Świat Idei i Polityki
ISSN 1643-8442
DOI: 10.15804/siip202001
2020, tom 19

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Austrian Government Cycle Theory

Summary: When government accounted for a small proportion of the economy, the Austrian Business Cycle Theory (ABCT) was apropos because private enterprises comprised the lion's share of commercial interactions. But, of late, in more and more countries, the share of the economy accounted for by the state has increased, and that by business firms, less and less. Thus, it is time, it is past time, to introduce a new concept, Austrian Government Cycle Theory (AGCT). The present paper is an attempt to move us in that direction.

Keywords: business cycle, Austrian economics, inflation, depression

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Introduction[4]

Cycle theory is a fundamental subject within economic theory and analysis. Particularly, since it is the greatest malady the economic science can be used to prevent, cycles have been studied from a wide range of different perspectives. As defenders of the Austrian business cycle theory[5], we support the idea that it is the government, through the manipulation of money and credit via a central bank, that is primarily to blame for boom and bust cycles.

However, when Ludwig von Mises and Friedrich Hayek developed their teories, governments had a relatively small weight with respect to GDP. Now, this proportion (taking into account federal, state and city governments) often rises above 50% in the developed world.

We present in this paper the theory that, although ABCT is still valid, in the sense that manipulation of money and credit remains the fundamental cyclical factor, a government of such a scale and scope has a similar impact. Hence, business is no longer the main character in cycles, but the government.

We explain our position in section I. Section II deals with government interventions into the macro-economy. We conclude in section III.

[4] We wish to thank an anonymous referee for valuable comments. All remaining errors and infelicities are our own responsibility, of course.

[5] For more on this see Bagus (2003), Bagus, Howden and Block (2013), Barnett and Block (2005; 2008; 2009A), Baxendale (2010), Block (2008), Block and Caplan (2008), Block and Garschina (1996), Block and Posner (2008), Davidson (2008), Davidson and Block (2011), (French, 1992 [2009]), Hanke (2008), Hayek (1931; 1933 (1966]), Hazlitt (1979), Hollenbeck (2013; 2014), Hoppe (1994), Hoppe, Hülsmann and Block (1998), Howden (2013), Huerta de Soto (1995; 1998; 2001; 2006; 2010; 2012; 2014; 2018), Hülsmann (1996; 1998; 2000; 2002; 2003; 2008), Kirzner (1990), Machlup (1940), Mises (1912), Mulligan (2006), Murphy (2010), North (2009), Oppers (2002), Polleit (2010), Reisman (1996; 2009), Rothbard (1962 [1991]; 1963 [2008]; 1975, 1991), Salerno (2010A; 2010B; 2011; 2012), White (2008A; 2008B; 2010).

Government, not Business

At a time when the government accounts for so large a portion of the economy, it is no longer appropriate to talk about a *business* cycle. The scope of this section of the economy has become more and more marginal compared to the gargantuan size and operation of the government. Of course, when such boundary is crossed[6] is a difficult question to answer. However, we can easily see[7] that when the government accounts for 50% and more of GDP, then its influence becomes beyond doubt of extreme importance.

In this situation, the private sector that still exists is affected by the government in both a direct and an indirect way. Thus, the government is the main character in the cycle, not business. It channels the resources from debt and taxes to the sectors determined by the bureaucracy, and the distortion of relative prices no longer comes solely from monetary manipulations which are channeled to the private sector through the financial system (although this could also happen at the same time, through the monetary expansion by the Central Bank in order to finance government deficits, or by the nature of fractional reserves[8]), but through this very same allocation of resources directed by the government (Block, 2019).

It could be said that such distortion always comes from the government, whether through monetary expansions or contractions, price controls of various sorts, or public spending sustained by taxes. But the central point we are now making is that in the classical case of the Austrian business cycle theory, the government is the *exogenous* agent that promotes the distortion of relative prices through the manipulation of money (Salerno, 1987), credit and interest rates (Salerno, 2016) which in turn impacts the private sector. In sharp contrast in the second case (bigger government spending), it is the very same *government* that promotes such distortion and

[6] See on this Block and Barnett (2008).

[7] Easily, at least, in comparison to when Mises and Hayek developed their theory. A 400% increase.

[8] See Bagus and Howden (2010; 2011).

channels it, therefore leaving the private sector as a marginal agent certainly with a *less* considerable importance than years gone by or the government on this regard. The government thus turns into the most relevant spending agent, because of the magnitude of its direct influence in the market, thus presenting itself as an *endogenous* agent, even when in *essence it is also exogenous*.

In this regard, it is important to highlight that both Mises and Hayek developed their main cycle theories in the context of government spending of 5-15% of GDP, with far less direct regulation and allocation of resources than at present. Moreover, in the case of the earlier economy, all sectors often make mistakes in their commercial decisions at the same time[9]. This is the result of central bank interest rates manipulation. This, in turn, in the modern era is also due to the fact that a large part of the productive and the consumption sectors depends directly or indirectly on government resource allocation. The central point is the same: the distortion of relative prices. In this case we characterize the situation as a *Government Cycle Theory*, *with an Austrian Base*. Let us examine its role in more detail.

Real Interventions by Government

The purpose of the interventions falling into the real category is not, in general, overall stability[10], but rather, the reallocation of resources to politically favored uses and the redistribution of wealth to powerful and politically-favored groups; that is, these interventions are of the types of government activity associated with the concept of

[9] Rothbard (1969) refers to this as the “cluster of error”.

[10] Although it is true that there are still some who would maintain that the governmental budget; *i.e.*, fiscal policy, is the primary tool of stabilization (Lee and Sung, 2007), and that the levels of governmental expenditures and taxes, and the consequent deficits and surpluses, are the primary determinants of such things as inflation, interest rates, and unemployment, etc., because the evidence of the real world seems to confute it, the credibility of this position among professional economists continues to be in decline.

"rent-seeking"[11]. These interventions are essentially microeconomic; that is, they consist of governmental actions which are intended to cause more or less specific results in particular markets and/or for specific groups of people. Such governmental actions can work only to the extent that they cause individuals to alter their actions to conform to the pattern of behavior necessary to bring about the intended results. The specific actions people take depend on their individual (subjective) values and perceptions of the alternatives available to them. As a result, real interventions take the form of alterations of, and succeed to the extent that they do "correctly" alter, the set of alternatives available in the particular markets or targeted groups of people intended to be affected[12].

Thus, any attempt to understand the (re)allocational/(re)distributional ramifications of such interventions requires a detailed examination of the particulars of each case. Real interventions, however, and, for the purposes of this paper, of more importance, also affect the macro-stability of the economic system. But analysis of the consequences for business cycles of such interventions does not require, fortunately, a detailed examination of each one. Rather, for this purpose, real interventions may be analyzed according to the way they interfere with the functioning of the market process.

There is a strong parallel between ABCT and AGCT. In the former case, government artificially lowers the interest rate (in relation to the natural rate), moving the market in the direction of more roundabout projects than would be justified by the time preference of the marginal person. But, this phenomenon[13] has not changed, certainly not as a result of the exogenous activities of the

[11] For a critique of this appellation, but certainly not of the phenomenon it represents, see Block (2000A, 2000B, 2002, 2015), Block and DiLorenzo (2017).

[12] The matter of governmental attempts to alter people's actions by attempting to alter their values raises difficult issues of moral and political philosophy; and, the consequences of such actions for the most fundamental of human values and rights are of the first magnitude of importance.

[13] This often is called a time preference "rate" in the scholarly literature of ABCT. But we eschew this verbiage since there is no real "rate" of preference here, any more than there is a "rate" of preference for vanilla vis a vis chocolate ice cream.

Central Bank in artificially lowering interest rates from the levels that would otherwise have prevailed. Instead, the people's saving and loan decisions are as they were before this state intervention into the economy. Thus, there is a "tension" between market prices, the interest rate in this case, and the desires of the populace.

A parallel situation takes place with regard to AGCT. Here, let us suppose, the government places its big fat thumb not in the direction of longer term projects vis a vis shorter run ones, but in favor of coal (Block, 2019), and thus against all other goods and services. The bureaucrats either subsidize coal, and/or penalize alternative energy sources. But the demand conditions have not changed. The market still demands coal in the old proportions, compared to other products. Thus, there is a similar "tension" in the AGCT case as well.

Real interventions affect both phases of the cycle: they impact the duration and intensity of the boom by changing the volume of fiat money/credit created and the specific uses to which it is put; they also affect the duration and severity of the contraction by interfering with the adjustment process (determining which adjustments take place and when they occur).

Real interventions do not "just happen". Rather they are governmental responses to perceived problems. The causes of the problems are perceived, virtually always and everywhere, to be the same: for sellers, insufficient demands for their goods or resources; and, for buyers, insufficient supplies of the goods or resources sought. Insufficient demands are the cause of sellers' problems in the sense that they think that their problems would be eliminated if they could but sell their goods or resources in greater volumes and/or at higher prices. Similarly, insufficient supplies are the cause of buyers' problems in the sense that they think that their problems would be solved if they could but buy goods or resources at lower prices.

Of course, these are the real problems, only if one takes the odd positions that: 1) re-sellers' problems, buyers should act not in according with their own values and the opportunities available, but the interests of the sellers; and, 2) re buyers' problems, sellers should act not in accordance with their own values and the opportunities available, but in the interests of the buyers. If these positions are rejected, the real difficulties are seen to be: for sellers, mismatches between their supplies and buyers' demands, requiring for their correction changes in the sellers' actions; and, for buyers, mismatches between their demands and sellers' supplies, requiring for their correction changes in the buyers' actions. The requisite changes for buyers are changes in their demands; the requisite changes for sellers are alterations in their supplies, which usually involve changes in production.

But, most people are more concerned about the markets in which they sell their goods and/or resources, especially their labor services, than about the markets in which they are buyers. That is, for most people, the role of producer is more important than that of consumer, in the sense that the events in the markets in which they sell their goods or resources dominate the events in other markets in terms of the impacts upon their material well-being. Thus, most people perceive the key problem to be one of insufficient demand[14] (Shades of Lord Keynes! Where is Major Douglas when we need him?).

Although from each seller's perspective the problem is insufficient demand for his goods and/or resources, in reality it is the mismatch between what the seller is producing and what the buyers want. Nevertheless, each thinks the solution is increased demand for his own goods and/or resources. Of course, even if producers' problems did consist of insufficient demand, this would be relative, not absolute. Thus, no general solution would exist as it is impossible for every producer to experience an increase in demand relative to the other sellers. Thus, any governmental intervention that "solves" the problem for one individual or group of people necessarily makes the problems of at least some others worse. That is, state intervention creates a zero-sum game.

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[14] We are all more concentrated as sellers (of labor services) than as buyers. In our latter role, we consumer literally tens of thousands of items. Just take a stroll through a modern supermarket (before the pandemic emptied the shelves; we write on April 2020). In contrast, most of us hold one job in a single occupation; it is the rare person who is spread more thin than that.

Nevertheless, people do seek the assistance of governments to solve these sorts of problems, and the bureaucrats do respond. Attempts to diminish the (perceived) demand problems of particular groups of producers affect the course of the business cycle because they inevitably hinder the adjustment process whereby the mismatches between demands and production are eliminated.

The producers' problems arise when the pattern of demand changes. This occurs when the monetary/credit expansion decelerates, and resource owners attempt to spend their decreased incomes in accord with their unchanged values[15]. If a monetary/credit expansion has reached significant proportions, the consequential adjustments will have to be large, involving great losses for many producers. For those experiencing a reduction in demand, the only alternatives available in the market are painful: price and/or quantity reductions, and the acceptance of the attendant losses. Each such producer thinks that an increase in demand for his goods and/or resources would solve the problem. But this is precisely the opposite of what is required.

Of course, a systemic effect takes place during this phase. Since the reduction in prices affects the price level downward, the real value of debt and liabilities increase. This, in turn, exposes companies and households to a greater financial burden, and in relation to their assets, it worsens their situation, i.e. what they sell is valued less. While their debts are nominally unaltered, they increase in real terms.

Hence, this dynamic feedback: the downward path of the cycle during the bust. It is, however, necessary. This is so because the process of liquidation forces companies and households to reduce the prices of their assets, and hence accommodate their values to the new situation. In other words, the price of assets needs to reflect their discounted future cash flows[16]. Once this process takes place,

[15] We are now back to ABCT.

[16] These decrease for two reasons, a reduced cash flow, and a higher interest rate.

assets get cheaper and it is profitable again to invest and allocate capital, which takes the economy out of the crisis.

There is, of course, another alternative: governmental intervention. With great regularity, producers finding themselves in such a position seek, and, also with great regularity, receive public sector's assistance (bailouts constitute real intervention). Such assistance is designed to maintain or increase the incomes of the favored producers. Although the details vary greatly from one such assistance programme to the next, the primary approach used is to artificially bolster demand for the favored groups' goods and/or resources, and/or artificially reduce their costs. Such interventions take diverse forms, the most important of which are: direct and indirect purchases by governments, e.g., the food stamp programme; direct subsidies to producers; indirect subsidies to producers, e.g., bail-outs of producers' creditors; subsidized credit for customers; and, restriction of competition. Such interventions make it possible for the affected producers to avoid the market alternatives: price and/or quantity reductions. This prolongs the agony[17]. Because in the real world supplies are not perfectly elastic, sound adjustments involve, sooner or later, some price changes. Thus, real interventions slow down the structure of prices from adjusting to people's unchanged time and goods and services preferences values.

Of course, such interventions thwart the real demands of the people based upon their values, substituting instead, artificial demands predicated upon political power. This process allows vendors to maintain the misallocation of resources begun in the boom. The longer the boom continues due to successive, and more rapid, increases in money/credit, the greater the misallocations, this is an ABCT insight. But the nature of the assistance is, precisely, the thwarting of the adjustments required to return the economy to a sound basis (correct allocation of resources); here, we wheel in the

[17] Woods (2009) points out that the depressions of 1921 and 1929 were initially roughly equal in terms of severity. However, there was little government intervention in the former case, and the depression phase was shallow and of short duration. The opposite occurred in the latter case.

AGCT counterpart analysis: the greater the number of producers seeking and receiving assistance, also the more misallocation.

In the context of a government that accounts for 50% of GDP, the (mis)allocation of resources is performed by it and perpetuated by it. The change between ABCT and AGCT is not the dynamics or the origin of the "cluster of error", but the focus on the main agent that carries it out. In other words, it is not the same to distort investment signals (as in the ABCT with interest rates) and then inducing business to err in its investment decisions, that the government directly misallocating capital (as in the AGCT). In both cases relative prices are distorted and the production structure changes (hence, there is still an Austrian type business cycle), but the main agent directing the process is different.

Thus far, we have been considering what Rothbard (2004) characterizes as triangular intervention. G, the government compels, or prohibits, acts between A and B, buyers and sellers in this case. But, there is also what he calls binary intervention: the state compels or prohibits commercial endeavors regarding just one person under its control, A. For example, G taxes A; compels A to render funds to it. Or G prohibits A from entering a specific industry, or paying his employees less than the mandated minimum wage. These, interventions, too, when G looms *large* in the economy, can also significantly misallocate resources, and set up an AGCT[18].

How is the AGCT triggered by binary intervention? Precisely by the allocation of resources to areas that the market would not have underwritten. However, the necessary condition to distinguish *simple* binary intervention from an AGCT would be a relatively high proportion of the government in the context of the economy. That is, when the public sector represents, for instance, 50% or more of GDP. In this sense, AGCT not only comes into being due to the government's role in allocating huge amount of resources, but also from its necessarily high taxation and/or inflation to finance it. The

[18] Government prohibiting individuals of smoking marijuana, or drinking alcohol, are also instances of binary intervention, but not economy-wide enough to count as business cycle related.

latter distorts the structure of production in much the same way as occurs with ABCT due to the artificial lowering of interest rates. Hence, AGCT is a possible, but not a necessary, outcome of binary intervention.

Another way in which large scale government affects the economic system is through its public financing operations. If the issuance of short-term debt is preferred to that of a longer duration, then it is likely that short term rates will increase. If that happens, it is also relevant to see what the situation is for long-term debt yields. That is important because if short term interest rates increase above long-term rates, it means the yield curve inverts (and this is a signal of future recessions[19]).

If the state wants to extend the duration of the boom, it can choose to finance its operations through the issuance of long-term debt, which will likely push long rates upward, hence reinforcing a positive yield curve. However, if the government cannot get enough buyers for its bonds, there is no other way but to finance through debt monetization, that later exacerbates inflation. In any case, relative prices (especially interest rates) are distorted. True enough, the Central Bank can hardly directly affect long-term rates, but the Treasury policy can indeed influence it. This is indeed a link between the fiscal policy and the interest rate, that in turn has systemic effects.

Where the government (in terms of GDP) is so big, its direct interventions in the market through "public investment", subsidies, etc.[20],[21]. distort relative prices in such a way as to emulate price distortions from monetary causes (as in the classical ABCT). And, most importantly, it is no longer business, or the private sector, the one that channels malinvestment, but rather the state itself[22]. The structure of production will also change, according to the specific

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[19] See Cwik (2004; 2008).

[20] A new form could be "Fiscal QE", see Selgin (2020).

[21] The economy we have in mind may be more similar to that of the economic system of fascism.

[22] Directly, or through government sponsored enterprises (GSEs). See Gjerstad and Smith (2014), Norberg (2009) and Pinto (2010A; 2010B).

government intervention in channeling resources. If it channels more resources to “public investment”[23], then more roundabout processes of production will take place, whereas if it focuses on subsidies to consumption, or direct consumption spending, then the economy will shift to the production of goods closer to consumption.

As we can see, government replaces business as the main character in the cycle play, but the Austrian analysis remains the same: distortion of relative prices and malinvestment.

The major effect of real intervention is that the distortion of the structure of prices away from peoples’ values persists indefinitely. It is as if these interventions form a “wedge” between people’s values and the structure of prices which prevents the latter from adjusting to, and conforming with, the former. This condition manifests itself in the form of massive and persistent misallocations of resources: the boom and the bust.

Moreover, economic cycle theory needs a general explanation of its occurrence. As such, the key is to identify why is it that business errs periodically in its resource allocation decisions. As the ABCT explains, the source is government monetary and interest rate policy. Here, we present the idea that, although business is the traditional agent that misallocates resources due to government manipulation of relative prices (especially interest rates), it can also be the case that the government itself does this job. Hence, a government-based cycle, AGCT. The central factor in the recurrence of errors in resource allocation, and therefore economic cycles, is the source of errors itself: the government (Hülsmann, 1998).

[23] Rothbard (1975) took the position that the state could only engage in consumption, never in production. For an alternative view, see Barnett and Block (2009B).

Conclusion

The consequences for business cycles of the confluence of important different categories of borrowers (households, domestic governments, and foreigners) in the monetary/credit system and massive increases in governmental intervention, both financial and real, are: 1) longer, more diffuse booms; and, 2) more severe contractions; 3) persistent, but erratic, inflation; 4) massive, persistent misallocations of resources; 5) stagnant productivity; 6) attenuated economic growth; and 7) deteriorated standards of living, compared to what otherwise would have been the case[24].

We note that the essentials of Austrian Business Cycle Theory are still relevant for understanding macroeconomic booms and busts. All that is required to enable ABCT to be used to gain key insights into current macroeconomic events is to extend it to account for significant alterations in economic institutions; e.g, AGCT. In other words, the interest rate is not the only channel to create an Austrian type business cycle. A fiscal[25] involvement of enough magnitude operates in a similar way.

Hence, it is important to distinguish between a government cycle and a business cycle. The distinction also has a psychological effect: although economic cycles are to be blamed always on government intervention, the use of the word "business" may implicitly give the impression that there is a sort of failure or malfunctioning in the market economy itself. It is important, at least when business is not the main character, to recognize the state apparatus as the key factor in play. Thus, a government cycle theory is coupled with an Austrian analysis.

According to Mises, Bohm-Bawerk said, "A theory of the trade cycle, if it is not to be mere botching, can only be written as the last

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[24] Continuing technological progress can often mask this phenomenon. The US was far freer, but poorer, in 1870 than in 2019. Does this mean the economic freedom reduces prosperity? Of course not. The difficulty here is that ceteris paribus conditions are not met. The latter period enjoys far better technology than the former.

[25] See also on this Chapter 5 of Garrison (2001).

chapter or the last chapter but one of a treatise dealing with all economic problems", a dictum with which he "fully agreed"[26].

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[26] L. v. Mises, "The Trade Cycle and Credit Expansion: The Economic Consequences of Cheap Money," 1946, in *On the Manipulation of Money and Credit*.

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Teoria cykli rządu Austrii

Streszczenie: Kiedy rząd odpowiadał za małą część gospodarki, autriacka teoria cykli gospodarczych (ABCT) była odpowiednia dla prywatnych przedsiębiorstw, które zawierały lwią część relacji biznesowych. Później w coraz większej ilości państw, udział gospodarki związanej z państwem wzrastał, a udział przedsiębiorstw prywatnych malał. Stąd nastał czas, aby zaprezentować nową koncepcję, czyli teorię cykli rządu Austrii (AGCT). Ten artykuł jest próbą ukazania tego właśnie fenomenu.

Słowa kluczowe: cykle gospodarcze, ekonomia austriacka, inflacja, depresja

Data przekazania tekstu: 15.05.2020; data zaakceptowania tekstu: 26.08.2020.