Even if we had an absolutely fixed quantity of an unchanging substance, such as gold, serving as money, its meaning might still vary greatly. In peaceful times with a booming economy, people might feel the need to hold very little money. But should a crisis, such as a war, suddenly arise, their desire to hold money as insurance against hard times might increase dramatically.

Nor will it help to try to adjust the value of money by some price index. Such indices try to gauge changes in the value of money by "measuring" the amount of other goods it can purchase. We can see that this procedure is viciously circular. The value to people of those other goods fluctuates as well. Initially, we were going to attempt to measure the fluctuations in the value of non-monetary goods by using money, but now we find ourselves measuring the fluctuations in the value of money by using the value of non-monetary goods! In regards to human action, there is nothing constant by which we can achieve stable measurement. If the price of oranges declines, was that because oranges are valued less, money valued more, or some combination of both factors?

The collection of national economic data and the attempt to "steer" the economy based on such numbers are plagued, among other things, by this measurement problem. We can measure the quantity of physical goods a society consumes or produces, but that tells us little about the level of satisfaction the members of that society gain from those goods. It might seem, at first glance, that we could perform capital accounting for an entire country using money prices, achieving at least the same accuracy of measurement as the businessman. But that mistakes the nature of capital accounting. As Mises says:

It is possible to determine in terms of money prices the sum of the income or the wealth of a number of people. But it is nonsensical to reckon national income or national wealth. As soon as we embark upon considerations foreign to the reasoning of a man operating within the pale of a market society, we are no longer helped by monetary calculation methods. . . . If a business calculation values a supply of potatoes at \$100, the idea is that it will be possible to sell it or to replace it against this sum. If a whole entrepreneurial unit is estimated to be \$1,000,000, it means that one expects to sell it for this amount. But what is the meaning of the items in a statement of a nation's total wealth? What is the meaning of the computation's final result? What must be entered into it and what is to be left outside? Is it correct or not to enclose the "value" of the country's climate and the people's innate abilities and acquired skill? The businessman can convert his property into money, but a nation cannot.

The collection of prices and quantities contained in, for instance, GDP figures, are an arbitrary choice on the part of the government. It is arbitrary to count

a dollar the government spends on some service no one may really want as "equal" to a dollar a consumer freely chooses to spend on a good she truly desires. It is arbitrary to count a dollar spent by me this year as "equal" to a dollar spent by you next year. The dollar amounts going into the GDP are adjusted yearly for inflation, but as we have seen, the measure of inflation is itself arbitrary. Nor is there any particular reason that yearly adjustments, rather than monthly or daily adjustments, should be used, other than the fact that we are accustomed to annual data. And we have no reason to believe, even if we could eliminate the above difficulties, that a dollar measure of GDP reflects anything constant about the satisfaction the citizens receive from the dollars they spend. Ultimately, GDP measures nothing more than how many dollars were spent in a nation's economy on selected goods and services.

Nevertheless, economic data and statistics are not useless. They are facts to be interpreted by economic history. If we see a steady decline in the price of raw land in some country during some period, we may draw on our understanding of other factors we know were involved and perhaps conclude that increased agricultural productivity was reducing the demand for cultivating previously raw land. But it would be a serious error to formulate a "law" stating that all declines in the price of raw land were evidence of the same process. In another country, at another time, a decline in the price of such land might be due to a general deflation, to a decline in population, or to a new source of cheap agricultural imports. Similarly, a decline in GDP figures may be rendered meaningful by being subjected to historical interpretation.

We may even find that certain quantitative patterns persist over years or even decades. That might mean that we had stumbled across an institutional or customary arrangement producing such a pattern. Political philosopher Terry Nardin has said that statistical studies in the social sciences "are not scientific generalizations about a truly time-independent class of phenomena; they are more or less well-disguised descriptions of customs specific to a particular historical situation" (2001).

A noteworthy example of this phenomenon has been pointed out by Roger Garrison. He observes that Milton Friedman's predictions on the relationship between the money supply and price inflation worked fairly well for a significant period of history. But, just as Friedman's version of monetarism was gaining acceptance with policy makers, Regulation Q, which forbade the payment of interest on checking accounts, was rescinded. The institutional framework within which Friedman's predictions had worked was altered

dramatically. As a result, just as Friedman's system was being adopted, it stopped working! If Friedman had viewed his work as determining an institutionally derived regularity, rather than an economic law, he might have expected that a major institutional change would have required a revision to his system.

The collection of economic data and their subsequent econometric analysis are perfectly valid activities, if they are used judiciously. Economic data are raw material for historical interpretation, and not the launching point for a futile search for eternal, quantitative economic laws.

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Most people make money, not by investing, but by earning a living. This is especially true of journalists, including financial journalists. If you want to see why analysts favor one view of the market, follow the money. ---- Gary North

Recovery or Boomlet?

by William L. Anderson

In recent weeks, the stock market has staged a mild rally. Though the most recent unemployment numbers are well over six percent, Republicans, as well as a few market analysts, are claiming that the long overdue economic recovery has arrived. While I wish that were the case, the facts demonstrate otherwise; this is not a recovery, but simply an unsustainable mini-boom that makes the long-term economic picture even worse.

That is not how we hear things from the government, not surprisingly. Administration officials, hopeful that a strong economy next year will boost George W. Bush's election chances, have been trumpeting the end to the longest economic downturn in this country since the Great Depression of 70 years ago. His media supporters, such as Larry Kudlow and Neil Cavuto, also agree and have called for the Federal Reserve System literally to open the money spigots. According to Kudlow:

No matter what the investment—be it corporate profits paid out as dividends, or capital gains, or new capital-goods orders and shipments by large and small businesses, or new high-risk venture start-ups—higher after-tax investor-class returns will place new liquidity demands on the financial system. The Fed must accommodate them.

A shock-and-awe liquidity-expansion policy from the Fed will counter our underperforming economic recovery, offset the forces of worldwide deflation and recession, and stomp out deflation fears at home. An aggressive liquidity stance will also accommodate rising transaction demands following the latest Bush tax cut. And it will even counter the negative effects of any potential breakdowns in the investment portfolios of Freddie Mac and Fannie Mae, the troubled loan institutions.[i]

Of course, "liquidity expansion" in Kudlow-speak is nothing more than a burst of inflation, and the Federal Reserve has followed suit, lowering its discount rate to something not much above zero. (Kudlow and the other inflationists wanted the Fed to cut its rates by more than what was actually done, but it would seem that the next logical step for the Fed would be simply to dump money from helicopters or hand it to passers by at the street corners.)

Kudlow is hardly the only offender here, and while his "shock and awe" analogies are over the top, the truth is that economists and pundits, both left and right, have been calling for basically the same solution: inflation, and more inflation. This not only reflects the total misunderstanding of the current economic situation by both the economic mainstream and political pundits (Well, what would we expect?), but also demonstrates ignorance both of business cycles and of money itself.

As Murray Rothbard and Ludwig von Mises tirelessly pointed out, an economic recovery occurs when consumers and investors begin to direct investment into sustainable lines of production. A recovery can only happen after the malinvestments that accumulated during the previous boom are substantially liquidated. Of course, a liquidation must be permitted to occur in the first place, something that the Bush Administration and the Fed have fought at every turn, which I note in previous articles.

Given that the government has done everything in its power to prevent the full

liquidation of malinvested capital, and given that the Bush Administration and Congress have substantially increased the burden of government that must be borne by individuals, it seems clear that the U.S. economy is not poised for a recovery. Indeed, from airlines to manufacturing, the liquidation has a long way to go before the economic downturn hits bottom.

Thus, any upturn whether in economic statistics or in the stock market is almost certain to follow the patterns not of economic recovery but rather a mini-boom. I say "mini" because there is no way that this particular boom, as pathetic as it is, can be sustained for a long time, unlike the boom of the late 1990s. In fact, the Fed's recent actions can only force more malinvestments which themselves will have to be liquidated in the future.

There is historical precedence for a mini-boom. During the early days of the Franklin D. Roosevelt Administration, which were marked by the passage of legislation like the National Industrial Recovery Act and the Agricultural Adjustment Act, the economy also experienced a small boom. In fact, the rate of unemployment, which stood at about 25 percent when FDR took office in 1933, fell to about 15 percent two years later.

The Roosevelt Administration was not the only active entity in Washington. The Federal Reserve System had lowered its discount rates to near-zero and the government was trying to force up the inflation rate, using tactics like destroying the gold standard and confiscating all gold money that individuals possessed.

The strategy worked, sort of. As noted earlier, some people were put back to work (although thousands also found employment doing government-sponsored tasks), but the boom was only temporary. Government was growing quickly, along with the tax burden, the regulatory state was taking form, and FDR openly savaged businessmen and his comments, as Robert Higgs has written, had a dampening effect upon the private investment needed to bring real recovery.

Roosevelt's mini-boom came to a screeching halt by late 1937, as the economy fell into the trenches again, the unemployment rate zooming to about 20 percent. To put it another way, FDR achieved a first: he helped to create a depression within a depression.

One hopes that the Bush Administration does not seek to emulate FDR,

although, like Roosevelt, this administration has forced through huge increases in government expenditures and with the recent Medicare bill, has dumped a gargantuan unfunded liability upon U.S. taxpayers. (At least FDR did not send the armed forces all over the world—at least during the 1930s. In the 1940s he helped launch the biggest and most destructive war in world history.)

As we hear the political pundits and mainstream economists debate the current economic climate, perhaps terms like "shock and awe" truly are appropriate. One is shocked at the economic ignorance that is demonstrated time and again by the "experts," who are still stuck in a Keynesian time warp that while discredited, still seems to rule the intellectual roost. And one is in awe of the truly bad policy prescriptions that emanate from the White House, Congress, and the mainstream press.

Yes, 2004 is an election year, and the Bush Administration is desperate to make voters believe that the long-awaited recovery finally is here. Furthermore, there is no shortfall of Republican pundits trying to publicly make the case that the economic policies of Bush II really are better than the policy disasters of Bush I.

However, there simply is no way that the policies of the Fed and the Bush Administration are going to give us an economic recovery. As Mises and Rothbard wrote time and again, an economic recovery within a free market economy occurs as a matter of course once the government steps out of the way. That clearly has not happened for the past three years, and now that Bush is desperate to manipulate the economy in order to pave the way for re-election, it is not politically possible for this president and his underlings to take the needed hands-off approach to the economy.

Instead, we will be given the news that the wise policies of the Fed and the meager and back loaded tax cuts that the Republicans have given us will be enough to bring recovery. However, pay no attention to the man behind the curtain (whether it be George W. Bush or Alan Greenspan), for he does not know what he is doing. We are not in recovery; it is nothing more than a little boom that ultimately will turn into a bigger bust.

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[i] Larry Kudlow, "Pour it On," www.townhall.com, June 17, 2003.

Why Do Capitalists Earn Interest Income?

by Robert P. Murphy

THE INTEREST PROBLEM

Eugen von Böhm-Bawerk's three-volume work, *Capital and Interest*,^[1] is a classic, both because of its brilliant analysis and its witty exposition. The first volume provides a history and critique of all preceding explanations of the "interest problem." For Böhm-Bawerk, the task of the interest theorist was to explain why a capitalist could regularly earn a net return on his financial assets, even though (unlike laborers) he apparently did nothing to "earn" this interest income.^[2]

BÖHM-BAWERK'S "AGIO THEORY"

Böhm-Bawerk's solution consisted of two steps. First, he framed the phenomenon of interest, not as a return to financial investments, but rather as a premium, or agio, in intertemporal exchanges. For example, take the case of a tractor. Typically, a capitalist who invests in a tractor (either directly or by lending funds to a farmer) can earn an interest return on his investment; that is, he will have more real wealth after the tractor has been used to harvest crops than before. What Böhm-Bawerk realized was that this phenomenon—the growth in real financial wealth through investment in the tractor—relies on an apparent undervaluation of the tractor.

To see this, suppose that the tractor is expected to yield an additional \$1,000 worth of revenue every year, and that it will last ten years (before being junked). Böhm-Bawerk argued that the only reason a capitalist could earn money through ownership of the tractor is that its initial purchase price is less than \$10,000. Only in that case could an investor use an initial amount of financial wealth and turn it into a greater subsequent amount (ten years later).

Thus, Böhm-Bawerk had transformed his original question. Rather than asking, "Why do capitalists earn an effortless flow of interest income?" he

could instead wonder, "Why is it that the initial purchase prices of capital goods systematically fall short of the future revenues they are expected to yield?"

The second step in Böhm-Bawerk's solution was to make the claim that present goods are preferred to future goods. Generally speaking, a person values present apples, houses, etc. more than he values claims to such goods that cannot be redeemed until the future. In the case of our hypothetical tractor, its purchase price is denominated in present dollars, while it only offers the hope of a stream of future dividends (of \$1,000 each year for ten years). Since no one would be willing to give \$10,000 now in exchange for a promise of \$1,000 payments for each of the next ten years, it naturally follows that no one would pay \$10,000 for our hypothetical tractor. Because of this fact—that present goods are worth more than future goods—the tractor can be purchased for less than \$10,000, and a capitalist can increase the market value of his wealth by investing in tractors (and waiting ten years).

THE "NAÏVE PRODUCTIVITY THEORY"

Of particular interest to modern Austrians is Böhm-Bawerk's refutation of a popular, rival explanation for the phenomenon of interest. Many economists would argue that, in the case of our tractor, the reason a capitalist earns a net return on his wealth is that the tractor is productive: After all, a farmer can harvest more crops, year after year, with a tractor than without one, and so naturally (these economists believe) someone who buys a tractor can earn an income over time. More generally, such economists argue that borrowers are willing and able to pay interest because of the "productivity of capital."

Böhm-Bawerk brilliantly refuted this line of reasoning, which he referred to as the "naïve productivity theory" of interest:

I grant without ado that capital actually possesses the physical productivity ascribed to it, that is to say, that more goods can actually be produced with its help than without. I will also grant...that the greater amount of goods produced with the help of capital has higher value than the smaller amount of goods produced without it. But there is not one single feature in the whole set of circumstances to indicate that this greater amount of goods must be worth more than the capital consumed in its production. And that is the feature of the phenomenon of excess value which has to be explained. (I, p. 93, italics original)

We can understand Böhm-Bawerk's argument in terms of our tractor example. The "naïve productivity" theorist claims that the owner of a tractor earns a net return on his investment because the tractor yields \$1,000 in marginal revenue each year of its life. So this explains (so thinks the naïve productivity theorist) the annual percentage return reaped by the capitalist.

But Böhm-Bawerk points out that this is only looking at one side of the matter. Yes, the productivity of the tractor explains why its owner enjoys \$1,000 per year in extra income; if he wished, the owner could rent out the tractor and charge up to \$1,000 per year for its services.

However, this flow of income will only represent a net return on the original investment if the original purchase price is less than \$10,000. For suppose that the tractor initially cost \$10,000. In that case, its owner would still receive \$1,000 per year for the ten years of the tractor's life, but at the end of the decade the capitalist would be left with his initial principal, \$10,000. In other words, the depreciation of the tractor would exactly offset the flow of dividends, so that the net rate of interest on the investment would be zero. Note that this is perfectly consistent with the fact that the tractor is productive, and so the tractor's productivity as such cannot be the explanation for a positive rate of interest.

THE NEOCLASSICAL APPROACH

Modern mathematical economists, who explain economic phenomena through systems of simultaneous equations, are often bewildered by the Austrian stress on subjective intertemporal preferences—rather than capital productivity—when it comes to interest theory. Indeed, a standard condition in a typical mainstream model is

$$r = f'(k),$$

which denotes the fact that in equilibrium, the real rate of interest is equal to the marginal product of capital, i.e. the increment in output produced by an increment in the capital stock k .

On the face of it, the neoclassical approach seems to commit the very fallacy that Böhm-Bawerk pointed out over one hundred years ago: The mainstream economists seem to argue that the real rate of interest is directly proportional

to (and in a sense "caused by") the extra output yielded by additional units of capital. So what's going on here? Do the mainstream models contain a logical error?

Actually, they do not. What has happened is that, because of their need for analytical simplicity, the mainstream models assume that the world has only one good. Consequently, capital goods and consumption goods are the same thing, and all of the difficulties in "Austrian" capital theory are assumed away.

We can see this most clearly by a simple example. In order to motivate their assumption of a single good serving as both capital and consumption, the neoclassicals might adopt a model in which sheep are the only good. In this fictitious world, people own stocks of sheep. They can choose to consume their sheep in the present, enjoying the current marginal utility of consumption, or they can postpone consumption (i.e. save their sheep) for a future period. If they choose the latter course, their stock of sheep will multiply (because of natural reproduction). If, say, the number of sheep doubles every year, then (the neoclassical would argue) the equilibrium real rate of interest in this fictitious world must be 100 percent.[3] It is through reasoning such as this that the mainstream economist believes that the "marginal product of capital" is linked to the equilibrium real rate of interest.

However, as I claimed above, this type of model assumes away the thorny issues in capital theory, which only the more sophisticated Austrian analysis attempts to handle. Recall that in our tractor example, the fatal flaw in the naïve productivity explanation was that it did not explain the initial purchase price, or market valuation, of the tractor, in terms of dollars. The tractor represents a claim on future dollars, but we cannot know the implicit interest rate on the investment until we know the present market value of the tractor in terms of dollars.

In contrast, consider the sheep example. In a fictitious world where sheep are the only good, the only measure of a person's real financial wealth is the number of sheep that he owns. In this simplified scenario, yes, if someone's stock of sheep physically doubles every year, then the market-clearing (real) interest rate must be 100 percent.

To put it another way: One sheep now represents a claim on an endless stream of future sheep. But unlike the tractor example, we do not here run

into the Böhm-Bawerkian problem: The current market value of one present sheep, in terms of sheep, is always one! In the tractor case, physical facts alone could not tell us how many dollars would exchange for the capital good; the tractor might cost \$5,000, or \$10,000, or \$15,000. But in the case of the sheep, we can say what the real price of the capital good (sheep) in terms of its future consumption good (sheep) has to be: One sheep trades for one sheep. Thus, the incidental use of a one-good model has allowed the neoclassical to completely sidestep the "Austrian" problem[4] of valuing the capital stock in terms of its eventual output of consumption goods.

AUSTRIAN ANALYSIS STILL RELEVANT

I would like to conclude with a personal anecdote that illustrates the relevance of Böhm-Bawerk's critique. After I had reconciled the verbal logic of Böhm-Bawerk with the mathematical models of the mainstream, I wrote a first draft of one of my dissertation essays in which I explained away the apparent conflict by pointing out the tremendous importance of the mainstream's assumption of a single-good world. I handed in my draft to a renowned mainstream economist, just to make sure that I hadn't misunderstood neoclassical theory.

When I got my draft back, I was quite surprised to find that the professor had clipped a single piece of paper to the front. On it he had written something like, "This is the only interest theory that I, and just about everyone else, understand." Below he had drawn a simple diagram, with $C(t)$ (i.e. consumption in period t) on the x-axis, and $C(t+1)$ on the y-axis. There was a semicircle connecting the two axes, which denoted the production possibilities frontier (PPF) for present and future consumption through tractors.

The professor had drawn two dots on the PPF. The dot that was higher on the circle represented the tradeoff that was available through saving: By moving to the left on the x-axis, a person reduced current consumption in order to invest in tractors. By moving up on the y-axis, a person increased future consumption because of the marginal output of the tractors.

And now the crucial step: Because of the shape of the PPF, and because he had chosen points on the right side of the curve, it turned out that the leftward shift in present consumption was smaller than the upward shift in future consumption. Therefore, my professor thought that this simple diagram had shown a technological cause of interest: Because of the productivity of

tractors, my professor was claiming that a small reduction in present consumption would cause a great increase in future consumption, i.e. a positive rate of interest.

What was so frustrating about this diagram was not that it was wrong per se, but that it completely overlooked Böhm-Bawerk's critique! My professor had completely overlooked the problem of pricing the tractors! Yes, the technological facts allow us to say that a given increment in future consumption (i.e. the gap on the y-axis) will require the present investment in a definite number of tractors; this is an engineering problem that does not involve subjective preferences.

However, just because we know how many tractors we need to buy in the present, we do not know how much such an investment will reduce our present consumption. In order to know this, we need to know the market price of tractors in terms of present consumption. By drawing the gap on the x-axis, my professor had just assumed that the tractors would cost less in terms of present consumption than their future output. In other words, my professor had assumed a positive rate of interest.

After several minutes of discussion, I finally got the professor to realize that he had been assuming away this difficulty. But he still refused to concede that physical facts alone could not explain a positive interest rate. No, instead he proclaimed: "Assume we can turn tractors into bananas one-for-one."

In conclusion, Böhm-Bawerk's critique of the naïve productivity theory was a brilliant leap forward for subjectivist economics. Unfortunately, its lessons are as relevant today as they were in the 1880s.

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[1] Böhm-Bawerk, Eugen von. (1959 [1881]) *Capital and Interest* (3 vols. in 1), South Holland, IL: Libertarian Press.

[2] Specifically, Böhm-Bawerk wondered, "Whence and why does the capitalist receive this endless and effortless flow of wealth?" (I, p. 1, italics removed).

[3] No one would lend out 10 sheep today in exchange for 15 sheep next year, because the owner could simply hold on to his 10 sheep and allow them to double into 20 sheep next year through reproduction.

[4] Actually, one does not need to use verbal logic to see the problem. In the mathematical appendix to my dissertation (available here <http://homepages.nyu.edu/~rpm213/files/Dissertation.pdf>), I develop a few general equilibrium models with two goods to illustrate Böhm-Bawerk's insight

Collectivism is bad for your health

Martin Masse 7/28/2003

Could this be the reason why Austrian thinkers tend to live to very old age? The Scotsman reports that "New research from sociologist Dr William Cockerham and colleagues from the University of Alabama in the United States has found that differences in attitudes to looking after your body and your health are predicted by your political allegiances. It seems those who believe the state should take responsibility for most aspects of life also tend to eschew personal responsibility for taking care of themselves.

The just-published research was conducted among Russians, comparing those who longed for a to return to the old-style Soviet system with those who preferred the free-market approach to the economy. Russian male life expectancy stood at 64 years in 1965, but steadily decreased to around 62 years by 1980. The most recent figures for 2000 show Russian males living 59 years, on average some five years less than in 1965.

Dr William Cockerham's research, published in the Journal of Health and Social Behaviour, concludes it is unhealthy lifestyles that appear to be the primary determinant of the decline in life expectancy in the former socialist nations. Health lifestyle research on Russia specifically describes an endemic, entrenched pattern of excessive alcohol consumption, heavy smoking, high-fat diets and lack of health-promoting exercise. These lifestyle practices are especially characteristic of middle-age, working class males, whose high mortality rates from heart disease, alcohol poisoning and alcohol-related accidents seem largely responsible for the overall decline in male longevity.

Psychologists identify a common person-type found in Russia and known as homo sovieticus - defined as a person with a collectivist orientation who does not like to assume any individual responsibilities. The theory is that Soviet-style socialism eventually induces passivity toward health promotion in the population. After all, previously the state provided for personal needs and the

individual in turn gave up personal reliance and freedom. The state was a shelter as it provided free health care and education, old-age pensions, low-cost housing plus food and guaranteed employment.

The data was collected through personal interviews by the Russian Longitudinal Monitoring Survey, a series of nationally representative surveys of the Russian Federation consisting of almost 9,000 adults. The results were that pro-socialists are nearly one and half times more likely to be frequent drinkers than anti-socialists. Anti-socialists are also significantly more likely to take exercise, in fact, being pro-socialist decreased your chances of exercising regularly by almost 50 per cent. Furthermore, anti-socialists were almost 25 per cent more likely to go for preventive health check-ups compared to pro-socialists. Anti-socialists in Dr Cockerham's research not only had healthier lifestyles but they also rated themselves as generally more healthy than pro-socialists."

Atlas Shrugging in Santa Fe

By Ed Tinsley

City Journal | August 15, 2003

My corporation—I'm president and CEO of K-Bob's Steakhouses, a 26-restaurant chain headquartered near Albuquerque—operates in four southwestern states and employs around 1,000 people. Recently, a new business I planned to open in Santa Fe became one the latest victims of the "living wage" campaign that is crippling firms and hurting local economies across the U.S. The campaign is the work of union-funded labor activists, whose success so far has been nearly 100 percent.

Earlier this year, Santa Fe passed a law imposing an \$8.50 minimum wage on all businesses in the city with 25 or more workers. The hike takes effect in 2004, with the wage rising to \$10.50—more than double the national minimum—by 2008. Not only is this the highest living wage in the U.S.; it is also unrivaled in its impact on private industry, since most of the 90 or so living-wage laws nationwide apply only to firms that do business with local government.

State and local lawmakers are working to help firms stay afloat during the current economic slump, but Santa Fe's bill will drive businesses to friendlier

climes. While I truly wanted to open a K-Bob's in Santa Fe, the huge labor-cost hikes would force me to jack up prices to such unreasonable levels that I decided to stay out of town.

The new bill is scaring off other new investment, too. Plunkett Research, a national market analysis firm, had planned to open a Santa Fe office—until the living-wage bill passed. Citing a “poor business environment,” Plunkett’s management found that the new wage minimums made it hard to attract the investors and partners they had hoped to attract, and they decided against coming to Santa Fe. Local realtors have seen other firms’ plans to move to Santa Fe put off or canceled because of the bill, including several big restaurant chains.

Even as the living wage scares away prospective Santa Fe employers, it is driving existing businesses out of town. Take Robert Powell, who owns a Santa Fe staffing agency with 200 or so workers. With his labor costs rocketing up to 65 percent higher than his smaller, exempt competitors, he says that the new rules will force him out of business—or out of the city. He expects to move. Nambe Mills, a metal manufacturer that provides Santa Fe with hundreds of good jobs and has been in the city for 50 years, may follow suit. In a letter to the Santa Fe City Council while the bill was being debated, Nambe CEO Jim Weyhrauch warned: “What do we do if you were to pass this measure? We are not likely to sit around and watch our business decline.”

Tom Allin, who operates an Asian restaurant in Santa Fe with 52 workers and a \$450,000 payroll, anticipates that a “compression effect” will push all salaries up the pay scale when the new minimum kicks in. Currently, Allin’s assistant managers make \$9 per hour—75 percent more than his new busboys, who receive a \$5.15-per-hour training wage. When the busboys are making \$8.50 per hour, Allin explains, his assistant managers will likely insist on keeping their 75 percent differential, pushing them up to \$14.85 per hour. Such increases, he says, will make it impossible to keep up with competitors exempt from the new minimum because they employ fewer than 25 workers. A business like his that stepped up from 24 to 25 employees might find its labor costs rising \$180,000 a year.

To compound the injury, labor activists made sure that the new law punishes violations with criminal penalties. The owner of a 24-employee firm who hires a one-hour-per-day temp for 30 days without boosting everyone’s pay will now be facing—unbelievably—up to 180 years in prison and \$360,000 in fines.

Wiser New Mexico communities are now taking advantage of Santa Fe's folly. Albuquerque and Lincoln County, for example, have basically hung out "open for business" signs. Officials in these municipalities are working to pass bills stating that they will not pass living-wage laws, signaling that firms considering fleeing Santa Fe are welcome in their towns.

Fleeing firms, lost jobs, and jail for company owners: this is no formula for economic recovery. Nonetheless, living-wage activists, emboldened by their win, are trying to push the Santa Fe model on the rest of the nation. Watch out, America.

Richard Cantillon and the Discovery of Opportunity Cost
Mark Thornton 9/3/2003

Richard Cantillon and the Discovery of Opportunity Cost

by Mark Thornton (Mises Institute)

Opportunity cost is a core, defining concept of economic science. The early Austrian economists are generally credited with the discovery of the concept and its early application. Here, it is shown that Richard Cantillon, the father of economic theory and method, developed and applied the concept of opportunity cost. His "intrinsic value" was not an objective cost approach, but merely an attempt to estimate opportunity cost. This finding exonerates Cantillon from the charge of objective cost theorist and predates the discovery of opportunity cost one hundred and forty years earlier. Had his readers, including Adam Smith, properly understood him, a gigantic cul-de-sac in economic theory—the labor theory of value—could have been avoided.

Health Care Coverage Prices Soar

Mises.org News

9/9/2003

Health Care Premiums Soaring Study Finds (AP): "Health care premiums for families in employer-sponsored plans soared 13.9 percent in 2003, the third year of double-digit growth and the biggest spike since 1990, a new study found. Annual family premiums increased to \$9,068 this spring, according to a survey of 2,808 companies by two health research organizations, the Kaiser Family Foundation and the Health Research and Educational Trust. Small

firms, with three to nine workers, faced the largest increase with a 16.6 percent surge in premiums. Mid-sized companies with between 200 and 999 workers had the smallest increase with a 12.4 percent growth rate. The portion of the premium paid by an employee for family coverage grew 12.9 percent to \$201 a month, or \$2,412 annually, while the amount a single employee paid for a policy rose 7.6 percent to \$508 a year, or a little more than \$42 a month. Employers paid the remainder of the \$3,383 premium for a single coverage. Experts were not surprised by the rise because employees have shunned the restrictive policies of managed care plans, which sought to reduce costs, while they still demanded the newest, most expensive drugs and procedures. With that issue unlikely to change -- and no new strategies employers believe will substantially reduce costs -- the trend of bigger health care spending is expected to continue."